

Q2 2012

Fellow Investors,

Stock markets generally dropped this past quarter, and our holdings were unable to escape the market's downward pull. Though stock prices declined, most of our holdings reported better-than-expected earnings and provided upbeat business outlooks. I've summarized our major holdings on the last page of this letter and remain convinced they are under-valued.

Stocks fell mostly in reaction to renewed concerns over Europe – the possibility of Greece leaving the Euro, and fears over the Spanish banking system. As I argued in my [year-end letter](#), I believe the US market over-reacts to European data and under-reacts to our own positive economic data. You can thank fears over Europe for pushing down gas prices and for the extraordinarily low interest rates that our government, companies and consumers enjoy. U.S. GDP continues to hit record new highs each quarter.

One bright spot for both our economy and our investments is that the housing market may have bottomed (see: [NY Times](#), [Calculated Risk](#), [LA Times](#)). A recovery in home building will create many construction jobs, helping our unemployment rate and GDP. A recovery in home prices will increase the net worth of home-owners, which will help consumer confidence and spending. Housing has been a large headwind to our economy for the past several years, but it may become a tailwind shortly.

The number of houses that began construction last quarter [improved to about 700,000](#), which is still about half of its long-term average. The long-term average of 1.5 million new houses per year comes from a simple demographic formula: our population growth (4 million people per year) divided by our occupancy rate (2.6 people per house).

Housing prices also may have bottomed. My metric of choice is the Case-Shiller index which rose modestly in their last report. For those of you interested in more evidence for a price bottom, I recommend this [Calculated Risk post](#).

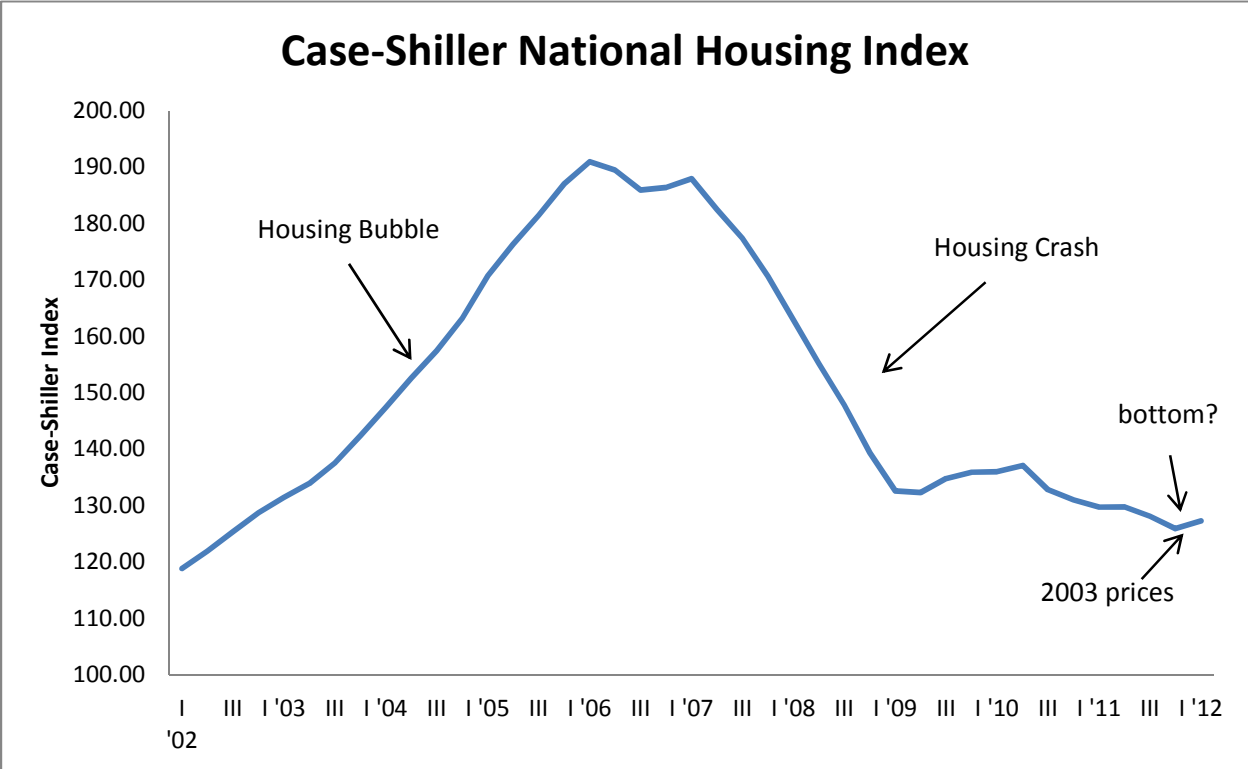
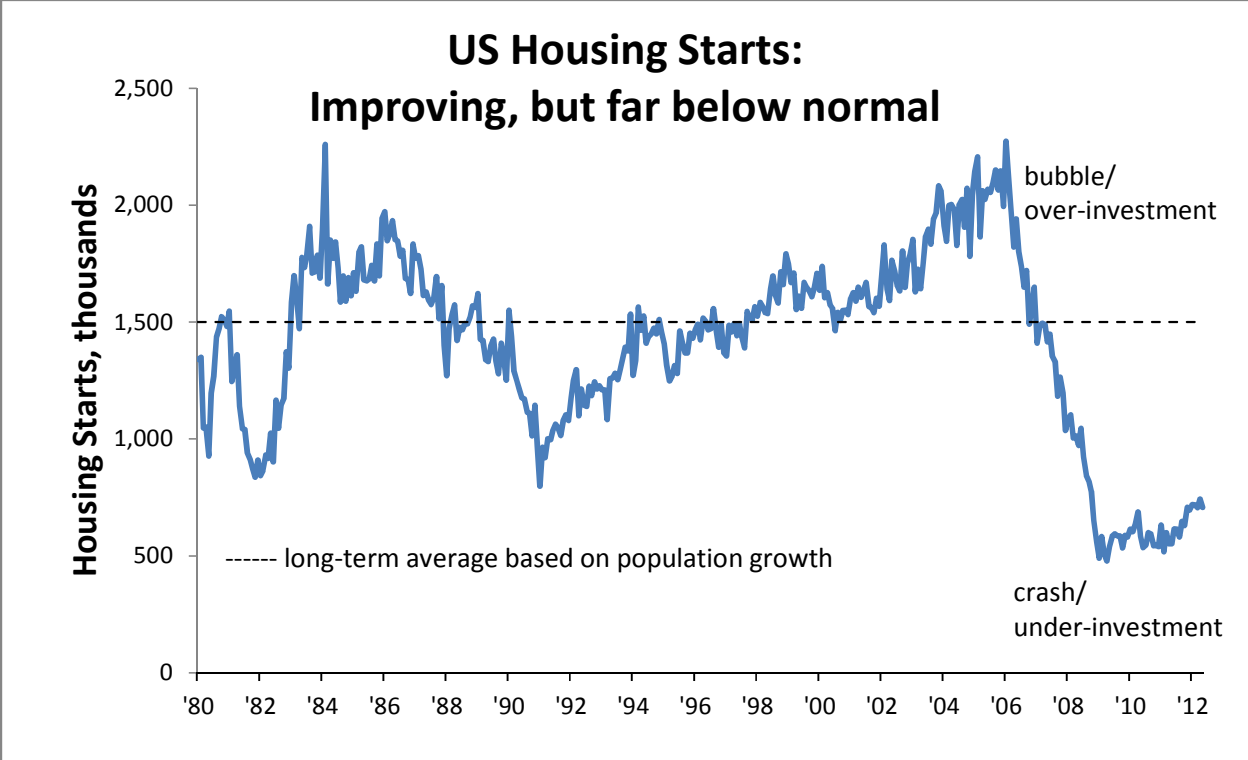
Housing has been a particular sore spot for banks which have struggled with housing delinquencies and foreclosures. As housing recovers, I expect our over-weight position in banks to be a large beneficiary.

