Keeping Your Balance

FOUNDERS CAPITAL MANAGEMENT
2010 ANNUAL REPORT

Investing for the Long Term. Every Day.

The examples and descriptions of investments in this client letter do not represent all the investments purchased, sold, or recommended by Founders and instead represent the 10 largest equity positions held by Founders' clients and/or the two largest equity positions in each industry group to which Founders has allocated capital. The performance of these investments was not a criterion in determining the representative list. It should not be assumed that the investments identified and discussed were or will be profitable.

Founders Capital Management, LLC

2010 Annual Report:

“Keeping Your Balance”

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PRINCIPALS' LETTER
From: Founders Capital Management

2010: Keeping Your Balance

2010 was a transition year for the stock and fixed-income markets. The Standard & Poor's 500 rose a more moderate 15.1% after 2009's 26.5% gain. This all followed 2008's precipitous decline—a year to forget, during which the S&P 500 lost 37%. As this letter is being written, the S&P 500 has risen almost 90% from the March 2009 low—quite a run in a short period. With the large rebound in the stock market, however, $1 invested in equities at the beginning of 2008 is worth only $0.92 two years later.

The average investor is now frustrated—viewing an equity portfolio that has declined around 14% over the past 10 years—as well as queasy—having not yet recovered from the severe stock market plummet of 2008 and early 2009. Needless to say, it is a gut-wrenching investment environment. In fact, many individuals—both professional and non-professional—apparently think the stock market is the last place to be: Individuals removed a net $55 billion from equities in 2009 and 2010, opting to shift $600 billion over to the fixed-income market during the same time frame. We call this a *massequity exodus*!

Many pundits persist in screaming, "Sell now, the stock market is going to revisit the previous lows!" One market technician—a "fortune teller" that reads stock market charts and predicts the market's future movement—is adamant that stocks will fall 90% from current levels. We will address these extreme ideas in this year's letter.

Our current condition reminds us of Joe McCarthy. Joe was like many other Americans that raised a family (of six children) during the Great Depression. He supervised linesmen working for Lowell Electric, who all got excited when they heard about a winter ice storm approaching—failing electric lines due to blistering weather conditions meant overtime for the linesmen whose families struggled to meet monthly bills. Although Joe and his crew did not have any money invested in the stock or fixed-income markets, he and his fellow linesmen felt the consequences of the outsize greed of Wall Street during the late 1920s, which was still shaking the foundations of Main Street more than a decade later. Joe was a very wise, buttoned-up manager who wore a shirt and tie under his flannel shirt. He used to tell stories about his crew climbing telephone poles in icy conditions and dealing with live wires that had thousands of volts of electricity running through them. To his crew, he stressed the importance of staying balanced—to being alert to prevailing conditions, to having the right tools and protection, and to being prepared for the unexpected. Joe's wisdom would have been a dream for investors in need of good management of their money on Wall Street these past couple of years.

This year's letter is about managing in treacherous conditions and the importance of staying balanced, especially in an unforgiving environment. Today's circumstances are not unlike those of the 1930s—we have experienced a financial earthquake the equivalent of 9.0 on the Richter scale. This quake—and its aftereffects—will likely impact us for the next decade. To succeed financially in these times, it is important for investors to maintain a rational and balanced thought process.

In our 2010 letter we will discuss:

- Today's Great Imbalance
- Challenges Ahead—the "State of the States"
- "Modern Economic Warfare"—Currency, Trade, and Monetary Policy
- How Greed and Fear are Influencing Investor Behavior
- The Lost Activity of Investing
- Changing Behavior—Toward a Balanced Future

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Founders Capital Management is pleased to report that the underlying business value of our aggregate equity holdings grew again in 2010, although the pace of this growth still remains slower than normal. The cumulative companies we own are very profitable and continue to exploit attributes that give them a long-term competitive advantage. Even in this difficult environment, most of our companies continue to grow stronger as competitors fall by the wayside or go out of business.

We have not changed our view stated in previous letters: Although the overall markets have been successful in generating a "significant rally" during the past 21 months, any sustainable rally is still suspect due to lingering risks in the financial sector. It is important to note that the equity and fixed-income markets will continue to undergo a long-term "deleveraging" process brought about by individuals and institutions that borrowed too much money. Therefore, we will most likely continue to see random price movements in both the stock and fixed-income markets in the coming years—along with a high degree of volatility.

This leads us to our usual statement, which we continue to evolve as market conditions change:

> **With today's uncertain environment of prolonged low interest rates, opaque financial markets, volatile commodity prices, high amounts of consumer and government debt, a bloated trade deficit, large currency imbalances, and ongoing geopolitical issues—investors (including professionals) *remain extremely cautious.* At current prices, we believe *equity* securities to be fairly priced, while most *fixed- income* securities seem overvalued.**

This is not a general statement on the future direction of the stock and fixed-income markets. Most fixed-income securities have risen considerably in the past few years, however, and the current longer-term yields being offered will not offer outsize returns going forward. We think there is now an imbalance between risk and return in the fixed-income field, and that this area is officially overvalued compared with stocks.

Fixed-Income vs. Equity in a Nutshell: Given that an investment at the end of 2010 in a two-year, risk-free U.S government bond offered the purchaser an annual payout rate of less than 0.6%, individuals have been seeking higher-yielding bonds that mature many years out. For example, during 2010, Johnson & Johnson issued a 10-year bond that provided a 3% annual rate of interest. Fixed-income investors flocked to this safe, higher-yielding bond. Meanwhile, the company pays common stockholders an annual dividend of 3.4% that grows approximately 8% per year. It is highly unlikely that Johnson & Johnson will skip any future dividend payments. J&J will earn more than $13 billion in 2010, has more than $20 billion of cash on its balance sheet, and carries only $12 billion of debt. The company could pay off its debt at any time, but why would it do that if it can borrow money at these low rates? A rational investor would forgo a 10-year J&J bond that provides a static annual return of 3%, given that an investment in J&J's common stock grants an immediate 13% greater return that grows over time. Yet this is not occurring—individuals are avoiding J&J's stock at all costs.

In summary, the irrational rush of money into fixed-income securities—more than $600 billion over the past 21 months—may be peaking as most corporations are now borrowing money at historically low rates and using these funds to increase returns for shareholders.

The Great Imbalance

> *"If you put too many tools on your belt, it's going to make the climb up the pole that much harder."*
>
> —Joe McCarthy

Many economists are referring to this great recession as a "balance sheet recession." A balance sheet recession occurs when individuals, corporations, and governments incur so much debt that their liabilities closely resemble, or exceed, their assets. When this happens, everyone begins to minimize debt because of balance sheet problems. If a balance sheet has negative equity due to liabilities that exceed assets, an entity will cease borrowing more money and, due to increased default risk, banks will stop lending money—no matter what the set interest rate.

A way to deal with an economy that has an overall balance sheet problem is for the government to spend and/or print money to inflate away the debt. These actions allow balance sheets to strengthen and stimulate economic growth. Governments throughout the world have, in fact, been spending and printing money—and will continue to spend and print until things turn around. Be prepared for additional stimulus packages once the $814 billion fiscal package enacted in 2009 runs out. It is likely that the government will do all it can in the coming years to reinvigorate a slow-growing U.S. economy.

But how effective is this stimulus? Although what the government has accomplished is laudable and economically necessary, we are unsure that excessive government spending and money-printing will be successful in stimulating enough economic growth to bring us back to the type of good times we experienced in the 1990s. Why? Because robust economic stimulus must be accompanied by an expansion of credit to achieve sustainable growth—and no one is borrowing, or lending out, additional money. In essence, we now have so much debt under our belts that the climb up the economic pole is going to be that much harder.

> **Our opinion is that we are not experiencing a balance sheet recession, but an IMBALANCE sheet recession: Too many important economic areas are at extremes, and until these areas are brought into balance, it is likely that any stimulus intended to jump-start economic growth will sputter.**

We anticipate that it will take a long period of time—perhaps up to 10 years—to rebalance the following areas that are now at extremes:

Labor
The U.S. currently has a labor surplus, with unemployment hovering around 10%, and despite moderate economic growth, we expect chronically high unemployment throughout the rebalancing decade. Nearly half the jobless (approximately seven million people) have been out of work for more than six months—the highest proportion since the1930s. The more relevant statistic is that more than 60% of the jobless have been out of work for more than one year—despite the recent economic rebound. One potential explanation for economic recovery coupled with continued high unemployment is increased productivity on the part of retained workers who are nervous about additional company layoffs—that is, companies are getting more productivity out of less labor. In addition, labor-intensive industries are still exporting work to low-cost regions such as China and India. We expect this trend to continue until the economic status of the educated work forces in the emerging markets begins to reach parity with that of developed countries such as the U.S.

Executive Pay
A chief executive officer of an S&P 500 company is paid, on average, around $19 million in total annual compensation. As millions of workers lost their jobs, homes, and retirement savings in the worst financial crisis since the Great Depression, top executives in the U.S. were earning more than 250 times the average worker's salary—a historical disparity. To put it in perspective: During the 1960s, top executives earned around 25 times the salary of the average American worker. The differential grew to 35-fold in the 1970s, 70-fold in the 1980s, 145-fold in the 1990s, and more than 200-fold after the turn of the century. Typical compensation of CEOs in foreign companies is about 20 times the salary of the average worker in that country. In short: American executive pay is at an extreme imbalance relative to the pay of an average worker.

Housing
There are about 4.1 million houses on the market today. Under normal circumstances, with approximately 1.5 million new U.S. households created each year, it would take almost three years for the market to absorb the available housing inventory. We are not in ordinary times, however. In fact, more than 1.5 million homeowners have "strategically defaulted" on their mortgages during the past two years because the value of their home was worth less than what was owed. Today, more than one-fifth of all U.S. households with mortgages have negative equity in their homes. Many of these homeowners with zero (or worse) equity cannot afford their monthly payments. But for others—even for whom the payment is affordable—the situation has created a perverse incentive to simply stop paying the mortgage. The idea of individuals feeling comfortable handing their losses to the bank (or mortgage investor) without suffering any repercussions presents an obvious looming menace for the financial institutions and investors that hold these mortgages. It may take many years for the market to absorb the excess housing inventory exacerbated by certain extreme activity, including the recent development that it has become socially acceptable to stiff one's banker.

Commercial Real Estate
More than half (around $1.7 trillion) of the $3.25 trillion of outstanding commercial real estate loans is held by 3,000 commercial and thrift banks. This large amount of real estate debt was supplied by banks that supported extreme refinancing by owners, who removed 100% of the equity from existing properties. Now this debt is coming home to roost—vacant office space continues to accumulate as businesses pull back on growth plans. The office vacancy rate is now pushing 17%—the highest level since 1993. As $1.4 trillion of commercial real estate debt matures over the next 60 months, we can expect additional financial pressure on banks, along with further contraction of commercial real estate development. We estimate that it could take up to 10 years for the market to absorb the excess commercial space available in many cities across the U.S.

Consumer Debt
Total consumer debt—which includes mortgage, credit card, auto, and other loans—is currently around 122% of after-tax disposable personal income. In contrast, consumer debt stood at approximately 65% during the 1980s. The average American household holds more than $8,000 in credit card debt—an oft-cited statistic that is more telling when dissected. More than 50% of American households have no credit cards or pay off their credit cards in full at the end of each month—a good number. This means, however, that the average American household that maintains a monthly credit card balance owes more than $15,000. According to VIP Forum Analysis, more than 35% of U.S. households that hold more than $10,000 in credit card debt earn less than $50,000 per year. This extreme revolving liability on a large portion of American households will take many years to pay off—especially if annual interest rate charges on credit card debt remain above 15%.

Regulation
In past letters, we have described the evolution of independent financial markets that went into fast-forward, creating a revolution in the global financial system that officially became interconnected. Basically, global capitalism truly emerged as financial assets freely trade in boundryless world markets. However, in this fluid global capital environment, regulation of financial markets has remained independent with each nation enforcing its own particular security laws that rapidly lost relevance in the fast-changing interconnected financial universe. Recently, legislation was introduced in the U.S. that addresses the imbalance between modern market activity and the financial regulation needed to enforce the "rules of the road." Needless to say, the new U.S. financial regulation is a step forward, but it does not go quite far enough. Unfortunately, the problem is not the rules that we don't understand, but the rules that we DO understand. Bankers are quickly lobbying to "water down" any rules that restrict their ability to use depositor and shareholder capital to maximize returns—for themselves. In addition, the U.S.-centric financial regulation being introduced will likely not make its way throughout the global financial system as other areas of the world choose not to adopt more restrictive U.S. banking legislation—leading to further potential imbalances as global banks circumvent the new U.S. financial industry rules.

