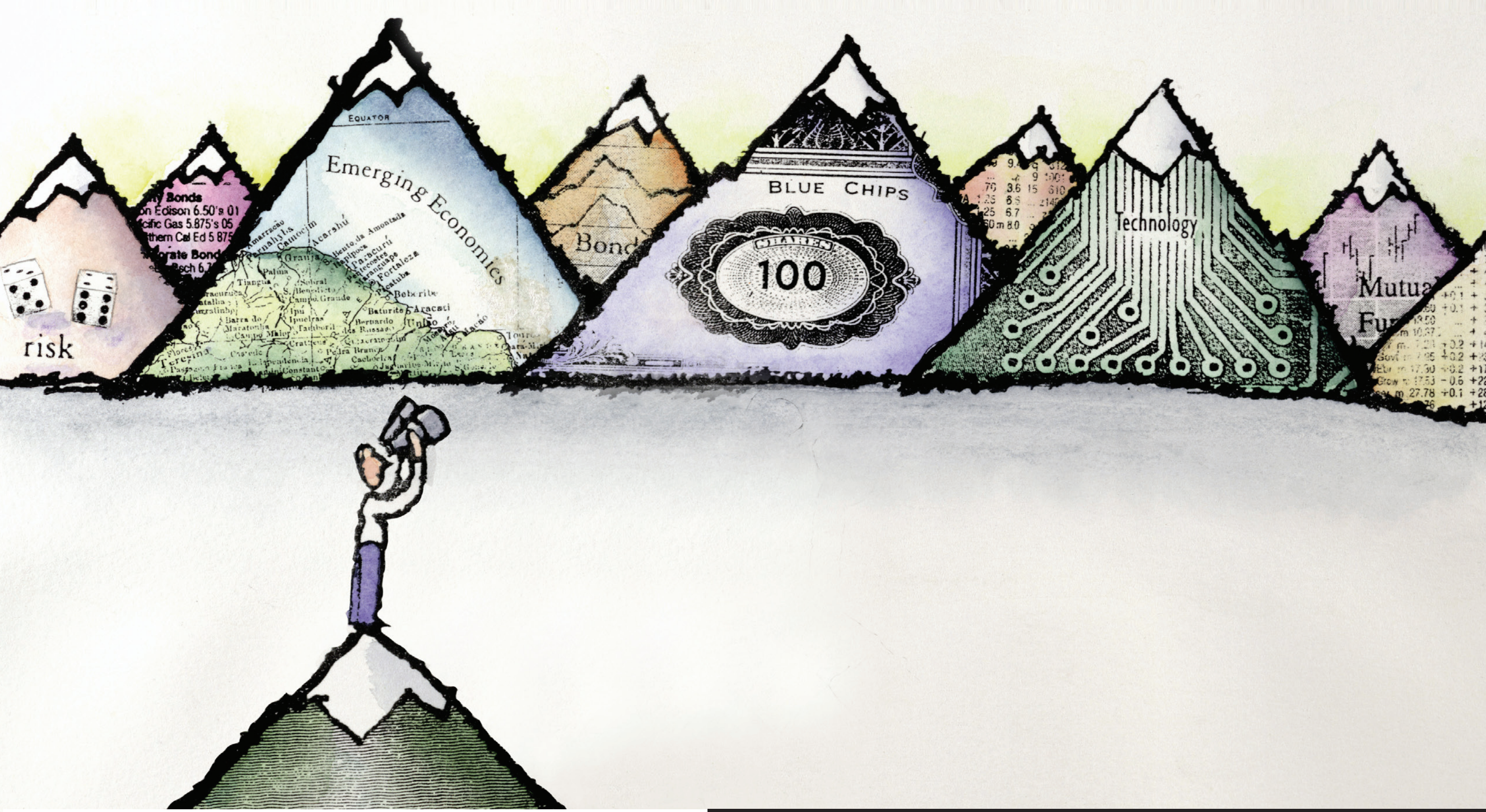

Watching the Market

FOUNDERS CAPITAL MANAGEMENT
2012 ANNUAL REPORT

Investing for the Long Term. Every Day.

FOUNDERS CAPITAL MANAGEMENT

An innovative money management firm investing in publicly traded equities and fixed-income securities. A deep base in business management with a truly global perspective. A drive to identify true fundamental value. A commitment to buy carefully and hold for the long term. A passion to provide customized investment solutions tailored to each client's financial goals and risk tolerance.

This is Founders.

Founders Capital Management, LLC

2012 Annual Report:

"Watching the Market"

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PRINCIPALS' LETTER
From: Founders Capital Management

2012: Watching the Market

2012 was one of those years that many seemed to be fixated on price movement in the market. When all the dust settled, the Standard & Poor's 500 (S&P 500) had increased 16%—indicating a very good year, particularly given the challenging economic backdrop. What was more interesting in 2012 was the divergence in returns between the so-called blue chip Dow Jones Industrial Average (DJIA) and the S&P 500, which represents a larger segment of the market. The DJIA total return was 10%, managing only 64% of the gain achieved by the S&P 500. Looking back, the S&P 500 has now risen more than 100% from the March 2009 low—a big run in a relatively short period. Even with a large rebound in the stock market, however, $1 invested in equities at the beginning of 2008 is worth around $1.08 five years later (including reinvested dividends).

