What a difference a month can make!

September 2010 produced the highest U.S equity returns in seven decades. As a result, equity markets turned positive for the year and more importantly changed sentiment from the very gloomy scenario earlier in the summer to a very positive view of future equity performance. Investors dismissed fears of a double dip recession and the European sovereign debt crisis and jumped back on the equity bandwagon based on the notion that the Federal Reserve will come to the rescue.

This hoped for rescue is based on the prospect of a prolonged period of abnormally low interest rates and "quantitative easing." Quantitative easing is a method whereby the Central Bank purchases government debt and funds the purchases with money that it prints or "creates out of thin air." The expectation is that the increase in the money supply translates into higher demand and stronger economic activity. The very real and significant risk is the prospect of substantial inflation in the future and a loss of credibility and alternatives if the stimulus does not revive economic growth relatively quickly.

We are not as confident in the ability of Central Bankers to fix a problem they themselves had a huge role in creating! Furthermore, there is substantial historical evidence that economies that experience deflated asset bubbles take several years to recover. Long term empirical data shows that time and patience are the true remedies. Thus we remain cautious in our outlook and believe that investors may be disappointed by the pace of future economic expansion.

The current interest rate environment coupled with the belief that interest rates will remain low for some time has created two new asset bubbles; long term debt and gold. In our view both government and corporate long term bonds are the riskiest asset classes today. Investors have flocked into these securities in order to receive some income and as a flight to safety after the recent losses in equities.

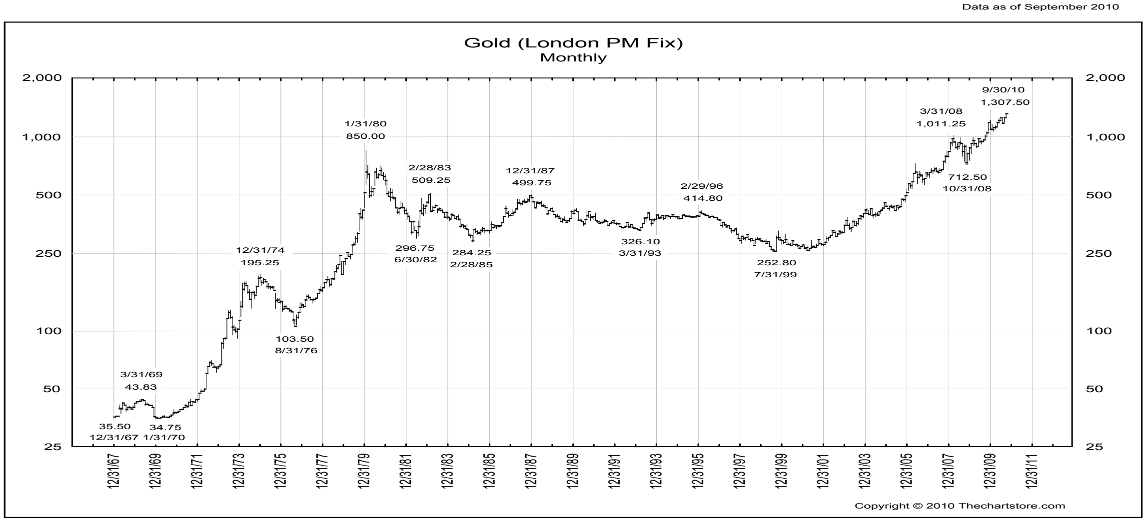
At current bond prices we strongly believe prospective returns are very low while the potential for loss is extremely high. If interest rates were to rise to only one half of their historical average fixed income securities would suffer <u>substantial</u> losses! We would recommend only very short term fixed income securities at this time. For those looking for income, high quality dividend paying equities are safer and will likely provide returns that are superior to fixed income alternatives over the next several years. Our view is based on the following:

> **Dividend yields of many high quality companies are now higher than short and long term rates available on fixed income securities;**
>
> **Dividends from these high quality companies have the ability to grow over time as economic conditions and business profits improve;**
>
> **The balance sheets of these companies are at their strongest levels in many years;**
>
> **Current valuations of many large, high quality dividend paying companies approximate their historical averages and over time should provide modest capital appreciation.**

Gold is also a very risky investment. As indicated in the chart below, courtesy of the Chartsore.com, the price of gold is at all time highs and in our view in bubble territory.

Chart 1

Data as of September 2010



Source: TheChartstore.com

The rise in the price of gold has been fuelled by the belief that the U.S. dollar will be dramatically devalued as the Federal Reserve attempts to inflate its way out of the current debt crisis and/or the fear that the global financial system is on the verge of collapse. We believe that the former view is overstated as global currency devaluation will keep the American dollar competitive on a relative basis to other major currencies and that the latter view is extreme.

In addition, the fundamentals do not support gold prices at these levels. Supply and demand are approximately in equilibrium, the current price is substantially above the cost of production and today's gold price is considerably above its long term average. Anecdotal evidence also suggests that gold is in dangerous territory; it has caught the public's attention, the media is focusing on gold and a plethora of gold related investment products are being created and successfully sold to the investing public. Like bonds, at today's gold price there is a high probability that the returns achieved from an investment in gold are not likely to produce a return that offsets the risk of substantial capital loss.

Turning from potential disasters in the making to an actual debacle in the recent past most "value investors" got slaughtered in the financial crisis of 2008 and 2009. As a result, many are now claiming that the beliefs that Graham and Dodd espoused are no longer relevant or need to be modified. In addition, many blame corporate managements and claim that the financial statements were misleading. We believe that those who make such statements should question their discipline and competence as opposed to blaming an approach that if practiced properly, has proven over time to be sound in principle and very successful!

The pressure to be fully invested was perhaps the root cause for the failure of an investment philosophy that should be rooted in the preservation of capital. This pressure led many to abandon their fiduciary responsibility and compromise their intellectual integrity. Many argued that their portfolios were safe because their investments were cheaper than the market. Consequently, most "value managers" entered the crisis holding

securities trading at substantial premiums to their long term historical valuations and above intrinsic value. A security selling at twenty times earnings is still very expensive and prone to substantial downside risk even if everything else is trading at twenty five times earnings!

The pressure to be fully invested also forced these managers to compromise on the quality of the businesses they were buying. A statistically cheap but highly indebted company or one with inadequate cash flows was far more acceptable than holding cash. Purchasing a low quality business is fraught with risk; many often don't survive serious competitive or economic shocks. The combination of expensive securities and low quality businesses led to the inevitable loss of capital.

Placing blame on corporate managements and the financial statements that they present for their losses is inexcusable. The ultimate responsibility for the investment decision rests with the investment manager. The investment professional should be trained in the analysis of businesses and accounting statements. Potentially problematic financial statements and their accompanying detailed financial notes <u>always</u> provide red flags that should lead to further investigation or to the disqualification of the investment idea. Failure to recognize potential problems on a consistent basis can only be the result of a lack of diligence and/or competence.

Purchasing high quality securities at a substantial discount to their intrinsic value, focusing on the preservation of capital and viewing an equity investment as the long term ownership of a business are timeless principles. Practiced with discipline and intellectual rigor the long term results of this philosophy should be more than satisfactory as Patient Capital has demonstrated over the past ten years.

Vito Maida

October, 2010