Q1 2012

Fellow Investors,

Our holdings performed well this quarter. This quarter's profits were enough to offset losses from a challenging 2011 and to pile on some gains beyond that. I view our results going back to the beginning of 2011 as respectable, though hardly impressive.

Many money managers are leery of acknowledging their money-losing positions because they fear customer withdrawals. But I sometimes emphasize them because I think they help us all maintain reasonable expectations for our investments by reminding us of our long-term investment strategy.

Our large holdings in banks, which I described in detail in last quarter's letter, performed particularly well this quarter. Last year, Bank of America was the Dow's worst-performing stock, and a major contributor to our losses. This quarter, Bank of America was the Dow's top performing stock, up 72%. JP Morgan was the Dow's second best performer, up 38%. We only own those two Dow components, and they solidly beat the Dow index which was up 8%.

Most of our other non-bank holdings also performed well this quarter. I'll describe our strategies and positions in more detail on the following page.

As you have seen, I am willing to accept short-term losses if I believe they will lead to better long-term results. And although I would accept both fewer customers and fewer assets in return for the freedom to invest in this way, I haven't had to accept either. You are still here and our results have been gratifying.

This quarter, I think our patience was rewarded. I was happy with the outcome and I hope you were, too.

Sincerely,
Kai Shih

Q1 2012 Highlights and Lowlights

Large Banks:
Bank of America, Citigroup, JP Morgan. The same investment rationale discussed in the last letter holds strong today, even after large gains this quarter. The banks hold record levels of capital and they are working through the lingering problems left over from the financial crisis. JP Morgan is leading the way with a substantial stock buyback and dividend; I think Citigroup and Bank of America will follow suit in due time.

Offshore Drillers:
Noble Corporation, Ensco. The price these companies charge for their rigs continues to increase to higher levels than I expected. Nearly all available rigs are working now. This is partially offset by greater downtime and higher costs related to increased regulation following the Macondo disaster.

A Big Mistake:
NRG. I've never spent so much effort losing money before. To recap, the main investment thesis was that Texas had insufficient plants to supply its electricity needs and that electricity prices would have to increase to incent new power plant construction. Texas did have severe shortages last summer and winter – a situation I think will become increasingly common and severe. However, power prices did not go up as I expected. I've sold what was formerly a large position in NRG at a loss. I continue to like many things about the company and there is a possibility I will re-establish a position in the future.

New Positions:
Tesco. The largest retailer and the largest private employer in the UK, Tesco, missed their profit targets last Christmas and their shares fell in Q1. Tesco pays a substantial dividend – around 5% – and has raised that dividend each year for the past 27 years. The UK is space-constrained of course, and Tesco controls large portions of the undeveloped land that are a prerequisite to building large new retail stores. Their large holdings of land have been called a monopoly (also known as a "tescopoly"). I borrowed this idea from Buffett who speaks highly of the company; we may well have it at a better price than he does. He bought it both before and after it dropped; we bought it entirely after the drop.

Xerox. Xerox is in the midst of a transformation from a copier company to a services company. Recently, they've inked several large, long-term deals which will provide profits for years to come. For example, they just started processing all of the Medicare payments for California under a 10-year contract. Because of these stable, long-term contracts, Xerox has a lot of visibility into future cash payments; and they've promised to return that cash to shareholders in large quantities over the next several years. If their projections of cash and cash returns are ballpark correct, the stock is very cheap. I borrowed this idea from David Einhorn who discusses it on page four of his annual letter.