It's little wonder that everyone's eye is on the price movement of the market. The average investor continues to be on pins and needles—frustrated and very anxious—and with good reason: The past 12 years have not been kind. Market participants felt the pain of loss when the technology bubble burst in 2000 and rode the significant market setback through 2002. More recently, the big one—the crash of 2008/2009—left many in a state of shock. At the moment, most investors are viewing an equity portfolio that has achieved near-zero returns over the past 12 years. In sum, this is a gut-wrenching investment environment for both professional and non-professional investors.

Given the extreme market volatility and anemic return history, many think the stock market is the last place to be. According to the Investment Company Institute, individuals have removed approximately $715 billion from equity funds over the past five years and shifted approximately $1.7 trillion to the fixed-income market during the same time frame—and the mass-equity exodus continues.

Who can blame the investor wishing to get off an old roller coaster that produces the same poor result—a sickly, returnless environment? Those who remain on this rickety ride may get ever more nauseous as they keep going round and round, up and down, all the while getting nowhere. Yet, the desire for *any* return is on the forefront of every investor's mind—and may entice them to switch to a ride that seems to start off smooth and easy, but ends up more nauseating than the roller coaster they left.

Because of the hyperactivity in the investment amusement park, this year we have switched our focus away from the "macro environment"—putting aside the U.S. "fiscal cliff," European financial crisis, and pending global recession, all of which are known. Instead, we will concentrate on the "micro environment" and emphasize the importance of understanding the difference between a company's increasing (or decreasing) stock price versus its movement in business value.

Why focus on the micro environment when there is so much financial trouble looming? We think the macro environment issues will eventually dissipate, making understanding of the micro environment more important for long-term investment success.

In our 2012 letter, we will discuss:

- The Continued Chase for High Returns
- Asset Allocation and Portfolio Management—Theory vs. Reality
- Our Focus—Price vs. Value Movement
- Measuring True Risk
- The Art of Arbitrage

* * *

The Continued Chase for High Returns

> **Speculating in the stock market should come with a warning label: "Hazardous to your wealth."**

In past letters, we have discussed at length how extreme thoughts permeate present market psychology among many investors and create an emotional response. This extreme thinking is more prevalent today than at any time in recent memory. Professional and nonprofessional market participants seem to be exhibiting schizophrenic behavior—chasing certain stocks one hour that supposedly have a tremendous future or seem to be chased by others, while turning around and dumping these same companies an hour later. Many of these investors seem to be speculating and participating in the greater fool's game—trying to buy low and sell high within minutes and hours. In our opinion, this short-term trading behavior has formally infiltrated the market—and will likely continue in the foreseeable future.

The "sizzling" opportunities that gurus have aggressively chased over the past 18 months are the initial public offerings (IPOs) of social media or similar companies that have scant revenue and profits. Individuals are attempting to make fast money by trading a piece of Facebook, Groupon, Zynga, LinkedIn, Pandora, Zillow, and Yelp. Of course, attempting to make quick money from companies tapping the public's pocketbook has produced great excitement but poor results—below is the performance of each company since joining the IPO fray.

	Market Cap at IPO Price *($ billions)*	Market Cap 12/31/2012 *($ billions)*	Gain/(Loss) since IPO	Price/Revenue at IPO	Price/Earnings at IPO
Facebook	82	57.6	(30%)	17.8x	95x
Groupon	13	3.2	(75%)	8.1x	Loss
Zynga	7	1.85	(73%)	6.4x	Loss
LinkedIn	4.8	12.3	256%	13.4x	300x
Pandora Media	2.5	1.56	(37%)	18.3x	Loss
Zillow	.66	.92	39%	14.8x	400x
Yelp	.95	1.2	26%	9.5x	Loss

The big one—Facebook's IPO—took place with the expectation that the company would arrive at the investor's doorstep with a business valuation of $100 billion. Unfortunately, buyers were quickly disappointed as Facebook's stock price declined from its $42 opening price to its year-end price of $26.62—a decline of more than 36%. Facebook has built a tremendous social networking ecosystem of more than one billion active users, of which more than 50% log in on any given day. The advertising revenue potential seems unlimited. When Facebook went public this past March, many analysts expected the company to double its revenues, to more than $8 billion in the current year, and produce after-tax earnings of around $2.5 billion. For 2012, Facebook's worldwide revenue will likely end up around $5 billion, with the company producing after-tax profits of $1.2 billion. In hindsight, the unprecedented growth did not materialize, and purchasers of Facebook's stock at the IPO price were disappointed.

Our concern with these so-called opportunities continues to be valuations that are totally dependent on the future. To us, it still makes little economic or business sense to purchase a portion of a company that does not have a *predictable* earnings stream (let alone losses), along with a *sustainable competitive advantage*. It is our opinion that the recent companies brought to the public lack both of these critical investment attributes.

We have stated previously that investor mania has happened before and usually ends with individuals being educated in the not-so-fine art of speculation. The human desire to "get rich quick" fully blossomed this year. Founders Capital Management did not participate in any of the speculative activity that continues to drive general market behavior—and will not in the future. We will adhere to our plan to allocate capital to obtain fair returns over time.

