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After a strong start to the year, where the S&P 500 advanced 12.5% in the first quarter, stocks fell approximately 9% through the first of June as investor fears over Europe returned. Stocks rebounded during the month of June, posting a 7% return, to finish down approximately 3% for the quarter but still up 9.5% for the year. Bonds, on the back of renewed investor fears, returned 1.5% in the quarter and are now up 1% for the year after falling 0.5% in the first quarter.

In the current environment, news out of Europe is driving the market on a day-to-day basis. We won't spend much time on the topic here as we recently published a piece briefly outlining our views on the Euro crisis (available on our website). We would reiterate, though, that while we have minimal holdings in Europe and believe the U.S. economy is on relatively firm footing, we still expect movements in stock prices to be heightened for the foreseeable future due to so-called "global macroeconomic uncertainty" – a fancy way of saying that everybody is on edge, mostly as a result of large debt loads and sluggish economic growth. Additionally, we will need leadership out of Washington to confront our difficult, though solvable, domestic fiscal challenges.

At the end of the quarter, the S&P 500 stood at $1,362. Analysts expect index constituents (the companies that comprise the S&P 500), in aggregate, to report $97.98 in earnings for 2012. While analyst estimates are often overly rosy (see our white paper entitled *Digging Underneath EPS – Understanding the Biases of Wall Street's Earning Forecasts*, available on our website), this means that stocks are trading with an implied earnings yield of 7.2%.[1] In comparison, a 30-year U.S. Treasury bond trades at a 2.8% yield and one could argue may carry more risk than stocks [for every 1% rise in interest rates, the price of a 30-year U.S. Treasury bond will decline by approximately 20%]. A 7.2% earnings yield strikes us as fair, especially given the current low rate environment.

Within the S&P 500, an investor finds 10 different industry sectors with varying earnings yields. Perceived "safe sectors," which include Consumer Discretionary (e.g. McDonald's), Consumer Staples (e.g. Colgate-Palmolive), Telecommunications (e.g. AT&T) and Utilities (e.g. AEP) trade at an average earnings yield of just 6.1%, while perceived "risky sectors," which include Energy (e.g. ExxonMobil), Financials (e.g. Bank of America), Health Care (e.g. UnitedHealth), Industrials (e.g. Caterpillar), Information Technology (e.g. Google) and Materials (e.g. Alcoa) trade at an average earnings yield of 8.4%.

The so-called risky sectors probably offer several good values, but in most cases we can't get comfortable enough to make purchases. Before we buy any stock, we systematically walk through the following questions:

1. Do we understand the business?
2. Does the business have attractive long-term economics?
3. Are we confident the industry's economics will remain consistent over time?
4. Are we comfortable with the firm's financial and operational risk profiles?
5. Are we confident that management will treat shareholders' money with due prudence and care?
6. Is the stock attractively priced?
7. Do we have a thesis for why the stock is mispriced? In other words, what is our "edge"?

[1] Earnings yield represents a company's profits divided by its total value. In other words, if you bought a company for $100 that earned $10 in profit per year, the implied earnings yield would be 10%.

We usually cannot answer yes to all these questions and therefore must pass. Finding above-average investment opportunities shouldn't be easy and rewards accrue to the patient and disciplined investor. For instance, we have increasingly avoided purchases in energy and information technology, as we find it difficult to answer question #3. Purchasing energy stocks requires an underlying view on how commodity prices will develop over time, something we feel is generally tough to achieve with conviction and something we likely don't have an "edge" in. There appear to be some cheap, cash-rich companies in the technology sector, but again it is too difficult for us to forecast how the competitive environment will evolve. Few foresaw iPads threatening the livelihood of personal computers just a few years ago.

This doesn't mean that we automatically preclude all energy and technology companies, only that the likelihood of us finding an acceptable investment in these sectors is low. For instance, we own shares in a technology company that is the leading supplier of capital equipment used to make semiconductors. This company is generally agnostic with regards to what technological devices win out (tablets vs. PCs vs. smartphones), succeeding as long as the world demands more semiconductors in 5-10 years than they do today. Although the company's results are quite volatile, due to the fact that demand for semiconductor capital equipment is cyclical, the company generates strong over-the-cycle returns on its capital employed, commands large market shares in its end-market segments and is focused on returning cash to shareholders, something we view favorably in the current environment. We estimate that our recent purchases have occurred at a 10% earnings yield based on normalized earnings.

In all of our internal debates, we spend a lot of time discussing #7 – *why* is the stock cheap? In the words of Warren Buffett, "If you've been playing poker for half an hour and you still don't know who the patsy is, you're the patsy." In other words, each time we purchase a stock, someone is simultaneously selling that stock, and we need to understand why we are being given an opportunity to earn above-average investment returns. Indeed, our stock screening process revolves around trying to look in the *right places* – places that entail a reason a stock might be fundamentally mispriced. Investor Joel Greenblatt explains:

> It's like the old story about the plumber who comes to your house, bangs on the pipes once, and says, "That'll be a hundred dollars."
>
> "A hundred dollars!" you say. "All you did was bang on the pipes once!"
>
> "Oh no," the plumber responds. "Banging on the pipes is only five dollars. Knowing where to bang – that's ninety-five dollars." In the stock market, knowing where to "bang" is the secret...[2]

[2] *You Can be a Stock Market Genius*, by Joel Greenblatt, 1997.

Likewise, hedge fund manager David Einhorn writes:

> Our research process reverses the analytical framework that most traditional value investors use. Many value investors determine whether a security is cheap. If it is, they seek to determine whether it is cheap for a good reason…[We] take the opposite approach. We start by asking why a security is likely to be misvalued in the market. Once we have a theory, we analyze the security to determine if it is, in fact, cheap…In order to invest, we need to understand why the opportunity exists and believe we have a sizable analytical edge over the person on the other side of the trade.[3]

We have internally catalogued a list of reasons why stocks are sometimes fundamentally misvalued; some examples include:

- The market focuses too much on short-term pressures or events (the main case in our housing investments)
- The market underestimates balance sheet improvements (the main case in our banking investments)
- The presence of motivated sellers regardless of price (for instance, in the case of a stock spin-off or the strategic exit of a large owner)
- The existence of a complicated security that investors ignore (such as long-dated warrants).

We believe that our recent stock purchases meet our rigorous criteria, including the operation of an understandable, consistent business, the presence of an aligned management team, an attractive price and a fundamental reason for why the stock is misvalued. Again, our process rejects the majority of investment candidates and we purchase a selective amount of stocks, but as Buffett writes:

> Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily-understandable business whose earnings are virtually certain to be materially higher five, ten and twenty years from now. Over time, you will find only a few companies that meet these standards – so when you see one that qualifies, you should buy a meaningful amount of stock…Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value.[4]

As always, we thank you for your continued confidence.

Sincerely,

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[3] *Fooling Some of the People All of the Time, A Long Short Story*, by David Einhorn, 2008.
[4] *1996 Letter to Berkshire Hathaway Shareholders*, by Warren Buffett, February 28, 1997.