The Challenges Ahead—the "State of the States"

Government Debt (Federal, State, Local, and Global)
U.S. federal, state, and local governments, as well as governments of many developed countries throughout the world, are now mired in debt. During this year, €750 billion of standby credit was set up by the European

Union and International Monetary Fund to support weak countries within the eurozone. The eurozone crisis is playing out as we speak, with a €110 billion bailout of Greece and a €85 billion bailout of Ireland—and Spain, Portugal, and Italy's days of reckoning are coming. The soaring government debt of the 16-member currency bloc will force the eurozone countries to cut back on government spending, which will stifle economic growth throughout the region. Fiscal restraint in Europe will also negatively impact America's growth as our exports remain tepid. Recent eurozone financial trouble, although anticipated for some time, is creating angst as pundits prognosticate a double-dip recession. We're not so sure about that. Germany—the main economic engine within the eurozone region—will continue to experience economic growth. In addition, emerging economies such as China, whose gross domestic product (GDP) is growing annually at 9+%, will likely offset any slowdown in the eurozone.

Either way, Americans should not cast aspersions on the financial state of our European friends—local municipalities and states in the U.S. are beginning to experience tremendous fiscal stress. For example, Illinois has been failing to make the required annual payments to its state worker pension funds for years, so the state borrowed $10 billion in 2003 and "invested" this money in its pension funds. Naturally, the recession sent the state's investment returns plummeting, and Illinois is now stuck repaying the $10 billion with interest. So what did the state do? Illinois decided to borrow an additional $3.5 billion in 2010 to fund its anemic pension plan. To make matters worse, the state is planning to borrow $3.7 billion more in the near future to further fund its underfunded pension plan. We'll see how this borrowing binge plays out over time. Illinois is not the only state contending with a pension deficit—the 50 U.S. states and local municipalities have approximately $4 trillion of hidden pension and healthcare obligations owed to current and retired employees, but only $2.5 trillion set aside. This $1.5 trillion pension obligation deficit dwarfs recent worries over any potential defaults on the $2.8 trillion of outstanding state and municipal bonds "on the books."

The word on the street is that a purchase of state and municipal debt is a "deal" right now—investors have an opportunity to purchase these higher-yielding bonds and to forgo paying taxes on so-called secure debt. In fact, experts are recommending that investors go "all in" on this opportunity, since it is virtually impossible for states and municipalities to default on their obligations. These experts cite the fact that much of this debt is insured against default, and that 99% of state and municipal debt was paid in full during the Great Depression decade. Of course, these same experts fail to mention the gut-wrenching experience for investors who waited to be paid on the 3,250 municipal bonds that went into default during the 1930s. Our thought about this: A few years ago, pundits were recommending investing in mortgage debt, contending that default on these bonds was nearly impossible. They reasoned that many of these bonds were insured, and that U.S. housing prices never decline across the country in concert. They were wrong.

Although we are not predicting massive defaults by states and municipalities, we believe that these entities are facing a once-in-a-generation financial shock. Not surprisingly, they are doing everything within their means to raise funds to meet their obligations—including taking corporate money in exchange for naming rights to subway stations and city parks, and selling revenue-generating assets such as toll roads and city parking meters.

Incidentally: We also see certain trends that concern us as investors attempt to maximize short-term returns in the state and municipal fixed-income arena:

- 30% of municipal debt is so-called "conduit financing"—money raised via municipalities by a nonprofit or private company under the auspices of fostering economic development. The nonprofit or private company gets access to lower-interest loans and has full exposure to the debt, while the (public) issuing municipality receives fees without taking on any legal or financial liability. You've got it—if these so-called municipal bonds that are not backed by the municipality fail, the investor is on the hook.
- $325 billion (11.5% of state and municipal debt) is held in tax-exempt money market funds.
- U.S. banks are purchasing state and municipal debt as they seek to obtain higher returns on borrowed depositor money—the top 10 U.S. banks own approximately 2% of all state and municipal debt.
- Well-known investment banks are "pitching" insurance to investors to cover potential losses on state and municipal debts that undergo default. Watch for these banks to begin purchasing versus selling insurance—placing a bet on actual state and municipal debt default.

The so-called migration of state and municipal debt into investment areas that rely on higher liquidity, coupled with increased interest in purchasing default insurance, could lead to credit market problems if investors become skittish over potential defaults in state and municipal securities. Thus, we remain very cautious about investing in state and local government debt.

"Modern Economic Warfare"—Currency, Trade, and Monetary Policy

> *"It is incumbent on every generation to pay its own debts as it goes. A principle which, if acted on, would save one-half the wars of the world."*
>
> —Thomas Jefferson

Trade

Although foreign trade makes up a small portion of the U.S. economy, it is still a source of economic growth. Unfortunately, the U.S. remains a "net importer" of goods, with exports constituting approximately 12% of GDP and imports accounting for 15.3%. This 3%+ difference ultimately represents a slow sale of the U.S. to foreign countries. Unless this growing trade imbalance is reversed over time, the U.S. will remain akin to the business owner who originally owned all his assets and then decided to sell off a small portion of his business every year to subsidize ever-increasing spending habits. Sooner or later, the business owner will have lost control of his enterprise, and in a worst-case scenario, will have nothing left to sell. Clearly, it is necessary for the U.S. to right this import/export imbalance over time if the country is to prosper.

Currency

As America imports an ever-increasing amount of goods, more and more U.S. dollars end up in the hands of foreign governments, creating an imbalance of currencies throughout the world. Due to our ongoing appetite for cheap Asian goods, China has now accumulated approximately $900 billion of U.S. dollars—and has largely turned around and invested the proceeds in U.S. Treasuries. This situation is positioning the U.S. to have to become more dependent on the kindness of strangers—with the hope that foreign governments will continue to recycle their accumulated dollars by lending the money back to the U.S. at less-than-average interest rates. Unfortunately, the price of righting this currency imbalance could lead to higher interest rates as foreign governments attempt to diversify from their growing influx of U.S. dollars via direct sale of their U.S. Treasuries, investing newly accumulated dollars in nondollar-denominated securities, or using accumulated dollars to purchase valuable assets around the world. Any execution of such methods, alone or in combination, could put the U.S. at a long-term competitive disadvantage and stifle future economic growth.

It is important to understand this currency imbalance and how it can impact investors. To appreciate what is occurring globally, looking at a microcosm of the economy can be instructive. Let's start by considering a manufacturer in China who makes electronic goods for a U.S. company that sells to U.S. consumers. As the Chinese goods are sold, the U.S. company either exchanges dollars into yuan (China's currency) to pay the Chinese manufacturer or pays the Chinese manufacturer with U.S. dollars. If the Chinese manufacturer receives U.S. dollars, it must exchange the money for yuan at a local bank to pay its workers. Now here is the tricky part: If the exchange rate is set, or "pegged," by the Chinese government, the exchange of dollars for yuan remains static— meaning the increased demand for yuan brought about by an influx of dollars is met through an infinite amount of available local currency provided via the Chinese central bank. In effect, the Chinese government chooses to print as much yuan as necessary to meet the exchange needs for incoming currencies. The result? China circulates a greater amount of local currency within its system to allow its companies and workers to grow income and wealth. This makes sense from China's perspective of building its economy; however, as the Chinese financial system becomes awash in liquidity due to the government's loose monetary policies, the consequence may be an overheated economy and associated inflation. China seems to be grappling with this problem today.

Now let's look at this from the opposite perspective: Imagine if the Chinese government allowed only a finite amount of yuan to circulate within its financial system. As local manufacturers who export goods to the U.S. collect vast amounts of U.S. dollars and attempt to exchange their dollars for yuan at local banks, the demand for a limited amount of local currency would result in a battle. Manufacturers would be forced to "bid" higher to exchange their foreign currency, paying banks more dollars for each yuan—increasing the value of a limited amount of Chinese currency. A significantly strengthened Chinese currency would result, which could actually

reverse the ongoing economic gains occurring in China and eventually make it more advantageous for Chinese citizens to "import" certain goods from the U.S. as the dollar loses value against the yuan.

This scenario illustrates why China has an incentive to "manage" the strengthening of its currency—China cannot afford to shock its economic system by allowing the yuan to trade freely and strengthen quickly against other global currencies—in particular, the U.S. dollar. Such a dynamic would suppress China's wealth creation and slow down jobs growth for its massive labor force (more than 300 million Chinese are expected to move from farming suburbs to manufacturing cities within the next decade—and many are in transit right now).

And so the ongoing increasing sale of Chinese goods to U.S. consumers continues, with China's central bank freely issuing unlimited yuan in exchange for U.S. dollars, resulting in a growing global imbalance of currency. What does all this mean? If the Chinese government chooses to establish an official "slow-changing" exchange rate and not allow the Chinese currency to naturally strengthen against currencies such as the dollar, then China's manufacturers will maintain an export advantage. Unfortunately, the export advantage gained through this currency manipulation can become elusive as China continually hoards U.S. dollars and prints local currency. In due course, the growing U.S. debt problem can become China's problem—holding too many U.S. dollars that become "worth-less" over time. To cite the impact, an analogy can be made between an individual and a bank. When you owe the bank $1, it is your problem; when you owe the bank $100 million, it becomes the bank's problem.

An even bigger problem: As China manages its currency to feed its growing economic appetite, other countries that feel disadvantaged are beginning to weaken their currencies to balance trade with China and stimulate their stagnant economies. The prevailing attitude of many governments is, "If China won't strengthen its currency, then we will."

A case in point: Japan recently issued $60 billion of yen to weaken its currency against the U.S. dollar and Chinese yuan. With the yen at a 15-year high against the dollar, exporting to the U.S. is becoming unprofitable, which is disadvantageous for Japan's economy—manufacturers such as Toyota are collecting dollars for Japanese goods sold in the U.S. and exchanging the dollars for less yen.

Japan is not the only government taking action with its currency to stimulate economic growth. Brazil is manipulating its currency by imposing a financial transaction tax on any foreign money entering the country to purchase fixed-income investments. The U.S. is feeling disadvantaged as a trading partner and is also looking at issuing more dollars through the monetization of debt—the U.S. central bank (the Federal Reserve) recently announced a program to purchase $600 billion of additional debt to boost the stagnant economy. One reason the U.S. may be choosing to print money is to create a favorable global trading position and improve economic growth.

The bottom line: Countries attempting to maintain (or gain) an economic advantage by controlling their currencies' value are ushering danger into the global financial system. The debasement of monies could lead to higher prices in the short-term (inflation), followed by price collapse (deflation) worldwide. This potential scenario is leading investors to seek assets such as gold, oil, and other commodities that will increase in value as a result of the devaluation of fiat currencies.

Global Monetary Policy

Central banks throughout the world are slowly socializing private debt to save their economies and banking systems. In the U.S. so far, we have witnessed the federal government's direct bailout of corporations such as General Motors and AIG, the purchase of $1.25 trillion in mortgage-related securities to save the U.S. banking system, and the recent announcement to purchase a total of $900 billion of U.S. Treasuries by the end of the second quarter, 2011—the so-called Quantitative Easing 2 (QE2). As we alluded earlier, the European Central Bank is now facing similar bailout dilemmas as sovereign nations such as Portugal, Ireland, Italy, Greece, and Spain attempt to remain financially solvent. Central banks around the world are creating a vast amount of excess financial reserves to save the global markets from collapse, but these reserves cannot remain in the system indefinitely or they could eventually trigger inflation. Given the ongoing challenging economic conditions, central banks have no immediate intention to remove this money from the financial system. If failing economic recoveries ensue, central banks may eventually need to continue monetizing debt through the purchase of government bonds and other securities—leading to QE3, QE4, QE5…. These actions could

potentially add tremendous amounts of money supply and create further imbalance in the global monetary system.

