2nd Quarter 2011

Fellow Investors,

Consistent with previous quarters, it was difficult to find new investments in Q2. Let me give you a tangible example of a persistent worry: Greece. Greece is far away both physically and financially from any of our investments, yet a poor outcome in Greece would almost certainly cause markets to fall worldwide.

The most accessible (not to mention funny) article on the problems besetting Greece is "Beware of Greeks Bearing Bonds," by Michael Lewis (who also wrote *The Blind Side* and *Liar's Poker*). To summarize: no one pays taxes, the government spends too much, and the country has vast amounts of debt that it can not repay. The holders of that debt are European banks and countries, and a Greek default could cause a domino-like wave of defaults through Europe then the world, much like the way the Lehman Brothers default precipitated a world-wide financial crisis in 2008. These and other worries that are macroeconomic in nature, keep me holding about 20% in cash ("just in case") in your and my accounts.

One purchase I did make this quarter was Bank of America (BAC). BAC is the largest bank in the US and it is currently beset by a number of problems surrounding mortgages it originated during the housing boom. It will likely take some time before the mortgage "cloud" dissipates, but when it does, the underlying profitability of the bank is strong. This one will require some patience, and I'll write about it in more detail in the next quarterly letter.

One way that I try to build value for you is by digging up information and perspectives that are not widely known in the markets. In May, I got some important information while touring one of Noble Corporation's new rigs. I talked to an employee of Shell who is responsible for billions of dollars of contracts with Noble. He explained why Shell decided to partner so heavily with Noble, and provided a client's perspective (which he mentioned that Wall Street seems to misunderstand). A full write-up of that trip is on the following pages.

I sold our investments in PNI media for a loss this quarter. After multiple conversations with their management team, I concluded their financial projections were too optimistic. Their recent product launches have been underwhelming. One of my rules is that if I don't trust management, I will sell the stock – and so I did.

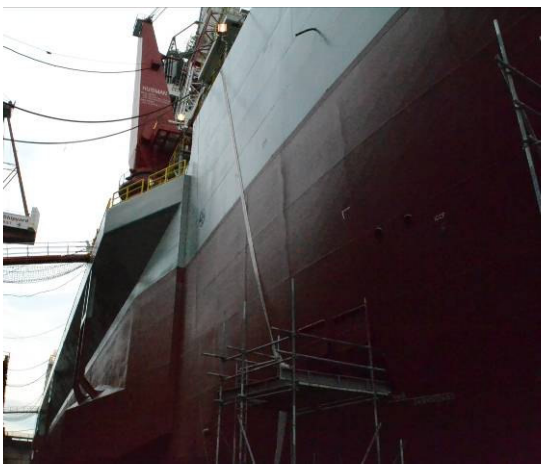
Although the investment climate remains challenging for the reason mentioned above, I'm continuing to look for great investment opportunities for us. Hope you have a great summer.

Sincerely,
Kai Shih

Noble Corporation (NE):

We are investors in Noble Corporation, which owns and operates offshore drilling rigs. In May, I had the opportunity to tour their newest rig, the *Noble Bully I*, a $600 million, state-of-the-art drillship that was being built in Singapore. The rig is now complete and on a multiple-year contract with Shell, which pays $440,000 per day for the rig and its crew.

As shareholders of Noble, we own a piece of the *Bully I* along with more than 70 other rigs. It might help to visualize what exactly you own: these rigs are enormous, floating cities with specialized navigation, propulsion, and drilling equipment. On the left is a photo shot from below the "compact" *Bully I* drillship, which can hold a million gallons of fuel. On the right, the group is standing on the heli-pad.



The *Bully I*, unlike older rigs, has automated many of the dangerous and manual parts of drilling process. On the left side, below, is the Huisman tower. You can see pipes stored along the side of the tower. These pipes are joined together, mostly by robots, to drill over a mile down. On the right side, I'm sitting in the drilling chair. Drill operators on modern rigs use joysticks and computers to control most of the drilling process, and they work 12-hour days so the rig can operate around-the-clock, every day of the year.