Asset Allocation and Portfolio Management—Theory vs. Reality

When investing, it is more important to own the right hens than to place lots of eggs in different baskets.

Many financial experts say that effective asset allocation—dividing an investment portfolio among different asset categories, such as stocks, bonds, and cash—is an important factor in portfolio management and determines the long-term returns for an investment portfolio. Before we discuss effective asset allocation, it is probably a good idea to establish its definition.

Asset allocation is based on the principle that diverse assets perform differently in changing markets and economic conditions. By allocating money to various asset classes, the temporary underperformance of one asset will be offset by the overperformance of another asset. Put another way: If you have one hand in the freezer and the other in the oven, on average you should feel fine. Following this principle, advisors typically spread investors' money among the following asset classes:

Equity:	Fixed-Income:	Real Estate:	Alternative:
Large Cap Core	Core Fixed-Income	Real Estate Investments	Hedge Funds
Large Cap Growth	High-Yield Fixed-Income		
Large Cap Value	Hybrid Fixed-Income		
International Value			
Intl. Small Cap Equity			
Small Cap Value			
Small Cap Growth			

The fundamental theory for allocating money among (and within) these numerous asset classes derives from the notion that assorted asset classes offer returns that are not correlated. In other words, sprinkling money among various asset classes provides diversification to an investor that reduces overall risk.

Over recent decades, academic researchers have meticulously explained the importance of asset allocation and portfolio management when comparing this theory to active money management. In fact, in the mid 1980s, a study was published regarding the effectiveness of asset allocation. The "BHB study" by Brinson, Hood, and Beebower showed that pension funds would have performed equally, or better, if they had simply allocated their money among the corresponding asset class market indices versus attempting to actively manage their funds. The study concluded that replacing active choices with simple asset class indices worked just as well as—if not better than—professional pension managers.

Warren Buffett has stated that *"index investing"* (i.e., passively placing money in a fund that represents the general market) is probably the best way to go for most investors. We believe Warren Buffett is likely correct. For the vast majority of individuals, index investing is far more profitable than picking individual stocks, bonds, or real estate investments. This statement deserves some qualification, however. Much of this has to do with an individual's ability to pick the "right securities" (or the right assets) at the "right prices" and having the "discipline" to hold on for the long term. Many investors fail to adhere to one of these three legs of the investment stool and would be much better off holding on to the general market or asset class.

At Founders, we choose not to index-invest. Why? If we were to attempt to mirror a stock market index, we would first look at the index and decide which businesses we would discard based on criteria such as low returns on capital, the competitive warfare nature of their industry, and/or dying entities.

Using these criteria, we would quickly throw out almost all airline companies, several automobile companies, retailers that are no longer relevant, and poorly run financial institutions. It makes little economic sense to us to own even a small sliver of any bad business. Once we discarded these poor businesses from the stock market index, we would then purchase a small slice of the rest. Of course, we would choose to distill this down further and invest in what we think are great businesses that have a true long-term competitive advantage that are positioned to grow for many years into the future. Warren Buffett himself has concentrated his equity investments in a few great companies versus choosing to invest Berkshire's funds in a stock market index. We would follow the same strategy with any asset class we invest in—we would first discard the issues that offered a low return for the risk we were taking, and then review the rest. Then we would take the few best.

Similarly, Wall Street has attempted to provide an opportunity for individuals to choose portions of the stock market indices through the introduction of Exchange Traded Funds (ETFs). Given their growing popularity, a brief review of ETFs is warranted. An ETF is an investment fund that trades on the stock exchange, much like a stock. Large investor groups, called "authorized participants" (think banks/brokerage firms), purchase shares of stocks—let's say in the energy sector—and deliver them to the ETF company, eventually turning around and selling ETF shares to investors on the open market. In essence, an ETF replaces the need for an individual to purchase a group of stocks within a sector and offers the investor exposure to a particular area through the stocks held within the ETF. An ETF can be viewed as a focused index fund that provides an investor the luxury of low-cost diversification along with an efficient tax vehicle similar to market index funds. This sounds like a viable alternative for investors who desire exposure to a particular sector, yet do not have time to research individual companies.

Of course, what starts as a good idea on Wall Street often becomes a not-so-good idea. Since all investors possess a human desire to look for an edge, a plethora of ETFs—more than 1,200—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—and generate more fees.) What investors don't understand is that in several cases, the underlying asset representing these ETFs is not the actual securities, 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 basic 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.*

ETFs also figure prominently into the high-frequency trading taking place on Wall Street. High-frequency traders have developed algorithms to identify a price discrepancy between an ETF and its underlying securities. When the ETF price is higher than the value of its basket of securities, the high-frequency trader sells the ETF and buys the underlying securities, and vice-versa. This practice of locking in a profit between the disparity in value and price of a security—called arbitrage, which we will discuss later—is another reason for the exponential increase in trading.