The ultimate danger is that, with so many extremes occurring throughout the global economic system, individuals, companies, and governments are beginning to think and react in extremes—for example, by:

- Aggressively cutting back expenditures in certain areas while at the same time spending aggressively in other areas
- Buying up bonds in fear of deflation and a gyrating stock market while at the same time adding debt as interest rates remain at multidecade lows
- Manipulating assets excessively while attempting to maximize returns in a return-less environment

Ultimately, individuals, companies, and countries are reacting in self-interested ways while trying to insulate themselves from global turmoil. This extreme thinking coupled with extreme reaction is the greatest danger of all and needs to be brought into rational balance if we are to achieve a sustained economic recovery.

How Greed and Fear are Influencing Investor Behavior

> *"The price of a man's hat has nothing to do with the size of his brain."*
>
> —Joe McCarthy

After a decade of less-than-stagnant returns in the stock market, investors are understandably frustrated. As a result, many smart individuals have decided to exchange their hats for more expensive models, hoping to find their portfolios brimming with generous returns. So what are these hat-exchanging investors doing? You guessed it—trading. Many, if not most, professional and novice investors are now seeking gain by quickly buying in and selling out of the stock market, or various areas of the stock market. This "bee-havior" of jumping from flower to flower in hopes of pollinating one's portfolio with immediate returns is causing individuals to practice investment insanity—doing the same thing over and over again in the hopes of achieving a different result. One has to ask: Who are the beneficiaries of all this trading? Before answering this question, we need to visit the past.

In the early 1900s, very few individuals were able to afford a brokerage account, but many Americans had a desire to take part in the growing stock market that seemed to be reserved for the wealthy. To fulfill this demand, storefront operations sprang up throughout the country that offered the common man an opportunity to speculate on the price movement of stocks and commodities using small sums of money. Storefront operators also allowed customers to borrow money on margin. In essence, these betting parlors, or so-called bucket shops, allowed individuals to wager on the movement of their chosen securities without ever owning a single share—similar to a derivative today. Trading (betting) through bucket shops became so rampant that in 1889, *The New York Times* estimated that bucket shop patrons were wagering approximately one million shares of stock per day. This was at a time that the New York Stock Exchange (NYSE) average daily volume was just 140,000 shares.

Bucket shops were made to "look like" Wall Street brokerage houses—they were ornate and featured fancy offices, tip-sheet mailers, and near real-time stock quotes (remember the "near real-time" for later). Bucket shop operators were unscrupulous, however. Unlike brokerage houses, which earned commissions for purchasing or selling securities on their clients' behalf, the bucket shop profited at the customer's expense. The goal of the bucket shop operator was to extract its client's money over a series of bets, not unlike a gambling casino today. Bucket shop operators used to "stuff the tape"—the practice of using their own brokerage account and simultaneously placing large purchase and sell orders on certain securities to move the market against their clients. Operators also obtained information on the movement of a stock prior to a client's buy or sell order, allowing the bucket shop to manipulate client bets. Bucket shop operators accomplished this quick information-gathering practice through the leasing of wires from brokers and telegraph companies. In fact, bucket shops competed to locate as closely as possible to the exchange to enable them to decipher information more quickly and thereby take advantage of their clients. You may ask: What relevance does this story have today? As we go through the next several sections of our letter, keep in mind that history and Wall Street share

the same fate—they never repeat, but rhyme. In the end, there is nothing new on Wall Street— manipulation and speculation are as old as Methuselah.

High-Frequency Trading

The average stock on the NYSE is held for around 12 months—hardly enough time for an investment idea to grow after birth.

Evolving new practices are exacerbating this investment insanity. Emerging "trading firms," hedge funds, mutual funds, and pension funds are developing sophisticated algorithms to recognize market inefficiencies and "automatically trade" to take advantage of supposed price disparities. As a result, the total daily volume in all stocks listed at the NYSE has gone from about two billion shares a day five years ago to 5 billion shares a day today. This "high-frequency trading" via computer programs and using minimal human intervention now accounts for more than 60% of daily trading on the NYSE.

You may ask: Why all this trading? The answer: Scalping for pennies!

Let's say a high-frequency trader develops an algorithm to place a layered series of bids and offers on a stock such as Microsoft. They might buy 100 shares of MSFT for $27.59, and sell it a fraction of a second later for $27.60. The profit in this case would be $1 (100 shares at a profit of $0.01).

Like most stories, however, there is more to the story. The various stock exchanges that compete for business pay rebates to provide liquidity on their exchange (offers to buy and sell stock). An exchange might pay, let's say, 14 cents per hundred shares. So in our example, the high-frequency trader would make $1 trading "the one penny spread," plus a 14 cent rebate for providing a bid (offer to buy) and another 14 cents for an "ask" (offer to sell). The total profit: $1.28. Do this millions of times a day, and the pennies add up.

There are now an estimated 400 high-frequency trading firms that produced a gross trading profit of $5.6 billion in 2010 (not including $2.8 billion in fees paid to brokerage firms and the SEC). Clearly, generating these huge profits requires trading a lot.

So what's wrong with high-frequency trading?

The high-frequency trading firms—reminiscent of bucket shops—have developed programs that recognize a high-volume buyer or seller of stock and employ various strategies to manipulate a stock's offer price higher or bid price lower to increase their trading profit. In addition, the high-frequency trading firm may decide to rapidly submit and cancel many orders simultaneously ("stuffing the tape") in an effort to slow down the system and use the resultant time lag to take advantage on a trade. Like many things on Wall Street, what begins as innocent arbitrage activity ends up close to embezzlement.

If the recipients of large trading profits are various trading and brokerage firms, where does the normal investor stand? You've guessed it by now—the normal investor is the one getting clipped, even if it's only for a penny. Speed is the essence of this game. In fact, high-frequency trading firms that rely on superfast (millisecond) trading have sought to position their computer servers as closely as possible to the servers of the various exchanges to cut down on the time it takes to send and receive information—reminiscent of bucket shops. As we stated earlier, there is nothing really new on Wall Street—charlatans have been figuring out ways to take advantage of Wall Street participants throughout history.

The problem is, this modern feeding frenzy was a major contributor to the now-infamous May 6, 2010 "flash crash," when the Dow Jones Industrial Average lost more than 600 points in minutes. When computers that automatically generate more than 60% of daily volume on the exchanges stop trading or are programmed to trade in the same direction simultaneously (i.e., all selling), an extreme imbalance causes fits and starts in the market. One has to ask what possible economic value is generated by this type of trading activity, which has no relation to any economic reality inherent in the companies these stocks represent. These are not the dynamics of capitalism—this is *casinoism* in action.

Next on the Docket: Exchange-Traded Funds (ETFs)

The "latest and greatest" idea for investors to consider is an investment in exchange-traded funds (ETFs). Although ETFs have been around since the early 1990s, they have recently become popular due to the desire of

brokerage firms and financial advisors to increase their offerings to meet investors' expectations of increasing returns, while at the same time decreasing risk. ETFs now hold $1 trillion of assets.

An ETF is an investment fund that trades on the stock exchanges, much like a stock. In essence, an ETF replaces the need for an investor to purchase a group of stocks within a sector (let's say healthcare) and offers the investor exposure to a particular area through the stocks held within the ETF.

For those that are interested, here is how an ETF is established: Large investors called "authorized participants" (think banks/brokerage firms) purchase shares of stocks—let's say in the healthcare sector—and deliver them to the ETF company. In exchange for those stocks, the ETF company issues new shares of the ETF to the authorized participant. *The authorized participant then sells those new ETF shares on the market at a price that is slightly above the per-share price of the underlying stocks.* In this way, the authorized participant makes a profit, and the new supply of ETF shares on the market helps push the price of the ETF back down toward the underlying value of the stocks in the portfolio (the so-called Net Asset Value, or NAV). The ETFs are then bought and sold throughout the day like stocks on a securities exchange through a broker-dealer (more fees).

A plethora of ETFs—more than 1,000—have emerged to meet the investor's appetite for diversification within a particular asset class. Initially, ETFs held assets such as stocks and bonds; today, investors can purchase just about any ETF imaginable, including leveraged ETFs, currency ETFs, commodity ETFs, etc. (If you can package the asset, Wall Street will put it into an ETF—more fees.) What investors don't understand is that in many cases, the underlying assets of these ETFs are not the actual assets themselves, but derivatives—possibly because, in the case of commodity ETFs, the fund does not wish to take delivery of and store agricultural products such as corn and wheat; or perhaps because it may be difficult for the fund to purchase the underlying securities that make up the ETF. What does this mean? In essence, *individuals are wagering on the movement of certain assets without ever owning them.* (Remember the bucket shops.)

We can't help but finish this exposé by pointing out the "domino effect:" ETFs figure prominently into our previous discussion on high-frequency trading and also contributed to the flash crash. Algorithms have actually been developed by high-frequency traders to identify a price discrepancy between an ETF and the underlying assets. When the ETF price is higher than the value of the basket, the high-frequency trader sells the ETF and buys the underlying assets, and vice-versa—all leading to an exponential increase in trading.

Once again, what starts off as a good idea for investors ends up in abuse. Taking a closer look, we see that the so-called "authorized participants" that generate ETFs and make money managing the rolling derivative contracts—at the expense of the investors—are large Wall Street banks/brokerage firms, which are raking in tremendous ongoing fees generated from all this activity. Once again, we have to ask what economic value is created by this activity that is unconnected to any economic reality inherent in the assets these ETFs represent. We are not happy to note that Wall Street's banks and brokerage firms are starting to look like modern bucket shops.

The Lost Activity of Investing

> *"I graduated from the school of hard knocks, and our school colors are black and blue."*
>
> —Joe McCarthy

As time marches on and market returns remain languid, investor frustration is imparting new meaning to the concept of investing. Individuals that rely on courses such as "trading and quick profits" are receiving brokerage statements in their school colors—black and blue. Unfortunately, it may take many so-called "educated investors" to obtain a degree from the school of hard knocks to learn the true concept of investing.

The concept of investing, at its essence, is putting out $1 with the hope of receiving something greater than $1 in the future. How each individual achieves this result makes a simple concept more complicated. At one extreme, the *chase* for more dollars can become so consuming that individuals subject themselves to the greater fool theory—being sold a bill of goods that $1 is easily turned into more. All you need to do is put out $1 today and hope that a greater fool comes along to offer you more than $1 tomorrow. In this case, the fools

lose money, and the only money made is by the sellers of this practice—the financial advising jokers. It is our firm opinion that the greater fool theory is grounded in speculation and is not the foundation of investing. To quote Mark Twain: "There are two times in a man's life when he should not speculate: when he can't afford it and when he can."

The true art of investing is actually not as complex as speculating on which stocks to buy low and sell high. Intelligent investing involves choosing a few top-rate businesses that you understand, and purchasing an interest in these entities at a fair price. Although this sounds easy in theory, in practice the hard part of investing is identifying a few top-rate businesses and understanding them thoroughly enough to decipher a fair purchase price.

To figure out a fair purchase price, a top-rated business can be viewed as a goose that lays an ever-increasing number of golden eggs. The job of the intelligent investor is twofold—to evaluate the goose's capability to continue producing golden eggs, and to have a predictable view of the number of eggs that goose will produce many years out. Very few businesses on the planet, of course, will fit the description of a rising golden-egg producer—so when an investor identifies one, it usually pays to purchase a meaningful amount of this goose. The objective to investing is correctly figuring out today's value of the golden eggs produced over the life of the goose—and then acquiring the goose at a discounted price. Principally, an intelligent investor tries to pick up $1 of today's value for the price of 65 cents.

How should the investor react to the changing price of eggs? The intelligent investor does not take the view that it is necessary to constantly exchange one's golden eggs, or to place them in a number of baskets to avoid the risk of changing prices. In fact, intelligent investors intently watch over the *goose* rather than the eggs (or the fluctuating price of eggs). True risk to an intelligent investor is not represented by short-term fluctuations in the quotation price of eggs, or in the number of baskets one puts one's eggs into. Risk resides in a lack of clarity about the goose's ability to lay golden eggs far into the future. The more cloudy, the greater the hazard.

Over time, if an investor correctly fills his portfolio with a select number of businesses that fit the description of a never-ending golden-egg producer, he will watch the value and price of his holdings grow—and can comfortably ignore short-term price fluctuations.

