2012 annual letter

Shih Investments

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[LETTER TO INVESTORS]

- **Strong 2012 returns - bank investments rebounded**
- **Portfolio still undervalued - but not exceptionally so**
- **Economy boosted by housing - government deficits remain a problem**
- **Comments on individual stock holdings**

Fellow Investors,

We enjoyed good returns this year. Throughout the year, our portfolios have been heavily weighted towards large banks: Bank of America, Citigroup, and JP Morgan. These holdings have been some of the stock market's best performers this year, appreciating about 100%, 50%, and 30%, respectively. As a result, we made up for last year's losses (and then some), with many of you hitting your all-time-high balances within the last month.

Last year's pain resulted in this year's gain.

In last year's letter, I acknowledged we had a tough year with investment losses. Those stocks which caused last year's losses drove this year's gains.

A year ago, there were news articles claiming that Bank of America was on the verge of bankruptcy; that it was on "death watch"; that it was simply "doomed." My investment style is to be drawn to such stocks. I did my homework – primarily on litigation risk, European exposure, capital levels and long-term business prospects – and concluded these headlines were simply false. A good summary of the issues and some of my research is in my Value-X conference presentation. The stock fell, I bought, and the stock fell more. One year ago, it was a major contributor to our losses.

In 2012, Bank of America's stock more than doubled. Near the end of the year, after the stock had already shot up, analysts rushed to sing its praises. Evercore partners added it to its conviction list (the firm's top recommendations). Meredith Whitney, famous for being bearish on banks, went on television to suddenly promote the stock, saying that banks "offered the best opportunity in years."

Analysts and markets tend to overreact to short-term news; I like to invest in stocks where sentiment changes drastically for the better. Even if it takes years to happen, the profit potential is very high. And I think our bank holdings fit that description.

Our holdings are still cheap; but not exceptionally so.

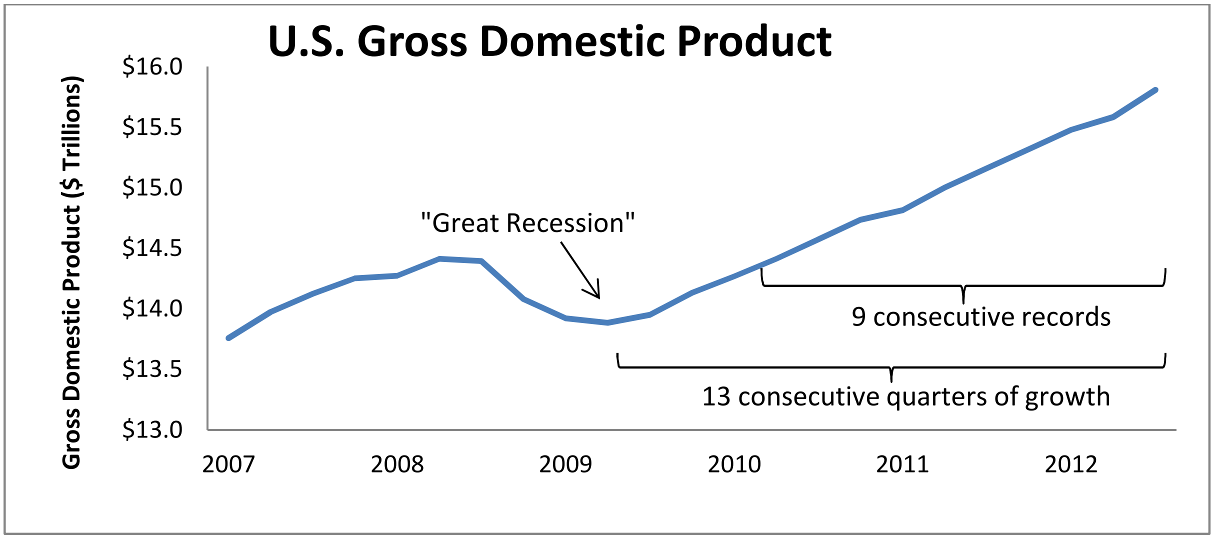
By a simple metric – the price/earnings ratio – most of our stocks are sitting around or below a price/earnings ratio of 10. Our stocks mostly trade below the market average price/earnings, and most of them are growing earnings faster than the market average. Our holdings are still undervalued, but they are not exceptionally undervalued like they were a year ago.

On the following pages, as usual, I'll have some more detailed observations on the economy and highlight some of our stock picks. Have a great 2013!