Many ETFs are now trading in the stock market with the same velocity as stocks —nobody wants to hold on to an ETF for the long term. And with the overabundance of ETFs on the market representing just about every asset class, abuse of these funds is not readily understood by investors. The authorized participants that generate ETFs make a lot of money managing the rolling derivative contracts embedded within the ETF—at the expense of investors. We have to ask what financial value is created by this activity that is unconnected to any economic reality inherent in the assets these ETFs represent. Wall Street and investors have officially "moved beyond the boundaries" from the original intention of a normal ETF investment.

The Reality

Once again, the rules of investing are being broken by professional and nonprofessional investors who:

- **Are not adhering to choosing the right business (or asset class):** They are acting like bees that jump from one investment flower to another, hoping to pollinate their portfolio with returns.
- **Are not purchasing businesses (or assets) at the "right price:"** They are "chasing" stocks (and other assets) that seem to be going up in price, giving little regard for the value of the asset they are purchasing.
- **Lack the discipline to hold on to any investment for the long term:** Once their stock (or asset class) increases in price, they seem to want to trade out of it and move on to another.

[A side note—the average investor with the above-described behavior has underperformed the stock and fixed-income indices by 50% over the past 20 years.]

Using the stock market as an example: The daily trading volume of the market equals approximately $60 trillion per year in transactional size. These numbers are so large that one needs to put them into some context. The $60 trillion of transactional volume is approximately 4 times the annual U.S. gross domestic product and around 3.5 times the entire market capitalization of stocks. The latter point is more important, as most average professional and nonprofessional investors now hold a stock for less than four months. Many pundits have stated that investors should no longer "buy and hold" stocks, as they are unlikely to obtain their expected returns. Our retort: "Buy and hold" investing has been going out of vogue since 1965, when the annual turnover of the stock market began to increase exponentially. Over the past 20 years, the daily trading volume of the stock market has increased more than 16% per year, while GDP has increased at an annual rate of slightly more than 4.5%.

The concept of undisciplined investment behavior goes well beyond the general stock market. Investors "flipped" high-tech stocks in the late 1990s and real estate earlier this decade, and they are flipping fixed-income instruments today. In the case of the current fixed-income bubble, nobody is buying a long-term bond (or fixed-income ETF) that yields 1% to 2% with the intention of holding it over the long term—they just want the price of the asset to increase quickly. In fact, the average investor holds a fixed-income fund less than three years, while many fixed-income money managers have annual turnover rates that exceed 100% of their portfolio. This means many money managers that purchase long-dated fixed-income securities hold these bonds in their fund for less than one year.

Index investing works for most investors because it forces individuals to purchase many of the "right" securities at a fair price. Most important, index investing provides a disciplined framework for investors to hold on to their investments for the long term and avoid excessive trading. This is why index investing beats most (over)active money managers. The ironic part of this statement is that the S&P 500 and other stock market indices are now traded actively—average investors no longer hold any index for the long term and instead attempt to "time" the market by moving money in and out of various indices.

At Founders, we will continue to be mindful of the emotion and *overthinking* that is so prevalent in both the professional and nonprofessional investing public. Today, the concepts of "buy and hold" and "concentrated investing" are more important than ever, but counter to what most investors are practicing—in any asset class. We understand it is a challenging environment and think it is important to stay diligent with the concepts and principles we have outlined in previous letters.

Although the overall markets have been successful in generating a "significant rebound rally" over the past four years, any longer-term gain is still suspect due to lingering risks in the global financial system. We believe that the equity and fixed-income markets will continue to undergo a long-term "deleveraging" process brought about by financial institutions and governments that borrowed too much money, whether to enhance returns or to support their growing deficits. We wish we could say that the market volatility is over or that the market fall has hit bottom—but as you know, we are not prognosticators. What we can say is that we still anticipate random price movements in both the stock and fixed-income markets in the coming years—along with a high degree of unpredictability.

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) have become less cautious. At current prices, we believe selective equity and fixed-income securities to be fairly priced, while speculative equities and longer-term fixed-income securities seem overvalued.**

Our Focus—Price vs. Value Movement

> **The definition of stock market insanity: Watching prices move every minute—up, down, and nowhere –while expecting a different result.**

Most individuals keep their eyes peeled on the price movement of any asset they own, including stocks, bonds, mutual funds, ETFs, and even property. But they fail to keep in mind an important question: Does the price movement of the asset owned reflect true change in value? If you asked an individual, "Would you rather own an asset that went up in price and down in value, or an asset that went up in value and down in price?" most would choose the former. This says a lot about our human nature. Of course, doing the opposite of our natural human inclination would actually lead to long-term investment success. Good investors are constantly working against human nature, reminding themselves to stay focused on the asset's value creation or destruction as opposed to its price movement.

Let's expand on this thought with an example: Suppose that you were contemplating giving up a $125,000 annual salary you have enjoyed over the past few years to pursue an MBA at a great business school—let's say, Yale. An outsider valuing you as an asset may initially place a lower "price" on you as you decide to leave your job and pursue your dream. In fact, the price could be significantly lower because you would no longer be earning any money, but instead looking to spend $175,000 over the next few years on continuing education. Adding insult to injury, your starting salary after obtaining your MBA will be in the same range as what you were earning when you entered school. If this is the case, why would anyone decide to pursue advanced education? The answer lies in the long-term value that can be created through the $425,000 investment. It is likely that today's value of the future *incremental* earning power of our hypothetical MBA student would more than offset the initial outlay. Given this knowledge, should the MBA student pay attention to the lower asset price placed on him by outsiders, or emphasize the long-term value he is creating by advancing his education?