Changing Behavior—Toward a Balanced Future

> *"The problems that we have created cannot be solved at the level of thinking that created them."*
>
> —Albert Einstein

Throughout this letter, we have cited many of the problems investors and, indeed, all Americans, are facing today. While it's unfair to point out problems without offering solutions, we do not feel conviction about any specific solutions that might stem our financial and economic troubles. We do believe, however, that rules and laws should be introduced to alter today's behaviors. For example, there is substantial disagreement about appropriate tax rates to be levied on middle-class and wealthy Americans. Our opinion is that a pure focus on the earnings and/or wealth of an individual should not be the only basis for determining our tax structure. A major portion of the wealth lost in the U.S. over the past 20 years has actually been due to a massive wealth transfer from Main Street to Wall Street, however, and this has affected all Americans, regardless of class.

Imagine the amount of money that would be generated for the U.S. government if all investment gains achieved in less than 12 months were taxed at 95%. Although we use this extreme number to make a point, one can see that the vicious trading cycle practiced by most participants on Wall Street would come to a virtual halt and force investor behavior toward longer-term thinking with a focus on fundamental value. The balance of capitalism would once again hold sway over today's imbalanced casinoism.

Similarly, we are highly suspect of the independent central banks around the world to coordinate their activities and work interdependently, and in the best interest of a global economy. Imagine if the representative central banks were unified through a global central bank that was chartered with the objective of managing global interest rates and currency flows, with the ability to issue multicurrency bonds. This action would

change the behavior of independent-minded central banks and lead to greater balances in trade and currency around the globe.

Although we can think of other areas that can be rebalanced, we believe the challenge lies in introducing laws and rules that *change behaviors* within the capitalistic environment, as opposed to introducing laws and rules that create further imbalances down road.

* * * * * * *

Let us close this year's discussion with our long-term thoughts about America.

Ever since America was founded as a democratic nation more than two hundred years ago, many around the world have predicted its demise—in some cases, actually wagering against the continued growth of the U.S. Today is no different—many around the world are betting on America's downfall. Of course, when we look throughout history, all wagers on America's demise have lost. Why?

There are two fundamental aspects of America that provide this nation a tremendous competitive advantage. First, we have a culture that is difficult to duplicate. Freedom to choose one's destiny makes up the very DNA of our system, but this type of freedom is far from ubiquitous around the world. Second, no other country in the world stimulates and incubates this essential freedom like America. The U.S. continues to provide the best institutions of higher education while encouraging a culture of innovation, entrepreneurship, and trade. In the U.S., the freedom exists for the hungry to grow—all one needs is desire. Nowhere but in America does the environment exist for companies such as Microsoft, Apple, Google, Cisco, Amazon, eBay, Starbucks, and Facebook—to name just a few—to blossom in a short period of time.

Some may claim that these organizations represent just a fraction of America and are not typically American—not true. Joe McCarthy, whose family emigrated from Ireland, is proof of the American dream in action. More than 50 of Joe's offspring are successfully participating in the future growth of America. In these doctors, lawyers, educators, and entrepreneurs, Joe McCarthy's American values live on.

What is Founders Management Group going to do in this investment environment?

> *"Plan your work, and work your plan."*
>
> —Joe McCarthy

At Founders Capital Management, our activity will remain deeply rooted in the time-tested principles of investment simplicity. We will seek investments in securities that we know and understand, and in assets whose intrinsic value we can fairly estimate. In essence, we have planned our work, and will continue to work our plan:

- **Managing our portfolio in a way that avoids excessive trading**
- **Striving to identify developing risks**—even in areas that have not yet erupted
- **Investing for the long term,** and concentrating on the distinction between what is knowable and important as opposed to what is either knowable and unimportant, or important and unknowable
- **Holding to the conviction that emotional stability and thinking independently from the crowd eventually lead to success,** despite random price fluctuations in the market.

MANAGEMENT'S DISCUSSION & BUSINESS UNIT REVIEW

Equity Holdings: 2010 Highlights

> *"The man who can smile is the man who is worthwhile."*
>
> —Joe McCarthy

Our current portfolio represents a collection of great businesses that we believe are trading at better-than-fair prices and that continue to gain value every day. As Joe McCarthy would have said: "There's not a lemon in the bunch." In fact, we wake up each morning with a smile, knowing that the worthwhile businesses we own—Berkshire Hathaway, Coca-Cola, PepsiCo, Procter & Gamble, Microsoft, Burlington Northern, Johnson & Johnson, Medtronic, Disney, and our other holdings—continue to grow their aggregate earnings and strengthen their businesses independent of any short-term gyration in their stock quotations.

Following is a summary of business highlights from our portfolio companies during 2010, along with our expectations for 2011.

Consumer Group

Our primary consumer holdings—Coca-Cola, PepsiCo, Procter & Gamble, and Kraft Foods—continue to climb the economic pole despite inclement conditions. These companies had an excellent 2010, and we expect our consumer group to produce very good results in 2011 as the recession cloud continues to dissipate.

Why do our specific consumer companies perform well during a difficult economy?

We have mentioned in the past how the daily worldwide consumption of products made by Coca-Cola, PepsiCo, Procter & Gamble, and Kraft enables these businesses to perform better than average in challenging economic environments. Nevertheless, there are many consumer companies vying for a share of the customer's wallet—not just ours. What makes our consumer companies special?

The businesses that make up our special consumer group all have a balanced "push and pull" business system that is difficult to duplicate. When we go to the grocery store and shop for cola, potato chips, laundry detergent, and cheese, we are usually "pulled" to particular brands such as Coke, Frito-Lay, Tide, and Kraft Cheese. Each of these brands carries a special attribute that attracts a large share of consumers—a comfort in knowing that the product is of a certain consistency and quality. The emotional comfort that consumers associate with these brands is produced through repetitive advertising, promotion, and purchases. When a product achieves the special status of being labeled a brand, the ability for a business to "push" these goods to the consumer becomes much easier. For example, if a company knows the consumer desires its brands, it can more easily persuade retailers not only to offer their products but also to give preferential shelf space within easy view and reach of the customer.

A balanced push-and-pull business system allows our consumer companies to use their assets effectively, producing a steady unit sales pattern that leads to consistent production efficiency— maximizing the return on each dollar invested in the business. In addition, a company in possession of a stable of branded products is able to charge higher-than-average prices due to consumer demand.

Businesses that do not have a push-and-pull business system—for example, companies that offer generic brands—suffer as their products become commoditized. Customers do not care about their products and tend to purchase these goods only when they are price-sensitive. Consumers may even expect poorer quality, because the lower price is the only attraction. As you can imagine, commoditized products generate little to no profit for companies that must entrust to the retailer any potential for advertising, promotion, and strategic shelf space.

All our consumer companies—Coca-Cola, PepsiCo, Procter & Gamble, and Kraft Foods—enjoy branded products that are not regarded as commodities by the consumer. These companies usually perform well in all economic conditions. Let's review each of them.

Coca-Cola

During 2010, Coca-Cola grew its overall volume at approximately 4.25% and improved per-share profits by 19%. Coke continues its decades-long remarkable growth in the worldwide beverage market. This company's balanced push-and-pull business system is the envy of all consumer businesses and provides a perfect example of how a corporation creates a large competitive advantage through consumer appeal and retail dominance.

Coca-Cola, the most recognized consumer brand in the world, embodies the American spirit—a feeling of being associated with happy times and freedom that transcends all cultural boundaries. This "brand promise" has resonated with consumers over 100 years of relentless advertising and promotion. Have you ever seen a Coke commercial that was not associated with happiness? Coca Cola has made sure that the happiness section of the consumer's mind is associated with its product—Coke has incredible consumer pull. The company also incorporates flexibility into the Coke product and brand, tailoring it to local markets and tastes without impacting its heritage. Coke is truly embedded in the consumer's mind, and this creates tremendous pull at retail outlets—consumers all over the world specifically seek out Coke.

Most individuals understand the intrinsic "pull" portion of Coke's supremacy but do not fully appreciate the "push" dominance of this company in the marketplace. Coca-Cola has developed an extensive direct-distribution network that enables the company to deliver its products to almost all corners of the globe. Coke also tailors its distribution methods to each country—for example, delivering its products via carts in emerging markets such as India. We believe the company's distribution network is a keystone of the firm's expanding economic moat, enabling Coca-Cola to adapt and deliver new products to consumers at a rapid pace. Coca-Cola continues to balance its investment in production and distribution through the company's recent purchase of Coca-Cola Enterprises—the largest distributor in North America. Focused also on the future, the company has committed $20 billion of investment in four key developing markets by 2020: Africa, Mexico, Russia, and China. Coca-Cola's global manufacturing and distribution footprint has become so dominant that it has become cost-prohibitive for a new entrant to replicate. A final point: We expect per capita consumption of Coke's brands to rise along with disposable income in developing markets, and Coke's developed infrastructure will leave the firm well placed to exploit that trend.

In summary, Coke is not only bringing happiness to the world, but to its shareholders as well. The company will produce approximately $7 billion for shareholders in 2010, up more than 15% over last year. Coke currently pays an annual dividend of $1.76 per share, which represents approximately a 2.7% yield, and we think the company will increase its dividend in 2011—to around $1.85 per share. In 2011, we believe Coca-Cola will grow its earnings per share at 10%, earning around $3.85 per share. This company fits the description of a business you want to keep in your portfolio.

PepsiCo

In 2010, PepsiCo continued to accelerate its global growth, with earnings per share rising around 11%, from $3.71 to $4.13. If Coke can be described as one of the perfect "push and pull" consumer business systems, PepsiCo is not far behind. PepsiCo is business juggernaut that has developed a combined push-and-pull global business system in two areas: Beverages and snack foods. The company's broad portfolio of brands includes Pepsi, Gatorade, Tropicana, Lay's, Doritos, and Quaker Oats—each with large consumer mindshare. The collective consumer pull of PepsiCo's stable of brands creates a unique competitive advantage for the company: Just imagine PepsiCo's sales team walking into a grocery store to negotiate shelf placement for Pepsi, Frito Lay, Gatorade, and Quaker Oats snacks. The retailer is backed into a corner, with no choice but to provide preferential shelf space to all the company's brands—or risk sacrificing a key relationship with a major supplier.

In 2010, PepsiCo purchased and combined two North American distributers—Pepsi Bottling Group and PepsiAmericas—hoping to grow its retail penetration for all PepsiCo products within the U.S. We believe that PepsiCo's vast distribution network, similar to that of Coca Cola, is a keystone of the firm's expanding

economic moat, enabling the company to adapt and deliver new products to consumers throughout the world at a rapid pace.

PepsiCo's vision is to amplify its competitive advantage by further developing a global "one-two punch" in its beverage and food businesses. For example, PepsiCo recently announced that it will acquire a controlling 66% stake in Moscow-based dairy and juice maker Wimm-Bill-Dann for $3.8 billion, with an option to acquire the rest of the company at a later date. This acquisition establishes Pepsi with the largest and most developed food and beverage distribution network in Russia and builds out its noncarbonated portfolio in this crucial growth market. The market for Wimm-Bill-Dann products in Russia has been growing at a fast pace—more than 20% per year—and we expect further growth in this strategic market in the future. In addition, this acquisition gives PepsiCo a base from which to expand its dairy and juice presence more extensively into Eastern Europe. Don't be surprised if PepsiCo's snack business piggybacks on this vast distribution network, delivering Frito-Lay, Doritos, and Quaker Oats products throughout the region. Clearly, developing a strong "push" within your business system can leave many competitors standing in the dust.

In 2010, PepsiCo continued to increase its return to shareholders, raising the annual dividend by more than 6.5%, from $1.80 per share to $1.92 per share. We expect PepsiCo to raise its dividend to approximately $2 per share in 2011, which implies a yield of about 3% at the year-end stock price. After acquiring PepsiCo's key distribution partners, the company reinstated its stock buyback program and purchased more than $3.5 billion of stock in 2010. This action adds another 3.5% return to shareholders, reflecting a 6.5% "look-through" dividend. In 2011, we expect PepsiCo to grow earnings another 10%, to 11%. This is another company that fits the description of a business you want to keep in your portfolio.

Procter & Gamble

We have made a significant investment in one of the largest consumer companies in the world that sells more than three billion products to more than four billion customers every day. We have stated in the past that P&G has one of the strongest stables of leading brands among consumer companies. Brands such as Pampers, Tide, Ariel, Always, Whisper, Pantene, Gillette, Bounty, Dawn, Gain, Charmin, Downy, Lenor, Iams, Crest, Oral-B, Duracell, Olay, Head & Shoulders, Wella, Vicks, and Braun provide P&G an opportunity to exercise a formidable push-and-pull business system that competitors envy.