Kai Shih

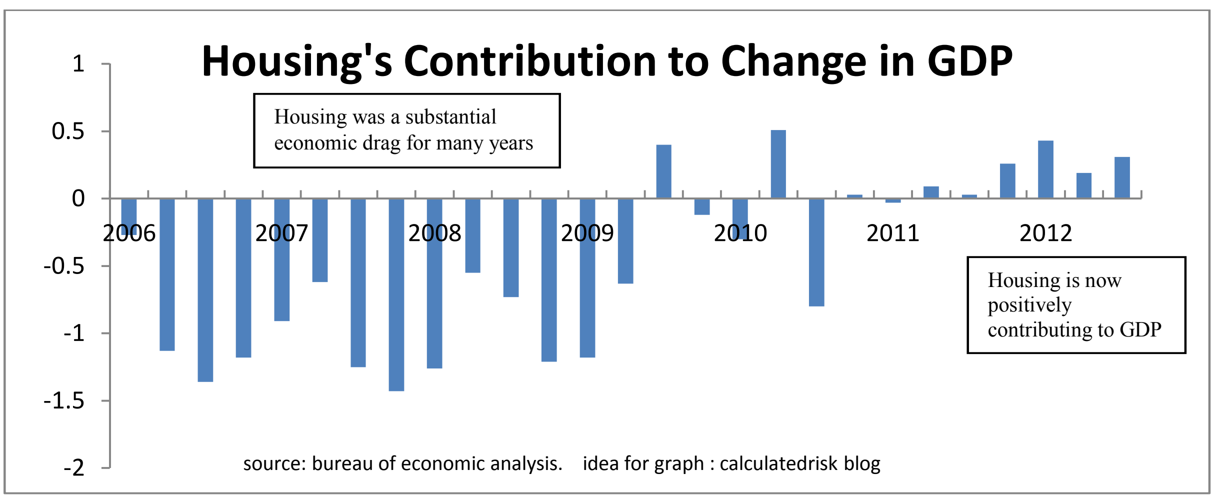
Comments on the Economy

The United States economy keeps growing – gross domestic product (GDP) recently hit its ninth consecutive record high. I'm going to discuss two contributors to GDP growth for 2013 and beyond – housing and manufacturing – as well as a negative in the form of too-high deficits.



Housing likely bottomed and is now boosting our economy

A year ago, I made the case that housing was going to bottom "in the next two years." The latest Case-Shiller national index shows housing has appreciated by about 3.5% over last year, and most economists now believe that housing bottomed earlier this year. Being early and correct about the housing call is a portion of the reason the banks – which have substantial exposure to housing through mortgages – were profitable positions for us this year.



As the graph above shows, 2012 was the first year in many where housing boosted GDP. I'd expect housing to continue boosting the economy for years to come, quite likely at a stronger level than we saw in 2012. And don't forget the multiplier effect of building a new house on the economy. Houses need construction workers, building materials, architects and real estate agents. Each of those workers will receive more money and likely spend more money. So as housing rebounds, I expect to see a virtuous cycle of economic improvement.

A recent trend towards "insourcing" may boost manufacturing

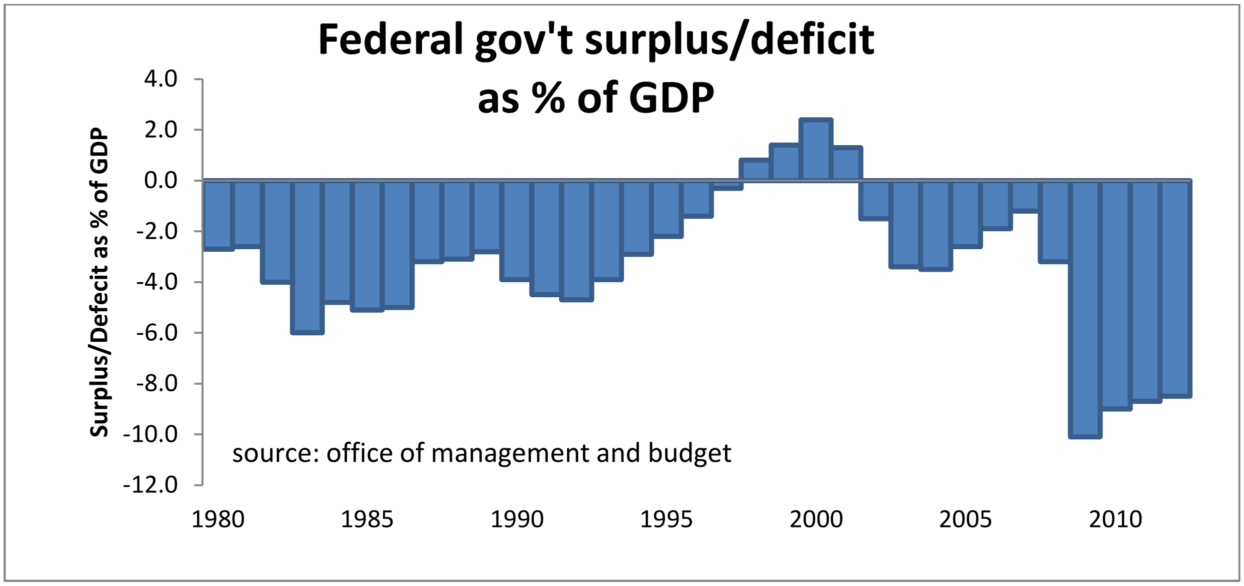
There has been a recent trend towards "insourcing" – bringing manufacturing back to the United States that was outsourced in the past. The Atlantic has an excellent article on General Electric bringing its appliance manufacturing home. Apple is bringing some computer manufacturing back. And I am on a long waitlist to get "the world's best hoodie," manufactured 100% in the United States by a start-up apparel company. Even Flextronics, a company built around outsourcing, suggests that manufacturing is moving back to the United States.