In June, I gave a presentation at an investor conference titled "[Bank of America: not the huge, risky mess you think it is.](#)" [Business Insider](#) and a few other business sites published the presentation. The presentation may interest those of you who want to take a deeper look at some of my investment decisions.

I'm happy with our holdings and the progress they're making, so I don't foresee a lot of changes to the portfolio.

-- Kai Shih, June 2012





Highlights and Lowlights

Banks

- Our bank holdings (Bank of America, Citigroup, and J.P. Morgan) beat earnings expectations in the first quarter and are cleaning up the lingering mess from the financial crisis.
- J.P. Morgan was a noticeable lowlight with a large, unexpected, and highly publicized trading loss. Even with the loss, J.P. Morgan is likely to be one of the most profitable companies in the world this year.
- Buffett has recently been active in buying both banks and bank assets.

Energy

- The prices of the offshore drillers (Noble Corp, Ensco) don't seem to reflect the fundamental improvements in the sector. Customer demand seems to exceed the supply of rigs, so the prices our companies charge have increased dramatically (up by about 40% over the last few years). Demand exceeds supply so much that they're negotiating contracts that wouldn't even start for a year.
- Total had a gas leak in the North Sea, which they cleaned up relatively quickly and with little environmental damage. Apparently the government hired people to eat fish from the surrounding seas, and the [fish tasted fine](#). Total's stock price seems to fluctuate heavily with European news, even though it sells oil and gas to a global market.

Miscellaneous

- Xerox won a series of new government contracts with a variety of states, and seems to be a preferred contractor in a number of areas like healthcare and toll billing.
- Tesco started a plan to invest about \$1.5 billion in upgrading and turning-around their U.K. stores; it will probably take a few quarters before we can see how well they have done.