P&G's worldwide net sales volume is expected to increase approximately 4% in 2010, with earnings per share growing 13%, from $3.53 to $3.98. P&G is accomplishing this growth in revenue and earnings by concentrating on two key areas: Innovation and productivity.

Innovation: P&G has developed a strong innovation pipeline that either extends or adds to its stable of worldwide brands. Some of the product innovations that P&G has introduced over the past year include Fusion ProGlide, Crest 3D White, Pampers Dry Max, Tide Naturals and Tide Plus in India, Gain Dish Care, a Gillette Guard razor in India, and Febreze Set & Refresh. Recently, the company also took Febreze Air Effects into seven countries in Latin America. The company's ceaseless focus on innovation creates ever-increasing sales opportunities over time.

Productivity: Coupled with its sales growth, P&G incessantly seeks cost-cutting opportunities to offset the rising price of commodities. For example, the company plans to cut the number of manufacturing lines in half over the next five years, from 300 to 150. The company also plans to combine smaller brands that are not achieving desired sales objectives, and to shed brands that are not profitable. In addition, P&G analyzes its total expenditures on packaging with an eye on cost-cutting—for example, the company recognized that it was purchasing more than 250 shades of white plastic and decided to streamline the number of color shades it uses when packaging plastic products, a move the company expects will produce annual savings of more than $50 million.

With P&G's "increase sales while lower costs" attitude, we expect the company to earn approximately $4.17 per share in earnings during 2011 and to return a large portion of its $11.5 billion in profits to shareholders in the form of share repurchases and dividends (dividends are expected to be more than $5.25 billion, or $1.92 per share—equal to a yield of approximately 3% at the year-end stock price). We remain excited about P&G's global opportunities and will continue to commit capital to this company.

Kraft Foods

During 2010, we allocated a significant amount of capital to Kraft Foods, the largest packaged food manufacturer in the U.S. and the second largest in the world, with annual sales near $50 billion. We have all heard of Kraft cheese, but the company is much more, including 11 brands that generate more than $1 billion in revenue each, and approximately 70 brands with annual revenues exceeding $100 million each. Although the Kraft name is not on many of these brands, they are familiar to us: Oscar Mayer meats, Philadelphia cream cheese, Maxwell House coffee, Nabisco cookies and crackers, A1 Steak Sauce, Cool Whip, Miracle Whip, Jell-O, Kool-Aid, and Oreos, to name a few. Kraft is large and global in scope, with 159 manufacturing and processing facilities and operations in more than 70 countries. Why our interest in Kraft?

In early 2010, Kraft acquired Cadbury to become a global leader in the chocolate and confectionary categories. When the purchase was announced, analysts were initially disappointed, believing that Kraft's offer for Cadbury was "more than a full price." Many large shareholders who were dissatisfied with the so-called overpayment decided to dump Kraft stock. (When management spends $1.20 for something that is worth $1, shareholders that disagree can vote with their feet—and in this case, a stampede occurred.) We took a close look at the situation and somewhat agreed with analysts' assessment of the rich purchase price for Cadbury—however, we were not current shareholders. Watching Kraft's share price deteriorate from the sidelines, we concluded that the market was overreacting, with shareholders taking Kraft Foods value down, much further beyond what they had overpaid for Cadbury. Being fairly adept at elementary math, when we witnessed investors throwing away $1 of value because the company had overpaid by 20¢, we purchased a lot of Kraft.

Of course, the short-term mathematical equation was not the only reason we purchased Kraft. We think the Cadbury acquisition adds to Kraft's terrific growth prospects. Why? A large portion of the Cadbury acquisition is represented not in chocolate but in chewing gum. Next to Wrigley, Cadbury has the largest stable of global gum brands, including Trident and Dentyne. In our opinion, chewing gum is one of the near-perfect consumer growth products. Unlike other candies or foods, chewing gum is rapidly growing on a global scale, does not spoil quickly, and is easily transferrable. These special attributes allow Kraft to utilize this anchor product to expand into hard-to-reach global markets and to bolt on sales of other Kraft brands. We are pleased with the added long-term growth the Cadbury acquisition may bring Kraft.

Kraft Foods will produce approximately $3.5 billion for shareholders in 2010, up more than 5% from 2009. Kraft currently pays an annual dividend of $1.16 per share, which represents approximately a 3.7% yield at the company's year-end stock price. In 2011, we believe Kraft will grow its earnings per share at a 14% clip, earning around $2.32 per share. This company also fits the description of a business you want to add to your portfolio.

Industrial Group

Our primary industrial and transportation holdings—United Technologies Corporation (UTC) and Lockheed Martin—were profitable in 2010, and we expect these businesses to produce good results in 2011.

How can infrastructure businesses such as these perform well in a difficult economic environment? The key is that each possesses a cemented infrastructure that is difficult to remove and/or duplicate. For example, it has taken more than a century to build the U.S. aerospace and defense infrastructure, and it would take a substantial amount of time and capital to create alternative organizations with expertise to compete with UTC and/or Lockheed Martin. Although defense and aerospace businesses are somewhat capital-intensive compared with most consumer-product businesses, certain attributes make this type of investment attractive in the current environment. When facing a challenging global environment under stressful times, countries continually invest in defense projects to protect their citizens and economic infrastructure. Any increase in long-term defense and aerospace spending (and revenue) over an established infrastructure that is difficult to duplicate spells higher profits for companies such as UTC and Lockheed Martin.

In addition, just as our consumer businesses have a balanced push-and-pull business model, UTC and Lockheed Martin also enjoy a balanced business model that provides a unique competitive advantage: While these companies concentrate on infrastructure products that are extremely expensive to produce and have a slow replacement rate—attributes that normally would be detrimental to a business's profitability—these

companies' products also have a considerable long-term servicing component. For example, when UTC wins a contract for supplying elevators or air conditioners for a building, or when Lockheed Martin wins a defense contract to deliver aircraft such as the F-35 fighter jet, once these products are delivered, the associated servicing contracts can continue for years (since it is highly unlikely that these costly items will be replaced anytime soon), providing a predictable and long-term revenue annuity.

We believe this industrial group comprises a special group of businesses that will produce long-term value for shareholders.

United Technologies

United Technologies (UTC) has an extensive product portfolio that is well known in the commercial and defense market segments. UTC owns firms such as Otis elevators, Carrier air conditioners, Pratt & Whitney jet engines, Hamilton Sundstrand aerospace systems, and Sikorsky helicopters. Each of these UTC subsidiary companies has achieved leadership and powerful market entrenchment in their respective areas of expertise. UTCs' balanced exposure in aerospace and defense reduces revenue uncertainty and helps the firm ride out downturns in the economy. As we stated earlier, UTC derives much of its revenue from servicing agreements associated with the sale of its products—around 42% of the company's $53 billion in revenues comes from aftermarket services. Plus, these services are always in high demand because UTC's products are extremely expensive and are used in critical, heavy-wear applications (one cannot have elevators and jet engines failing).

The pace of global economic recovery and the size of the U.S. defense budget are obvious factors that impact UTC. Despite the slower-than-normal economic recovery and defense outlays that are expected to ease from an all-time high of $708 billion in 2010, we expect UTC to continued expanding its infrastructure-based business in the future. Following are a few highlights:

- **UTC's emphasis on energy-efficient solutions** in cooling and elevators is paying off as overseas markets develop. Growth in the interior of China remains robust, while India and other emerging markets of the world are also quite attractive. During 2010, UTC's sales volume increased more than 35% in India and 29% in Russia, and growth in Brazil has averaged 40%+. The company's sales in emerging markets are now $10 billion and account for 18% of total company revenues.

- **UTC's Hamilton Sundstrand has seen orders rise by 30%**, with volume up 10%. Much of the increase can be attributed to aerospace systems—Hamilton Sundstrand has a $15 billion project to deliver aircraft components and systems to Boeing's 787 Dreamliner. We expect good results in this area during the upcoming year.

- **Pratt & Whitney has a new geared turbofan engine** that will reduce fuel consumption by 12% and noise levels by 10% compared to existing comparable engines. We believe this technological innovation will increase penetration into the commercial jet engine market. On the defense side of the business, P&W is the sole jet engine supplier to the fifth-generation F-22 fighter jet and is positioned to supply the multibillion-dollar F-35 fighter jet program—which would be a big future commitment.

We expect UTC to produce approximately $4.73 per share in earnings during 2010 and to increase earnings to $5.32 per share in 2011. We also expect the company to distribute around $3.5 billion of its $4.9 billion in profits to shareholders through dividends and share buybacks.

Lockheed Martin

Berkshire Hathaway acquired Burlington Northern in 2010. We replaced a large portion of our Burlington Northern holding with Lockheed Martin. A short overview of this company: Lockheed Martin is a $45 billion global security and information technology (IT) company. The majority of Lockheed Martin's business is with the U.S. Department of Defense as well as U.S. federal government agencies. Lockheed Martin is the largest provider of IT services, systems integration, and training to the U.S. government. Lockheed Martin's business also includes sales of products and services to the governments of other countries as well as some commercial sales.

Lockheed Martin's operating units are organized into broad business areas:

- **Aeronautics**, with approximately $12.2 billion in sales, includes tactical aircraft such as the F-16 and F-35 fighter jets, airlift, and aeronautical research and development lines of business.
- **Electronic Systems**, with approximately $12.2 billion in sales, includes missiles and fire control, naval systems, platform integration, simulation and training, and energy programs lines of business.
- **Information Systems & Global Services**, with approximately $12.1 billion in sales, includes federal services as well as government and commercial IT solutions.
- **Space Systems**, with approximately $8.6 billion in sales, includes space launch, commercial satellites, government satellites, and strategic missiles lines of business.

Lockheed Martin interests us for several reasons. First, we expect the company's F-35 jet fighter program to be a huge growth driver for the company. The F-35 is the single largest Department of Defense project. This planned stealth fighter will replace the aging fleet of Air Force F-16, Navy F/A-18, and Marines AV-8B aircraft. The F-35 program is expected to deliver up to 3,173 aircraft to eight countries around the world. In total, this project is worth up to $1 trillion—encompassing $300 billion in new equipment and $700 billion in maintenance contracts—and should power earnings growth for years to come despite stagnant growth in the defense budget. Second, we think Lockheed is positioned to widen its expertise in the promising information systems business. Increasingly, modern warfare depends on information systems to analyze potential threats and secure information assets. We believe that government funding in this area will continue to grow, and we anticipate Lockheed's $12 billion information systems revenue to increase concomitant with this increase in spending.

Lockheed Martin will produce approximately $6.55 per share in earnings during 2011 and should distribute around $2.5 billion to shareholders through dividends and share buybacks. Incidentally, Lockheed Martin pays an annual dividend of $3 per share, which represents an approximately 4.3% yield at the company's year-end stock price. Given this company's high payback to shareholders, we are willing to be patient long-term investors in Lockheed Martin.

Healthcare Group

Our primary healthcare holdings, Johnson & Johnson and Medtronic, achieved profitable growth during 2010, and we expect these medical businesses to grow their earnings throughout 2011.

Notwithstanding ongoing legislation to reform healthcare and the difficulty in predicting the future of drug development, we still believe that investing—at the right price—in a diversified portfolio of healthcare companies that do not carry many of the typical risks associated with this sector can be rewarding. Despite the negative market returns generated by these two companies in 2010, these businesses grew in intrinsic value over the past 12 months. We remain persuaded that Johnson & Johnson and Medtronic are two companies that fit our long-term investment criteria: Each company occupies product segments that are resilient under any economic condition or social reform, and each displays consistent purchasing patterns and strong loyalty from a growing customer base. It is our opinion that both companies are positioned to do well as the global population increases and ages in the coming decades—and we believe both are now selling at "better than fair prices."

Johnson & Johnson

J&J is the most diversified healthcare company in its sector, with more than 250 companies selling to every country in the world. The company competes in three healthcare segments—Consumer, Pharmaceutical, and Medical Devices and Diagnostics—that constitute approximately 30% of the $4 trillion global healthcare market. Although J&J is a very large company, its sales represent only about 5% of total sales in the sectors in which it competes—the other 95% represents future potential. J&J's diversified approach are key reasons the

company has been able to deliver an exceptionally consistent performance for decades, racking up more than 75 consecutive years of sales increases—and we imagine this will continue. With its entrepreneurial culture and decentralized management style, we think the company will continue to adapt and take advantage of growth opportunities.

