Q3 2012

Fellow Investors,

Our year-to-date and quarterly returns have been respectable, led by our large holdings in banks. While most of our holdings have had decent returns this year, I still believe they are quite undervalued relative to their longer-term value, and thus I am content to keep our portfolio mostly intact.

As usual I will begin by summarizing some of the bigger picture economic items before drilling down to our individual holdings.

The economic big picture was mostly positive in the third quarter. The ongoing financial crisis in Europe eased after the European Central Bank (ECB) announced it would make unlimited purchases of sovereign bonds. The ECB is effectively telling European governments they will be a buyer of last resort, which reduces government borrowing costs and makes a European Union break-up less likely. The situation in Europe is likely to be "two steps forward, one step back" as it has been for years. But over the long run, I believe Europe will find a way to muddle through their problems and when the region returns to stability, our holdings will benefit.

In the United States, a growing number of analysts believe that housing prices have hit bottom and are now increasing. The Case-Shiller housing index shows nationwide housing prices up approximately 7.5% from their lows earlier this year.

This year is shaping up to be an inflection point where we transition from six years of generally falling housing prices, to one where housing prices slowly climb. I think investors are generally underestimating the importance of that shift on our economy – from construction and manufacturing employment to consumer spending to overall GDP. Housing has been falling for so long that investors do not remember how housing can benefit, rather than drag, our economy. Our stocks should show an above-average price improvement as the housing situation continues to improve.

Comments on Individual Holdings

- Banks. For the last four years, banks have been directing their efforts and capital toward repairing mostly self-inflicted wounds from the financial crisis: improving their balance sheets, defending against litigation, conforming to new regulations, and selling or closing entire business lines. But the most recent quarterly reports show capital levels well above what I had expected, which I believe indicates that the banks will soon transition from "defense" to "offense." The rebound in housing prices and very good credit metrics are also helping. Positive inflection points like these are one of my favorite investment themes.

- Our specific bank holdings (BAC, C, and JPM) all had strong earnings. I woke up at 4AM on several days to get the earnings releases as soon as they happened – and I was happy with their results.

- Tesco, the world's third largest retailer, has been experimenting with innovative ways to sell products. Some of my favorites include ordering groceries while waiting at the subway and drive-through service. Today, Tesco is valued similarly to other retailers – steady and boring. But some of these experiments may translate into a faster growth rate and thus a higher stock price.

- Noble Corporation's Q2 earnings tripled from the year before, to 63 cents per share. And analysts are predicting the company's rapid growth to continue. That growth is not currently being priced into the stock. However, Noble Corporation recently reported some delays and operational issues that are frankly frustrating – a repeat of issues that I had hoped they had already overcome. I will be keeping a careful eye on their ability to solve these problems and will consider whether to switch some of our investment away from the company.

Thank you all for being great investors and maintaining a long-term outlook on the market. Every investment manager wishes for clients just like you.

Sincerely,
Kai Shih