The insourcing trend has some solid financial foundations. The labor costs in China are, of course, lower than here. But the labor costs in China are increasing rapidly, while in the United States, labor costs are stagnating. Meanwhile, there are plenty of other cost inputs which are cheaper in the United States. Local manufacturing means lower transportation costs, and faster times to market. It also reduces coordination and managerial costs – when designers, engineers, managers, and workers can all be together in the same time zone, speaking the same language – companies get better results. And finally, the United States has abundant low-cost sources of energy – natural gas and coal – which is giving us a lasting edge on energy costs.

It is too early to tell how significant the insourcing trend is, but I am optimistic that some high-value manufacturing can profitably be returning to the United States.

Government deficits remain a problem

From 1980 through 2008, the government averaged a deficit of around 2.6% of GDP. For the last four years, however, our deficit grew to around 9% of GDP – much too high. Warren Buffett suggests the deficits should be 3% or below, which would keep our debt growth comparable to our overall economic growth. Our current debt equals about $54,000 per capita, and growing – an uncomfortably high number.



James Montier has a good paper dealing with the impacts of the deficit on corporate profits. Large government deficits, he says, are pushing corporate earnings upward – and as the government inevitably reduces their deficits to more normal levels, corporate earnings will fall.

Somewhat uncharacteristically, I don't have a strong opinion about the economy going forward. There are many positives: housing and manufacturing are improving; consumer confidence is high and consumer interest payments are low. There are high corporate cash balances, which mean that corporations can make investments freely if they see good economic conditions. Arrayed against this is a major negative, which is related to economic slowdowns when we inevitably address our large deficits. The likely case is we see continued moderate economic growth, similar to what we've experienced over the last few years.

While I don't have a strong opinion on where the economy is heading, I do feel our stocks are undervalued and will continue to generate profits for the portfolio for quite a while. I discuss these further in the next section.

Comments on Individual Holdings

- Banks. Even though the analysts have turned more bullish on the banks recently, I still think their estimates of capital returns are too low by billions of dollars. Large banks are now required to submit their plans to the Federal Reserve in early January, and get a response in March. My analysis of potential capital returns is billions of dollars higher than analyst expectations, and if my analysis is correct, I'd expect the large banks to appreciate further. I'll update you next time on how I did.

- Tesco (TSCDY). As you may recall, Tesco is one of Warren Buffett's favorite stocks. I believe we own shares at a lower price than he does. Buffett has been critical of one aspect of Tesco – their attempt to build a grocery chain, called Fresh & Easy, in the United States – a move he called "foolhardy." This quarter, Tesco decided that Buffett was right and announced plans to sell off their Fresh & Easy stores.

- Offshore drillers. In Q4, I sold Noble (NE) and bought more Ensco (ESV). Last quarter I mentioned my dissatisfaction with Noble's operational performance – they were having more maintenance problems than their competitors. This quarter, I switched our investment to a competitor, Ensco, which has an excellent track record of strong operations and profitability. Ensco trades at higher earnings multiples than Noble, but my hope is that their superior operations will result in fewer disappointing earnings calls and ultimately result in greater price appreciation.

- Xerox (XRX). Xerox was one of our few holdings whose stock price declined this year. The company didn't achieve some of the financial goals they had set for themselves. Nonetheless, I am optimistic that their growth businesses of consulting (medicare processing, toll automation, etc.) will outweigh their shrinking legacy businesses (copiers, printers). The company still looks undervalued and the company has been good about returning cash to shareholders, so we are holding the position.