Given the large market opportunity in the healthcare market, J&J continues to broaden its horizon in its categories. The company's recent vaccine, aesthetics, and biosurgical products acquisitions are part of the ongoing strategy to diversify into new long-term opportunities. In addition, J&J recently announced its acquisition of the remaining 82% of Crucell (J&J already owned approximately 18% of this company). J&J's $2.3 billion offer for the rest of this Dutch biotechnology company makes this its largest acquisition in the last four years. J&J's previous major acquisition was in 2006, when the company paid $16.6 billion for Pfizer's consumer products division—a portfolio that includes brands such as Listerine, Visine, and Neosporin. J&J's purchase of Crucell moves the company toward a focus on developing vaccines, proteins, and antibodies to fight infectious diseases—creating, we think, a huge revenue and profit opportunity.

We also remain positive on J&J's pharmaceutical pipeline: We think that J&J's key upcoming drugs—Xarelto (stroke prevention), telaprevir (Hepatitis C), and abiraterone (prostate cancer)—are blockbuster opportunities. All three drugs could be launched by early 2012 and will further help to accelerate J&J's earnings growth over the next five years.

Finally, we remain encouraged about J&J's prospects in emerging markets. The most significant opportunities will come from the BRIC countries—Brazil, Russia, India, and China. These growth areas will also contribute to the company's expansion in the coming years.

J&J will earn approximately $4.75 per share in 2010 and should grow earnings at slightly above 5% in 2011, to $5 per share. The company generates more than $11.5 billion of owner earnings and will return this cash to stockholders through continual share repurchases and close to $6 billion of dividends (a 3.5% dividend yield at the year-end stock price). Given the current return to owners of this company, along with its optimistic future, J&J remains a very attractive position in our portfolio.

Medtronic

We have accumulated a large position in Medtronic over the past few years. Medtronic is the leader in implantable cardioverter defibrillators (ICDs) and other devices for managing out-of-step hearts. The company also continues to be a leader in devices that manage chronic diseases of the spine, pancreas, and brain. The stock price of Medtronic has stalled since our initial investment—many analysts believe the company's core franchises in the cardiac rhythm management and spinal businesses have slowed down as patient volume has fallen off and managed care has begun to push back on reimbursement. Yet we remain excited about this long-term investment. Why?

Medtronic is positioned to launch its new product cycle, starting off with the first-to-market MRI-compatible pacemaker in Europe. Medtronic is also set to roll out its next-generation spinal products in 2011, which should further solidify its leadership position in this important market. The company has also refocused on what it does best: Innovation and growing markets by acquiring technology. The company has now infiltrated areas of potential emerging therapies, including atrial fibrillation, transcatheter aortic valves, drug-coated balloons, and regenerative biologics. Although these opportunities may not come to fruition right away, we are confident that Medtronic will be able to maintain its competitive advantage in the future.

Medtronic announced a major acquisition in 2010: It has acquired the remaining 89% of Ardian that it does not own for $800 million upfront, plus milestones through the end of 2015 equal to annual revenue growth. We are thrilled with this acquisition. Ardian's product is the Symplicity Catheter System, a radiofrequency (RF) ablation procedure for renal denervation (RDN) in patients with treatment-resistant hypertension. RDN is a catheter-based procedure that uses low-power RF energy to deactivate the renal sympathetic nerves, which is believed to reduce hyperactivation of the sympathetic nervous system that is often the cause of chronic hypertension. The procedure may also allow patients to reduce or eliminate the need for lifelong antihypertensive medications, and may also be used to treat other conditions characterized by elevated sympathetic nerve activity such as heart failure, diabetes, and chronic kidney disease. Given the number of patients suffering from hypertension, market potential could exceed $1 billion.

The company estimates that more than 25 million people in the U.S. could be candidates for the procedure. The product is approved in Europe and Australia, with a clinical trial expected to begin in the U.S. in early 2011. It is our opinion that the product could be available for market by 2014 (we think long-term).

We expect Medtronic to earn approximately $3.40 per share in its fiscal year ending April, 2011 and to grow earnings 8% in the following year, to approximately $3.67 per share. The company is also returning money to shareholders via a 90¢ per share dividend, yielding 2.4% at the year-end stock price. We believe that Medtronic remains undervalued, and we plan to hold this quality healthcare company in our portfolio over the long term.

Technology Group

Microsoft

Microsoft, our largest technology holding, had very good business results in 2010, and we expect the company's growth to continue in 2011. Currently, the investment market is underappreciating the strides this technology powerhouse is making in the marketplace. It is our opinion that Microsoft remains a perfect example of a company that exhibits a disparity between its market price and intrinsic business value. We estimate that Microsoft's intrinsic business value has significantly risen over the past five years, and during this same time frame, the company's stock price has remained flat.

What do we think of Microsoft's current valuation? The company's current market capitalization is approximately $240 billion, including $45 billion of cash on the company's balance sheet—total debt is only $10.5 billion. Microsoft will likely generate more than $20 billion of cash in 2011, and this is expected to grow at 8% to 10% per year. Under this scenario, Microsoft would still be able to buy back most of the company from shareholders in less than 10 years. In this case, we don't need to come up with an "exact" number that reflects Microsoft's value—we just know these numbers reflect a business that is trading at a big discount to the company's intrinsic value.

Microsoft continues to roll out successes in the corporate market despite its so-called missed opportunity in the consumer smartphone and computer tablet areas:

- **Windows 7:** The next generation of Microsoft's operating system released in October 2009 will catalyze sales as corporations face an enterprise refresh cycle over the next few years. Approximately 90% of personal computers (PCs) in the workplace are still running Microsoft's XP or Vista operating systems, and the largest share of the Windows 7 corporate upgrades will take place in 2011 and 2012. According to a recent survey of corporate technology decision-makers, 80% of companies are in the process of upgrading to Windows 7 or are looking to upgrade in 2011. The number of corporate PCs that need to be replaced due to technological obsolescence has never been higher. It is estimated that more than 250 million business PCs are at least four years old. This PC replacement cycle will invigorate the movement to Windows 7 and fuel enterprise upgrades through 2012.

- **Microsoft's Enterprise Business** that serves the corporate market generates 70% of the company's income and is extremely strong across all Microsoft platforms—Office, Windows, and Servers. This segment will drive double-digit billings growth in future years and lead to positive earnings growth. The corporate enterprise refresh cycle is also in early stages, and Microsoft believes it could achieve 70%-80% Windows 7 penetration in the enterprise area—much higher than any previous system release. We believe that more than 90% of corporate enterprises will buy new Windows licenses. We also consider Microsoft's large established moat around its franchise in the corporate market—can you imagine the cost of removing this company's software across all areas for a company like United Technologies or General Electric? It would be astronomical.

- **Microsoft Kinect:** Microsoft recently introduced a new product: Kinect, which is a hardware extension to the Xbox gaming console that allows games to be played with only body movement—without a controller device. This innovative consumer device also contains robust voice and facial recognition. We believe this device has applications far beyond gaming, with the potential to change the way we interact with technology. Sales of this product are robust—the company expects to report sales of

more than five million Kinect systems during the 2010 holiday season. If these projections bear out, Kinect will be the fastest-selling device of all time, at an introductory sales rate 2.5 times faster than that of the Apple iPad.

- **Microsoft Tablet 7?:** A good deal of investor uncertainty has accompanied the computer tablet's impact on the PC market and on Microsoft's consumer business—all legitimate. Nevertheless, we are not discounting Microsoft in this important area and, in fact, believe that Microsoft will have a more meaningful position in the tablet segment in 2011 and 2012 than the pundits predict. Why? We believe that Microsoft will release a mid-cycle version of Windows 7 that is specific to the tablet market. Windows Tablet 7—sold on devices made by Hewlett Packard, Dell, Sony, Toshiba, etc.—is expected to feature a user interface that responds to touch and to be consumer tablet-friendly. In addition, similar to what the company has done with Windows Phone 7, it is our opinion that Microsoft will work with tablet manufacturers to execute hardware requirements that will provide confidence to application developers that their "apps" will run fluently on all "Windows 7 Tablet Edition" devices. Incidentally, this would be in contrast to Google's Android. (An ongoing concern about Android is the lack of complete specifications for its operating system—application developers cannot be sure that a manufacturer's smartphone or tablet will have all the features necessary for their application to run smoothly.) Finally, we expect Microsoft to eventually establish Windows Marketplace as the company's version of Apple's iTunes Store. In summary, we are not overlooking Microsoft's future in the consumer tablet market.

Microsoft will earn approximately $2.45 per share in its fiscal year-end, June 2011, and should grow earnings at 10% the following year, to approximately $2.70 per share. The company will generate more than $20 billion of owner earnings and will return this cash to stockholders through share repurchases of $10 billion and $5.5 billion of dividends (an approximate 6.5% look through dividend yield at the year-end stock price). Given the current return to owners of this company, along with its optimistic future, Microsoft will remain a large position in our portfolio.

Financial Services Group

Berkshire Hathaway

Berkshire Hathaway should show an additional increase in shareholder equity of approximately 20% in 2010, from $135.8 billion to $162 billion. Even though Berkshire's book value (a measure of a company's worth if all its assets were liquidated) has grown at more than 75% since the end of 2005, the company's stock price has only increased 35% in the same time frame. Although we think Berkshire is currently selling at around its intrinsic value, we would highlight that this valuation is somewhat depressed due to a down insurance market and the company's construction-oriented businesses, including, Shaw, Manville, ACME Brick, Mitek, and Benjamin Moore. Berkshire's earnings from its building enterprises have decreased, from $1.3 billion to around $0.2 billion. With a turnaround in the economy these businesses will fare better, at which point we believe Berkshire will be worth more than its current stock quotation.

Of course, many experts also think that Mr. Buffett will not be able to grow Berkshire's intrinsic value in the future at the same rate as in the past—we agree. We also believe, however, that the company remains poised to allocate capital in an exceptional way during this difficult economic period.

During the financial crisis of 2008, Berkshire was in the enviable position of having a high level of cash on its balance sheet. As a result, in the midst of the most distressed financial markets in decades, Mr. Buffett went on his biggest spending spree in history. Berkshire made investments in a number of high-quality companies at highly distressed prices:

- **Berkshire invested $6.5 billion with the Mars family to purchase the Wm. Wrigley Jr. Company.** In exchange for this investment, Berkshire received $2.1 billion of preferred stock and $4.4 billion of "subordinated notes" due in 2018. The notes will be held to maturity and are currently collecting annual interest at 11.45%.

- **Goldman Sachs Group, Inc. agreed to sell $5 billion of perpetual preferred stock to Berkshire Hathaway in a private offering.** The preferred stock has a dividend of 10% and is callable at any time at a 10% premium. In conjunction with this offering, Berkshire Hathaway received warrants to purchase $5 billion of Goldman Sachs common stock with a strike price of $115 per share, exercisable at any time for a five-year term. (These warrants are now very profitable, given Goldman Sachs' share price exceeding $165 at the end of 2009.)
- **General Electric sold $3 billion of perpetual preferred stock to Berkshire Hathaway.** The preferred stock has a perpetual dividend of 10% and is callable after three years at a 10% premium. Berkshire Hathaway also received warrants to purchase $3 billion of GE common stock with a strike price of $22.25 per share, exercisable at any time for five years.
- **Berkshire acquired a 12% convertible perpetual capital instrument issued by Swiss Re** at a cost of three billion Swiss francs.
- **Berkshire acquired three million shares of Series A Cumulative Convertible Perpetual Preferred Stock of The Dow Chemical Company** ("Dow Preferred") for a cost of $3 billion. The Dow Preferred was issued in connection with Dow's acquisition of Rohm and Haas.
- **And finally, the big one—BNSF:** During 2010, Berkshire closed on its Burlington Northern acquisition, purchasing the remaining 77% of BNSF Railroad that it did not already own for $26 billion—valuing the entity at $44 billion, including the assumption of $10 billion in debt. Mr. Buffett's investment is a bet that railroads will increase their relative share of the transportation market as fuel prices increase, and that the U.S. economy will grow in the future (increasing the amount of goods being transported)—so far, so good.

The benefits of these investments are translating into higher earnings for Berkshire. We expect segment earnings to rebound from depressed 2009 levels to $10.8 billion in 2010, and estimate that earnings should grow to $11.4 billion in 2011.