The answer to this question is obvious, and investors should consider the assets in their portfolios in a similar manner. The important question to ask when investing is: How does the increase or decrease in *price* of our holdings correlate with the increase or decrease in their *value*?

This leads us into a discussion on the assessment of intrinsic value, as well as value creation. When analyzing an individual investment, investors should seek a few simple relevant insights. First, on the financial side of the equation, an individual should seek to *approximate* the intrinsic value of an investment (not the precise price at which it is quoted), while at the same time estimating the current yield on a potential investment and the growth in this yield over time. Important ingredients to these equations are:

- **Investment yield:** The current cash produced from the investment compared to its present price
- **Growth of the investment yield:** The money plowed back into the investment, with an anticipated return
- **Anticipated investment period:** The duration of the holding period
- **Future expected price:** The future cash created from the investment compared to its expected price
- **Opportunity cost:** Comparison of the anticipated return against yields on alternative investments
- **Anticipated investment return:** The value of our expected investment

For example: Suppose we own Candy Co., which produced $2 per share of cash, and the current price of the investment (stock price) is $30. The entry *investment yield* on Candy Co. would be around 6.6% ($2 cash ÷ $30 stock price). If Candy Co. produced earnings of $3 per share and obtained a return of 25% on each $1 it retained in the business, the investment would grow slightly above 8% per year—the equation [($1 kept within the business ÷ $3 earnings = 33% of earnings retained) x 25% return] = 8.33%. This is the approximate *growth of the investment yield.* Let's assume Candy Co. is a stable business and can repeat the above performance over the next 10 years *(the anticipated investment period)*. If this is the case, then we could project that our investment would produce approximately $4.45 in cash in a decade ($2 cash growing at 8.33% per year over 10 years). The last question to ask is: How much would a stable investment be worth in 10 years if it produced $4.45 of cash for investors? If the 10-year U.S. Treasury bond is at 6% in 10 years *(*our *opportunity cost),* then our investment in Candy Co. should be conservatively equal to this rate ($4.45 ÷ .06 = $74 per share.) In the end, if we were able to purchase Candy Co. at $30 per share today, and keep it for 10 years when it is selling at approximately $74 per share, the annual *anticipated investment return* would be roughly 9.4%, plus any dividends that Candy Co. provided to shareholders.

(We must remind ourselves that in financial circles, *quantitative analysis is necessary, but not sufficient.)*

Second (and this is the hard part), when considering investing in a business, we add the following attributes to the above ingredients and ask five questions to assess the *approximate* intrinsic value of the business:

- What are the interesting long-term prospects for the business?
  (How and where can it grow over the long term?)
- How predictable are these prospects for the future?
  (How certain are we that growth is attainable?)
- What price are we willing to pay for the future prospects inherent in the business?
  (How much are we willing to pay for this growth today?)
- How well does management allocate capital that is retained in the business?
  (What are the expected returns on incremental invested capital in the business?)
- How is management's ability to allocate excess capital favorable to shareholders?
  (How much money will management share with shareholders?)

Sticking with our Candy Co. example, some questions that would help us evaluate the long-term value creation for the business include: What is Candy Co. doing to grow its business over the next 10 to 20 years? Where will it grow? How predictable are the prospects for this growth endeavor, and how much more are we willing to pay for this growth today? And finally, we would need to ensure that Candy Co.'s management is allocating capital effectively—within the business to obtain equal or better returns than achieved in the past, as well as sharing excess capital that is not needed for growing its business with shareholders—either through increasing dividends or share repurchases.

In summary: An investor should be familiar with the company that interests him and should be comfortable with the industry, the company's competitive position, and the organization's management. An investor who is not able to assess these attributes should pass on the opportunity to allocate money to that business, since he does not truly understand the investment. Once an investor is familiar with a business and the returns he is seeking, he should ignore the ups and downs of the general stock market and wait for its price to reach a "comfort zone" before taking advantage of a deal. When a business's share price reaches a point at which the company is "on sale"—i.e., selling at or near his price target—making a purchase provides an opportunity to obtain a fair return on an investment over a long period of time.

After we own the business, a key question that we continually address (regardless of the company's "price quote") is:

How is the company building value to create long-term wealth for its owners?

An investor should be far more interested in evaluating a business positioned for long-term growth in value at 8% to 10% per year (and willing to weather a short-term fall in share price) than in watching a business fall in value with the hope that a foolish investor will come along and bid up the share price by 20%. In the first scenario, the "real value" of an investor's holding is increasing, but in the latter situation, the "real value" of his holding is decreasing.

Measuring True Risk

> **"Risk and return" in the stock market is hard to define; we just know we'd rather jump in with a life preserver than without one.**

Investors are constantly evaluating the risk versus reward of any potential investment. Given everyone's desire to minimize risk and grab upside potential, financial theorists have concocted "risk and return" measures that are intended to guide an investor when allocating money to an investment.