Noble’s share price dipped a great deal last year in the aftermath of the BP Macondo accident. At the time, I argued that the share price had fallen too far, because the value of Noble's rigs plus the value of their billions of dollars of rig contracts exceeded their share price. Since then, their share price has mostly recovered, but today with $13 billion of contracts and many new rigs like the *Bully I* under construction, the stock still seems undervalued.

The difference between analysts and investors

During lunch, an analyst asked “off the record” for the pricing on some contracts Noble had not disclosed. I snorted. (Inappropriately, perhaps?) To their credit, the Noble representatives did not answer the question. I’m dubious that knowing the exact amount would have changed either mine or the analyst’s opinion in the least.

Analysts, along with much of Wall Street, seem unduly preoccupied with getting very accurate estimates of near-term earnings. Currently, about 40 analysts cover the company and frankly, I’m in no position to compete with them on near-term accuracy. I prefer to think about the much easier (and I think profitable) question of what is the pack of analysts going to be focusing on in a few years?

- Noble is building 11 new rigs, which will be completed between late 2011 and 2014, many of which are already committed under long-term contracts. As the rigs are completed, they will switch from being a capital cost to producing substantial earnings and cash flow. Noble’s earnings this year are being hindered by the Gulf of Mexico drilling moratorium, but I would expect earnings to grow strongly each year through 2014.
- Because rigs cost $600 million and several years to build, Noble does not have many peers. The industry is currently consolidating, so I’d expect even fewer competitors moving forward. The demand for offshore drilling keeps increasing, so I expect the long-term supply and demand picture to favor Noble.
- Offshore rigs have a long lifespan. A portion of Noble’s fleet is old (25+ years), but around 90% of these are still profitably being rented out today. The longevity of assets is related to the company’s long-term profitability - imagine if Hertz could rent out cars they paid for 25 years ago!

These are the basic, long-term reasons we are invested in Noble. But in Singapore, a chance conversation with Noble’s largest customer made me understand that Noble has other long-term competitive advantages that Wall Street has largely missed.

What I learned from Shell, Noble’s largest customer

Shell has contracted eleven of Noble’s rigs, which commits them to paying Noble billions of dollars in revenue over a period of years. Shell has chosen Noble for its most sensitive projects. Shell is trying to be the first company to drill offshore in Alaska; Noble will be handling that task. Shell received the first new deepwater permits in the Gulf of Mexico, and again, Noble is handling that drilling.

On our bus ride over to the *Bully I*, I happened to sit next to the Shell employee in charge of rig contracts. He made a comment about Wall Street viewing rig contracts differently from Shell. At that point, my ears really perked up. From Shell's point of view, the best way to drill wells is not to find the cheapest rig rates, but to find companies that drill wells quickly and safely.

The Shell employee mentioned they would not consider contracting rigs from newer, smaller companies that have only a short operational track record. For Shell, that would be taking a safety risk that could potentially end up like the BP disaster (he said he didn't know why other oil companies would want to take that risk either). He mentioned that Noble has lots of experience and centralized teams of experienced engineers, which newer companies simply can't match. He said crews operate similarly when everything is going well, but you see a big difference in experience when something unexpected inevitably happens.

So, Shell created metrics to evaluate the various drilling contractors and found that Noble was consistently a top-quartile company on these metrics. Shell considers their identification of efficient and safe drillers to be a competitive advantage. When I asked if Noble might be considered a "preferred contractor," he agreed and stated that companies with better metrics would get more business in the future. Perhaps this explains why over half of Shell's deepwater contracts are already with Noble.

Prior to this conversation, I had the view that rigs were simply a commodity – that price was the major way companies competed with one another. But the comments from Shell make me believe that some drillers have long-term competitive advantages over others – that an identical rig in Noble's hands will be operated more safely, drill faster, and ultimately bring better returns to their customers. Over time, that should lead to higher utilization rates and pricing than their competitors, and faster growth. Curiously, although several analysts had heard the Shell employee talk about why they're happy giving billions of dollars of contracts to Noble, I've yet to see any of them discuss it in their reports.