Berkshire's basic business model is making investments in and/or buying good companies at attractive valuations with low-cost funding. Mr. Buffett has been highly successful at buying businesses that generate very high levels of cash flow that accumulates over time—and then effectively reallocating this cash to ever-increasing opportunities. Mr. Buffett is clearly a very intelligent investor, picking up $1 of today's value for the price of 65¢.

This business model has also resulted in a high level of cash accumulation at Berkshire—the company is virtually gushing cash of more than $10 billion a year. As a result, by the end of 2011, Berkshire will likely replenish 100% of the approximately $45 billion in cash that sat on its balance sheet prior to the 2008 financial crisis. In the meantime, Mr. Buffett is currently sitting on approximately $35 billion, waiting for the next onslaught of investment opportunities to come along—and we believe that he will have opportunities to deploy this cash at very favorable returns.

In summary, we remain pleased with Berkshire's progress and Mr. Buffett's excellent capital allocation talent. We will continue to be enthusiastic holders of Berkshire Hathaway, and we look forward to watching the intrinsic value of this holding grow in the upcoming years.

Retail Group

Our major retail holdings, Home Depot and Walgreens, had a very good year in 2010 as retail purchases recovered due to increased consumer activity. Notwithstanding this recovery, we remain very interested in our large, industry-specific retailers that have gained economic value throughout the recession. In the past few years, the retail sector has undergone consolidation as smaller competitors were forced out of business. This has been especially true in specialized areas such as home improvement and pharmacy retailing. The retail areas in which we are invested involve a couple of two-horse races—between Home Depot and Lowe's in the home improvement market, and between Walgreens and CVS in the retail pharmacy market. All four are

gaining ground in this difficult economic era. In our view, it is nearly impossible for new competitors to gain a foothold in these specialized retail segments that require substantial infrastructure and real estate development.

Home Depot

Although home repair and remodeling remains slow as a result of the recession and significant housing downturn, Home Depot is seeing an upturn in its business performance. Nevertheless, we believe that continuing pressure on housing prices in 2011 due to factors such as continued foreclosures, an inventory glut, and rising delinquencies will weigh on a robust U.S. economy recovery and on Home Depot.

In last year's letter, we pointed out how Home Depot was making great strides in improving the company during this difficult period. Since then, the company has rolled out a new distribution system along with innovative information technology tools to exploit efficiencies in merchandising, store operations, and transportation.

Home Depot's Rapid Deployment Centers (RDCs) were at the epicenter of the company's plan to reduce its cost structure and improve sales. As you may recall, the RDCs were to provide Home Depot a more flexible flow of inventory throughout its extensive store network, along with better insight into inventory levels at the stores and within their supply chain. The RDCs proved to be a success, and as a result, in early 2010 Home Depot reported its first rise in sales at stores that had been open at least one year since 2006—quite a long time.

Home Depot is also placing an emphasis on improving in-store customer service. The company's management team is working to simplify the store environment, create high service expectations, and leverage technology. One tool that will help the company achieve this set of objectives is the Home Depot FIRST Phone. The FIRST Phone device allows Home Depot's associates to engage more effectively with customers by quickly locating products that the consumer may need. The device also acts as a mobile register to decrease customer wait time and improve the quality of cashier checkout. You may have seen similar mobile customer platform devices used by associates at an Apple Store—they make assistance and checkout easy.

Home Depot has been reporting improved results throughout 2010, and the company is resuming store growth, with plans to open 10 new stores next year—which would bring its total store count to more than 2,250. Long-term, the company is indicating that it expects to open 44 new stores through 2013, including about 20 new stores in Mexico. It is our expectation that Home Depot will place greater emphasis on international growth as emerging economies continue to flourish.

We expect Home Depot to earn approximately $2 per share in 2010 and to increase its earnings 14% in 2011—to $2.28 per share. Given the negative housing conditions, this is incredible performance. The company will generate more than $4 billion of owner earnings and will return this cash to stockholders through share repurchases of $2.5 billion and approximately $1.6 billion of dividends (a 7%+ look-through dividend yield at the year-end stock price). We remain confident that Home Depot is doing the right things for the company, its customers, and its shareholders, and we will remain committed owners of Home Depot.

Walgreen Company

The Walgreen Company is one of the powerhouse retail firms that is emerging from the difficult economy and changes in healthcare. The company's large store base offers consumers unmatched convenience, its brand name is one of the most recognized in the retail pharmacy business, and there is a Walgreens store within five miles of 70% of U.S. households. The company also owns the real estate beneath 19% of its stores—a hidden asset. It is our opinion that it would be a near-impossible task for a startup competitor to match the Walgreen Company's convenience and brand pull with its customers. In the future, Walgreens will benefit from an aging population base in the U.S., continued growth in the pharmaceutical market, and an overall increase in healthcare spending—especially in patient healthcare maintenance.

The healthcare market continues to evolve, leading to several changes in the past few years. The U.S. population base is continuing to age, with more than 30% of Americans turning 65 during the next 10 years. Along with this fact, 30 million more Americans are expected to gain healthcare coverage. Unfortunately, there is a higher incidence of chronic diseases among individuals today—especially diabetes. These trends are

expected to continue and will drive growing demand for prescription drugs and healthcare-related services. In this new healthcare environment, it is our expectation that information will be more readily available to consumers, enabling patients to shop for healthcare services. It is our firm opinion that Walgreens is in a "sweet spot" to build a different and unmatchable experience for its growing customer base. How?

Walgreens' plan is to evolve from a retail drugstore to a retail health and daily living destination. Company management envisions putting the Walgreen brand within an arm's length of everyone in America using several tactics:

- **A large number of retail locations:** There are currently 7,600 Walgreens drugstores located in communities throughout America. Approximately six million patients visit Walgreens stores every day.

- **Investing heavily in e-commerce and mobile-commerce:** These so-called multichannel offerings increase customer satisfaction and reach and will drive additional growth without the need to add bricks-and-mortar real estate.

- **Providing a customer-focused network of healthcare providers:** Through 26,000 certified immunizing pharmacists, 728 Take Care Clinics and worksite locations, and 119 medical campus pharmacies, Walgreens is bringing its name to the frontline consumer at critical touch points.

The Walgreens of the future is aiming to become much more than a retail pharmacy. We think the company's planned evolution to offer consumers a more integrated package of health-care services will create significant value for shareholders.

In the meantime, we are pleased with the continued positive results The Walgreen Company is achieving during a challenging retail economy. The company earned approximately $2.13 per share in its fiscal year-end, August 2010, and should grow earnings at 20% in 2011, to approximately $2.56 per share. The company will generate more than $2.5 billion of owner earnings and is expected to return this cash to stockholders through share repurchases of $2 billion and $650 million of dividends (a 7%+ look-through dividend yield at the year-end stock price).

Media Group

Media and communications is a unique business due to its reliance on the ongoing development of infrastructure (internet, cable, etc.), as well as the necessity to create and distribute "great content" to customers. In no other business can a customer switch loyalty as quickly as in the media business. For this sole reason, it is important to choose media companies that have a special toehold in the marketplace. In this category, we have assembled several of the best media businesses in the industry. Disney and Comcast, our largest media holdings, continue to grow and deliver great news, stories, and shows to America every day.

During 2010, companies across the media landscape continued to retrench to survive the toughest economic environment since the Great Depression—and Disney and Comcast were no exception. Although this sector has experienced a recovery in advertising expenditures, on which most media companies rely, a resurgence in profitability is in the early stages. Disney and Comcast fare better than most competitors in this area, since they are less dependent on advertising as a source of revenue. We remain confident that Disney and Comcast will continue to gain competitive strength during the economic downturn due to their solid foundations in family entertainment and in cable and Internet.

Walt Disney Company

During 2010, Disney's revenues and profits recovered as a result of increased bookings at its theme parks, delivery of creative content *(Toy Story 3)*, and increased advertising—especially at ESPN. Following are highlights from Disney's main business segments:

- **Parks and Resorts:** In 2010, Disney reported an improvement in bookings and visitors to its theme parks. Although this business segment experienced a 7% reduction in operating income for the past

year, the company announced that hotel bookings for the first quarter were up 5% over the same quarter last year. This is noteworthy not only because it represents the best bookings pace in a few years, but it has taken place in spite of higher hotel prices, which are also up 5%. Coupled with the company's recent price ticket increases at both Disney World and Disneyland, we think that as the economy improves, the positive trend in theme parks will lead to increased profitability in 2011.

Disney has also moved one step closer to a deal for a Shanghai theme park. Located in the city's eastern Pudong district, the amusement would be a Magic Kingdom-style theme park with characteristics tailored to the Shanghai region. This theme park is worth highlighting as it will be a meaningful development with regard to Disney's future in China, serving as an anchor to drive content and consumer products sales throughout this huge market.

- **Cable Networks:** Disney's cable networks reported a robust recovery in advertising in 2010, with revenues and operating income increasing 9% and 5%, respectively. ESPN was a star performer, reporting a revenue increase of 19% during the recent quarter. Of course, the underlying driver of this revenue growth was an increase in advertising, which grew 22% over the previous year's quarter. Even more encouraging is the continued double-digit pace that management expects ESPN to keep in the upcoming quarter, making for a robust 2011. ESPN is a diamond in Disney's vast array of growing properties—one that many investors never associate with the company.

  In the first quarter of 2011, the Disney Channel will debut Disney Junior, a new multiplatform brand targeting children ages 2-7 and their families. Disney Junior will be available on basic cable in more than 99 million U.S. homes and to millions of other viewers on 25 Disney Junior channels as well as free-to-air broadcast partners around the world. It will also be available via video-on-demand and at www.DisneyJunior.com. During 2012, Disney Junior will also debut as a basic cable and satellite channel in the U.S.

- **Broadcasting:** Disney's broadcasting division reported an increase in revenues and operating profits of 1% and 30%, respectively, in 2010. Even with this increased profitability, Disney's main broadcasting network—ABC—continued to struggle as consumers enjoy expanding choices presented by cable and other distribution outlets (including devices such as the Apple iPad). Individuals are slowly choosing to tune out of traditional network television. Given this negative trend, Disney's year-over-year broadcasting revenue declined 7% in the most recent quarter, and we expect revenue in this area to decline an additional 10% in the upcoming quarter. TV production is increasingly challenging—new hits are hard to come by, and older shows fade—ABC's *Ghost Whisperer* and *Lost* are cases in point. Although the network is undergoing a cost-containment program, we expect increased profitability in Disney's broadcasting segment to remain challenging due to anticipated lost viewership over the long term.

- **Studio Entertainment:** Disney's studio revenue grew 9% over the previous year, with profits increasing from $175 million to $693 million. The Walt Disney Studios achieved a first-time feat this year with two animated films grossing more than $1 billion each—*Toy Story 3* and *Alice in Wonderland*. Recent positive results were driven largely by the international box office performance of *Toy Story 3* and the related sales of *Toy Story 3* merchandise. Yes— Disney optimizes its profits via sale of merchandise associated with characters in its animated movies.

  In addition to movies and merchandise sales associated with each movie, Disney extends its brands through theatrical performances. For example, Disney's theatrical performance in the most recent quarter was also led by the international performance of *Toy Story 3* (which sold an estimated $140 million in the U.S. in 90 days, and about $400 million internationally). To round out the profits in the studio division, Disney releases home videos of its movies. The company released *Iron Man 2* in September 2010 and announced that one million units had sold on the first day, and that five million units were shipped during the first week. Clearly, the making of one successful movie leads to an ongoing profit stream for Disney.

Even under stressful business conditions, Disney remains incredibly profitable. We still believe that Disney has stronger long-term growth prospects than most investors realize due to the company's highly competitive

position within the media and entertainment industry. Disney's broad range of content and growing international presence allow the company to extend its reach throughout the world.

Disney earned $2.03 per share in its fiscal year-end, October 2, 2010, and should grow earnings at 20% in the current year, to approximately $2.45 per share. The company will generate more than $4.0 billion of owner earnings and is expected to return a large portion of this cash to stockholders through share repurchases of $2.5 billion and $750 million of dividends—and to use the remaining $750 million to reduce outstanding debt. Given the increasing value this franchise is creating, we will remain excited long-term holders of Disney.