We will spare you the math, but over the past four decades, colleges teaching financial theory have relied on the concept of measuring risk using the "Capital Asset Pricing Model"(CAPM). A basic component of this model is something called "beta." Academics came up with the idea of beta to define investment safety in another way, claiming that risk management encompassed measuring the relative volatility of a stock or portfolio of stocks when investing. The conclusion was that it is wise to evaluate a security's price volatility compared to that of a larger number of stocks—with lower volatility equating to a safer investment. Using past data and statistical measures such as regression, academics compute the exact beta of a stock (or portfolio) to obtain a figure that represents its past relative volatility. They then propose that, theoretically, investors should base capital allocation and individual investment decisions on this single calculation.

Once again, what is good in theory often does not translate well into practice. Enron, a company in vogue during the 1998–2000 market ramp-up, had a beta value of .90 (meaning its price went down less than that of the general market). Of course, Enron went bankrupt in 2001. AIG, Freddie Mac, and Fannie Mae had a collective average market beta just prior to the 2008 financial crisis that required them to take a government bailout. In 2005, Kodak's market beta was around 1.0 (meaning its price moved up and down with the general market) as the company was falling slowly into the abyss and eventually filed for bankruptcy in early 2012.

We think the point has been proven: Assessing risk by relying heavily on past data is like driving down the highway and staring in the rearview mirror—it's an accident waiting to happen. In our opinion, investors should be cynical of any models that are based largely on history—or of any model, for that matter. Financial and econometric models may seem intelligent and impressive, but in many cases falling for them can make someone both smart and stupid at the same time.

To manage risk, Founders Capital Management does not follow academic doctrine that focuses on analyzing the price history of a stock—in fact, most academics would frown on our approach to managing risk. Our approach involves looking at where a company is today and projecting its prospects as far as we can accurately "see" into the future. As true business owners, we think the use of esoteric formulas that count on historical information would be rather useless in providing guidance about a company's prospects. Academics and money managers that rely on beta to measure business risk fail to ask pertinent questions about the products a company develops, their market acceptance, and the competitive nature of the industry. If we were to use beta as our sole investment criteria, it is likely that many less-than-stellar businesses would end up in our portfolio, and great companies such as Coca-Cola, United Technologies, and Johnson & Johnson would fall by the wayside.

It is worth repeating: The goal of an investor should be to understand the value of a business based on its long-term economic and market characteristics, as well as the price at which to purchase one's interest that will provide a fair return over a long period of time. Although these criteria may be easily understood, very few businesses can claim to stand the test of time—the investment world is full of pretenders. It is our opinion that putting together a collection of great businesses that will be significantly worth more in 10 or 20 years provides a significant margin of safety and is the best way to manage risk. In the end, **what is truly relevant in the investment world is to understand what is dependable and defendable, as well as predictable and protected.**

The Art of Arbitrage

> *"Give a man a fish; feed him for a day. Teach a man to fish; feed him for a lifetime."*
>
> —Lao Tzu

Our discussion of risk management and asset allocation leads to another investment topic that we would like to highlight this year—*arbitrage*.

The word "arbitrage" initially referred to an investor (arbitrageur) who profits from differences in price when the same security, currency, or commodity is traded on two or more markets. For example, an arbitrageur may simultaneously buy one contract for silver in the Chicago market and sell one contract for silver in the New York market, locking in a profit due to the fact that the selling price in the New York market is higher than the buying price in the Chicago market.

Fundamentally, when practicing arbitrage, the arbitrageur takes advantage of disparities in the value of assets. His talent lies in the ability to recognize disparities and to profit from the ultimate convergence of price and value. Popular sporting events provide a clear illustration of arbitrage in action: When the University of Connecticut plays Villanova in basketball, you can usually count on someone selling tickets for $50 apiece on game day, even though he acquired the tickets for around $35 apiece a few months prior to the game. Clearly, the individual who initially purchased many tickets for $35 anticipated a sold-out game. When evaluating this potential opportunity, the person probably asked a few questions:

- How probable is it that the basketball game will sell out?
- What will be the value of the tickets on game day?
- How far in advance should I purchase the $35 tickets?
- What will the tickets be worth if the game is not sold out?
- What will be the value of the tickets if the game is canceled?

Founders Capital Management holds a large number of short-term and long-term investments that could be considered arbitrage by nature. For example, over the past few years, we have steadily purchased stock in ConocoPhillips and Kraft Foods. Although these two companies are very different, they have one thing in common: Both companies decided to break up their holding company and spin off into several businesses that would be traded on the stock exchange. During 2012, ConocoPhillips spun off its refining business (Phillips 66) into a separately traded company, while Kraft Foods split its company into two entities—Kraft Foods Group (North American grocery business) and Mondelēz International (global snacks business). When these companies initially announced their intentions to split their businesses, investors had the opportunity to value the separate entities and compare their "untraded value" to the whole company priced on the stock exchange. If the estimated value of the separate companies turned out to be higher than the "traded value" of the whole entity prior to the spin-off, then an arbitrage opportunity existed—basically, one could make an advance purchase of "tickets" with confidence that the tickets would likely be worth more on "game day" (the day the spin-off occurred).