Comcast

We hold a position in Comcast, the largest cable provider in the U.S. The firm's networks reach approximately 50 million households. In addition, Comcast offers customers high-speed Internet access and phone service.

In 2011, Comcast will close on the company's joint venture with General Electric, which will hold GE's NBC Universal assets and Comcast's cable networks assets (including E!, Style, E! Entertainment Television, the Style Network, Versus, Golf Channel, G4, and a collection of regional sports networks). This new company, which Comcast will initially own with a 51% controlling interest, combines Comcast's cable franchise with NBC Universal, the fourth-largest media and entertainment company in the U.S., with assets spanning cable and broadcast television, TV production, digital media, filmed entertainment, and theme parks and resorts. Over time, Comcast would like to leverage its strong cable distribution network with NBC Universal's content to increase profitability. For example, this distribution/content combination could alter the movie industry—when Universal Studios comes out with a new movie release, it is highly likely that the film would be assigned priority showing through Comcast's On Demand service, prior to release to after-theater distributors such as Blockbuster and Netflix. In the relatively near future, we may be ordering most movies soon after release through cable television. This change may also hold true for television viewing, since NBC content could be shown anywhere, at any time, through Comcast.

Comcast will have the opportunity to increase its ownership of this joint venture over a seven-year period. GE will have the right to redeem 50% of its interest at year 3.5 and its remaining interest at year 7. The arrangement for NBC Universal was made in such a way that Comcast could absorb NBC Universal in due course without negatively impacting Comcast shareholders. GE would also not have to sell its complete interest in NBC Universal at a discount during the current recession. In the meantime, since both parties are near-equal owners, they have an incentive to grow the joint venture's value over the next seven years.

Comcast continues to leverage its cable assets and should grow free cash flow at approximately 15% per year over the next five years—from $4 to $8 billion. This will have a positive impact on the amount of money Comcast distributes to shareholders. Comcast currently distributes $1 billion in annual dividends —$0.38 per share. The company also intends to complete the $2.4 billion remaining on its current share repurchase authorization over the next 24 months. We think Comcast has talented management a bright future, and we plan to keep this company in our portfolio.

Commodities Group

Our Commodity Holdings include Barrick Gold, Central Funds of Canada, Chevron, and ConocoPhillips, along with smaller positions in several other oil companies. In the latter part of 2004, we began investing in commodities such as gold, silver, and oil for two core reasons:

- Given the growing U.S. debt, we believed that the value of the U.S. dollar would deteriorate over the long term, and that the country would have no choice but to eventually inflate away its rising debt. This assumption continues to prove correct, and thus we have not changed our view. We believe our country's ongoing lax monetary policies will likely result in a continuing deterioration of the U.S. currency. Over a long-term period in which the dollar has continued to lose relative strength against other world currencies, gold and silver have respectively risen to around $1,400/oz. and $30/oz.

  We have stated before that changes in the dollar's value will not be the only factor in determining the price of certain commodities. The U.S. is not the only country printing money to bail out its financial

system—the European Union is coming apart at the seams as countries such as Portugal, Italy, Greece, and Spain face mounting debt problems. The European Central Bank has no choice but to lend and eventually print money to bail out these sovereign nations. This fact further supports the argument for higher long-term commodity prices, since a growing world money supply can ultimately lead to global inflation and a deterioration of all fiat currencies.

- There continues to be a long-term growing imbalance between commodity supply and demand. For example, daily worldwide oil consumption is almost back to pre-recession levels of approximately 86 million barrels of oil per day. It is our opinion that "safe" worldwide oil production capabilities are about equal to current demand. Demand for energy is increasing, however, as emerging economies grow at a rapid pace. In 2010, Lloyds of London issued a report that stated the following: "We could witness an oil supply crunch because of increased Asian demand. Major new investment in energy takes 10-15 years from the initial investment to first production, and to date we have not seen the amount of new projects that would supply the projected increase in demand."

Gold & Silver

When one first considers gold as an investment vehicle, it makes little to zero economic sense. The metal has no utility—all the gold produced from the beginning of time still exists. This metal is dug up from the ground, refined, and then placed in permanent storage—and individuals pay an ongoing fee for this privilege. From time to time, however, another aspect of this metal comes into consideration: Gold has no utility until it has utility.

Since the beginning of civilization, gold has been used as a form of currency. The metal's disassociation as a form of currency occurred in the early 1970s, when the U.S dollar was taken off the gold standard, no longer officially backed via exchange for gold, but by the good faith of the U.S. government. Today, there is not a currency in the world that is backed by anything but the good faith of its issuer. Unfortunately, the good faith of all currency issuers is waning as governments mired in debt throughout the world are printing money and debasing their paper currencies at a rapid pace. Naturally, currency debasement is not new and has origins as far back as 400 BC, when Dionysius of Syracuse ordered all the coins in the city brought to him upon penalty of death. Dionysius performed similar magic to modern-day governments: He restamped each coin so that it read two drachmas instead of one drachma. This ancient story of Greece is not unlike what we are witnessing today—except that the situation now is a lot more sophisticated. Governments around the world are issuing debt, and then repurchasing this same debt with money produced out of thin air —in essence, printing more and more money, and turning $1 into $2. In this environment, as citizens around the world begin to understand that their paper currency is slowly losing its utility, they are attempting to find new utility in the time-tested currencies of gold and silver.

Our investment in gold and silver is an attempt to find alternative utility to the debasement of global currencies. Because we like to place capital in companies that have true utility and produce economic value for shareholders, in 2004 we decided to invest primarily in Barrick Gold Corporation, a gold and silver mining company. Barrick Gold Corporation has mines that span the globe and is the world's largest gold producer, as well as a significant silver producer. This precious metals giant is targeting increased annual production of gold by roughly 6% in 2010 and is expected to produce nine million ounces of gold within five years—the company produced 7.4 million ounces in 2009. With the soaring prices of gold and silver, Barrick is generating a lot of cash.

Barrick is expected to earn $3.25 per share in 2010 and should grow earnings at 20% in the upcoming year, to approximately $3.90 per share. The company is expected to return a portion of its earnings to stockholders through a distribution of $400 million in dividends. The remainder of the owner earnings will likely be used to repurchase shares and/or reduce the company's outstanding debt.

We also have a sizeable investment in gold and silver bullion through our interest in Central Fund of Canada, a specialized investment holding company that purchases gold and silver in the open market and stores the bullion in a bank vault. Central Fund's net assets at market value are approximately $4.5 billion, represented by approximately 56% gold bullion and certificates, and 45% silver bullion and certificates.

Oil

We made our initial oil investment in Chevron, a leading international integrated oil and gas company with operations worldwide, in early 2005. At that time, we felt rather confident that an imbalance in worldwide oil supply and demand would push long-term oil prices higher, increasing profits of integrated oil companies. Since our initial allocation of capital to this sector, our confidence has been further emboldened due to the lax monetary policies of the U.S. central bank (and other central banks around the world). The majority of the world's oil is priced and traded in U.S. dollars, and we now think the price of oil may rise quite a bit higher in the future than we had originally envisioned. Therefore, during the market downturn, we increased our exposure to integrated oil companies through investments in businesses that we felt traded at significant discounts to their long-term values such as ConocoPhillips and other integrated oil companies. In summary, we now have a rather large investment in the energy sector and anticipate oil trading at more than $90 a barrel.

Compounding the problem that supply/demand challenges and monetary policy will have on the price of oil: This commodity is becoming more difficult and expensive to find. The recent BP deepwater drilling disaster in the Gulf of Mexico highlights the literal depths to which the industry is pursuing new oil discoveries. As this crisis developed, we made an investment in the deepwater drilling sector when the stock of these companies plummeted by more than 40% due to the short-term drilling embargo enacted after the Gulf oil disaster. We did not think deepwater drilling would be banned indefinitely—and this ban has now been lifted.

In the meantime, our combined oil holdings are gushing cash. The average dividend being paid by our integrated oil companies is greater than 3%—essentially, in this case we are being "paid" for our insurance against future inflation.

Fixed-Income Investments

The Morningstar taxable bond index was up 7.7% in 2010. This positive result follows a 14% gain in 2009. The credit market has recovered quickly, with investors aggressively purchasing fixed-income securities. In fact, since the credit crisis, investors have been so skittish about the stock market that they threw a net $600 billion into bond funds while removing a net $55 billion from equity funds. Bottom line: Investors are leery of the stock market when they should really be concerned with the fixed-income market.

It is our opinion that too much money is now chasing too few opportunities in the fixed-income area, bidding up bond prices to what we think are bubble levels. (By the way, this statement is not a prediction that the bond market is about to experience a disastrous fall—bubbles can persist far longer than most predict.) We need to remind ourselves, however, that the "deterioration" in credit quality remains among most fixed-income instruments (including governments), and the "real risk" still resides in the credit market, not the stock market. Recently, the most frequently traded bonds have been high-yield bonds. These "junk bonds" are being lapped up by investors seeking mediocre returns associated with high-risk companies. In our opinion, many of these bonds will end up living up to their name in the coming years: *Junk*.

We continue to emphasize several points that concern us about fixed-income instruments. Looming risks associated with this "secure investment vehicle" include the possibility of future rising interest rates and even greater chances of default. We believe that long-term market interest rates may move upward in the future as the Federal Reserve begins to struggle with maintaining low interest rates and high liquidity in the market. The Federal Reserve could pull back on its goal to assist banks to recover losses and allow leveraged borrowers to refinance their debts. On the other side of the Federal Reserve coin: As incoming data show continuing housing difficulties and rising mortgage default rates, we may experience a prolonged loosening of monetary policy, resulting in a permanent increase to the money supply. (We won't even begin to think of the consequences on interest rates if default levels increase on municipal debt, and states require federal assistance to back their local governments.) If the Federal Reserve continues to put the "pedal to the metal" on quantitative easing (money printing), the market response is likely to be a rise in long-term interest rates as inflation threatens to take hold of the economy.

In 2010, we have had several tranches of municipal and corporate bonds come due. We have continued our strategy of avoiding longer-term fixed-income investments, which are more sensitive to rising interest rates,

and are carefully allocating money to shorter-duration fixed-income securities (one to seven years), given that interest rates and default rates may rise in the future. We are avoiding speculative investment activity and maintaining our attitude of finding the best-yielding securities, understanding the risks we are taking with each individual fixed-income allocation.

In summary, we remain concerned about:

- **Unresolved long-term issues related to lax lending practices** by major banking institutions that have not yet worked through the system
- **The possibility of higher inflation** in the future due to an expanding money supply
- **Long-term rising commodity prices**

In this volatile environment, we will stay committed to short- to mid-term fixed-income opportunities that offer a fair risk-and-reward profile.

WHAT'S NEW AT FOUNDERS?

In 2010, we continued to evolve our business. We are fully utilizing Bloomberg, a computer system that has enabled us to better monitor and trade fixed-income instruments. We previously mentioned that bonds are priced (and traded) very differently than stocks. Bonds are more akin to a private transaction that takes place between a buyer and a seller—in other words, a negotiation takes place. In this price-sensitive time of trading fixed-income securities, our investment in the Bloomberg technology has been paying off in spades. We are also expanding our relationships with institutions that participate in the fixed-income market, and we continue to improve our ability to recognize and respond quickly to opportunities.

At Founders Capital Management, we believe that the best way to approach investments is with a sense of balance. Although there were (and will continue to be) challenges ahead, we will keep our focus on what's in front of us—not swaying from our value-based investment principles. We will fully understand where and why we are investing capital and will maintain a view on the intrinsic value of our holdings. As such, we continue to invest in high dividend-paying stocks and bonds—and then watch the value (and price) of our investments grow.

In this age of continuing high uncertainty, it is our opinion that to be successful at the investment game, it is important to focus on long-term business and economic considerations rather than short-term trading strategies. We will continue our effort to avoid making irrational decisions based on emotions—including fear of failing to meet desired returns for clients, fear of lacking intelligence and overanalyzing a situation, and being greedy when prudence should prevail.

We are comfortable with our current businesses and the future worldwide prospects for each of our operating companies. We are also comfortable with our fixed-income investments and believe the returns are fair for the risks we are taking. We want to assure you that we continue to be mindful of the risks in today's markets and will strive to allocate capital in a way that minimizes any long-term effects on the value of our holdings.

Thank you for the opportunity to serve you and for your continued trust. We look forward to working on your behalf during 2011.

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