As capital managers, we seek a margin of safety on our investments by attempting to be good arbitrageurs. We discipline ourselves to look for discrepancies between the short-term and long-term "price" versus "value" of our investments. Given our desire to steer away from any speculative activity, the practice of arbitrage raises the probability that we will achieve a fair return on our investment activity over time.

The General Forms of Arbitrage We Practice

Short-Term Arbitrage

In the first form of arbitrage that we practice, which could be labeled *short-term equity arbitrage*, certain equity investments have a holding time frame associated with them that is highly predictable, whereby we can take advantage of a so-called work-out opportunity. The ConocoPhillips and Kraft Foods spin-off examples cited above fall into this category. In each case, we knew the approximate spin-off date associated with our holding that allowed us to evaluate the probable return from the date of our initial purchase price.

Another form of short-term arbitrage that we take advantage of involves mergers and acquisitions. In the past few years, we have participated in several merger and acquisition arbitrage situations. Each of these cases demonstrates similar attributes to the UConn/Villanova basketball scenario. For example, let's say ABC Co.

announces an all-cash purchase of XYZ Co. on June 1 for $20 per share, with an expected acquisition closing date of around December 1. On the date of the acquisition announcement, the stock of XYZ Co. jumps to $19.25 per share. The reasons XYZ's stock price did not increase to the full $20 offer are:

1) The time value of money—i.e., $20 six months from now is worth less today due to inflation
2) The deal may become delayed and the closing date may be pushed further out than December 1
3) There is some possibility that the deal may fall through and ABC will not complete the acquisition of XYZ

With this knowledge, we can assess the probable return we would obtain from a purchase of XYZ stock on June 1 at $19.25 per share and anticipate receiving $20 of cash on December 1. In this hypothetical case, we can expect a probable 7.75%+ annualized return on our purchase, plus any dividends distributed by XYZ between the time of the announcement and final acquisition date.

We also participate in so-called arbitrage opportunities through our fixed-income investment activity. S*hort-term fixed-income arbitrage* situations can occur due to nuances embedded within a fixed-income security. For example, several of our fixed-income securities may have maturity dates that are long-dated (i.e., maturing seven to 10 years from now); however, there is a provision that allows the company to "call in" the fixed income security at an earlier date. Similar to our merger and acquisition arbitrage example above, we can isolate the probable return we would receive between our purchase date and the call date on the fixed-income security, and compare the yield-to-call (and yield-to-maturity) against similar investments within the same time frame. In this case, the primary reason for a meaningfully higher return on this type of security is due to the fact that the corporation may or may not exercise its right to call in the security at the expected date—possibly resulting in a lower annual return if the bond is held to its eventual maturity. We have purchased quite a few of these fixed-income instruments over the past few years and have seen most of these securities called—resulting in a challenge to reallocate this capital toward higher-return opportunities.

Long-Term Arbitrage

Our favorite arbitrage opportunity exists in purchasing, at a discounted price, an interest in a company that we intend to hold for many years. "*Franchise arbitrage"* occurs when normal valuation models break down and the market significantly underestimates the value of a great business based on application of traditional "financial valuation metrics."

The financial valuation method most commonly used to value a business is the "discounted cash flow model." Using this model, value practitioners attempt to ascertain the value of a company by isolating the cash available to business owners over an indefinite time frame, and then discount the forecasted cash streams to the present. Of course, this model can generate a wide range of numbers based on the need to "guesstimate" the future cash available to owners, as well as applying a varied discount rate to determine the present value of future cash flows. To mitigate the large wiggle room in forecasting future cash available to owners, traditional finance teaches practitioners to estimate distributable cash over a defined period—usually 10 years—and then forecast all future owner cash flows beyond the 10-year period to grow at around the rate of inflation. Again, financial theory does not always translate well into practice.

There are *very few* companies that perfectly fit the discounted cash flow model—either the projected cash flows are erratic and undeterminable or, in the case of several predictable businesses, the cash flows can be projected well beyond 10 years. This is the opportunity we like a lot! In our opinion, the performance of a business like Coca-Cola can be projected several decades out just by gauging the global per capita consumption of Coke's products today versus 20 and 30 years from now. In the U.S., the annual per capita consumption of Coke's products is slightly more than 400 eight-ounce servings—Argentina per capita consumption is 345, Chile is 460, Australia is 309, and Germany is 190. Here is the good part: In China (population >1.3 billion), annual per capita consumption of Coke products is only 38, and in India (population >1.2 billion), per capita consumption is 12. It is not hard to see why we think Coca-Cola's franchise growth can be forecasted many years out, given the company's low (and fast-growing) penetration in these massive developing markets.

Looking at the situation from a "business perspective," it seems silly to limit Coke's growth forecast to 10 years. Of course, attempting to find the perfect forecast period of growing cash available to shareholders can be equally foolish and would yield a valuation for Coca-Cola that would seem too high. In the end, there is a so-called financial model breakdown in this instance, and a franchise arbitrage opportunity exists for investors that wish to purchase Coca-Cola and hold it over a very long time frame. This is one of the reasons Coca-Cola trounces the market averages over the decades.

> **We continually seek arbitrage opportunities that provide us a long-term investment advantage, given that it is virtually impossible to guess at what price each holding will be selling on December 31. Ultimately, we are seeking to purchase, at a fair price, several businesses that possess a high probability of growing well into the future—providing us the greatest return over the longest period of time.**

At Founders Capital Management, our activity will remain deeply rooted in the time-tested principles of investment simplicity. We will continue to seek investments in securities that we know and understand, and in assets whose intrinsic value we can fairly estimate. We will stay disciplined in evaluating the movement in value of our investments, versus focusing in on the movement of prices. To accomplish this, we are committed to:

- **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 general market

EQUITY HOLDINGS: 2012 HIGHLIGHTS

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 long-term investors, we can wake up each morning knowing that the terrific businesses we own—Coca-Cola, PepsiCo, Procter & Gamble, UTC, Johnson & Johnson, Medtronic, Microsoft, Berkshire Hathaway, Home Depot, Disney, Chevron, and our other holdings continue to grow in value and strengthen their enterprises independent of any short-term gyrations in stock prices.

Following is a summary of business highlights from our portfolio companies during 2012, along with our expectations for 2013.

CONSUMER GROUP

Our primary consumer holdings—Coca-Cola, PepsiCo, and Procter & Gamble—continued to grow their global franchises during this year, despite the ongoing challenges confronting world economies. We expect our consumer group to produce positive results in 2013 and in the years to come. In fact, each of these companies falls into our "franchise arbitrage opportunity" category.

In the past, we have pointed to the special business model that characterizes our consumer companies. Coca-Cola, PepsiCo, and Procter & Gamble all market products that demonstrate a consistent purchase pattern that provides an efficient revenue and profit stream. The daily worldwide consumption of Coca-Cola, PepsiCo, and Procter & Gamble products enables these entities to perform better than average in both good and bad economic times. These businesses are not as capital-intensive compared to the average business, and they all sell products that possess a "consumer pull" that is difficult for competitors to duplicate. Each of these companies' brands—for example, Coke, Frito-Lay, Tide, and Gillette—carries a special attribute that attracts large consumer mindshare and the security of knowing that the product will be consistent and of a certain quality. The emotional comfort that consumers *worldwide* associate with these brands is produced through a repetitive process of advertising, promotion, and purchases.

This is where the franchise arbitrage comes in: Given the global strength of these business franchises, we can forecast with a high degree of probability that Coke, PepsiCo, and Procter & Gamble will continue to demonstrate the same characteristics in the future as they do today. It is highly likely that each business will penetrate substantial developing markets over the next 10 to 20 years, and the accumulated potential growth of these businesses cannot be fully identified using traditional financial models. This knowledge underscores the hidden value-creation potential of these companies. Global franchise businesses with these qualities fall into the category of "just because I can't quantify the value doesn't mean it's not there."

Coca-Cola

During 2012, The Coca-Cola Company grew its overall volume an additional 5% (similar to its performance in 2011). This growth was once again led by the company's double-digit growth in selected emerging markets such as Thailand and India. The company also improved its per-share profits in 2012 by approximately 5%, selling more than 1.7 billion servings each day to customers around the globe.

When envisioning Coca-Cola's products, most consumers picture the soft drink in its signature "skirt" bottle. This one Coke product's "share of mind" is so entrenched that it has led many current potential investors to declare: "Carbonated soft drinks are on the decline" or "Coke is all over the world and cannot grow in the future like it has in the past." What many fail to understand is that the core Coca-Cola brand soft drink is just the tip of the iceberg for this beverage juggernaut. And comprehending the scope and breadth of Coca-Cola is very important for long-term investors. So here are a few facts to absorb:

- Coca-Cola markets 3,500 different beverages in more than 200 countries worldwide.
- The company's largest-selling beverage in Japan is not even the famous Coca-Cola soft drink we are all familiar with—it's a drink called "Georgia," a canned coffee-flavored beverage.
- In India, a Coca-Cola-owned beverage called "Thums Up" is the country's most popular soft drink. Other Coca-Cola beverages sold in India include "Maaza" (a mango-flavored soft drink), "Limca" (a lemon- and lime-flavored soft drink), and "Kinley" bottled water.

These facts demonstrate how the Coca-Cola "beverage" company is aggressively adapting to satisfy local markets around the globe.

In addition to the company's diverse beverage portfolio, Coca-Cola possesses one of the most intricate distribution systems in the world—represented by 275 bottlers that manufacture and distribute products to within an arm's reach of every global consumer. This unmatched business system is very difficult—if not nearly impossible—to duplicate and allows Coca-Cola to maintain a sustainable competitive advantage. This wide network also positions the company to extend its tentacles into markets that have not yet been fully penetrated.

Questions about Coke's future performance fall into two categories: First, what is the company doing to adapt to local market beverage tastes, either by continuing to introduce new beverage brands or by tailoring the core Coca-Cola brand to local tastes? (Coke tastes different all over the world.) Second, what is Coca-Cola doing to further develop its strong distribution network in developing markets? Answers to these two questions provides long-term investor confidence that Coca-Cola will continue to grow its global volume for decades to come—providing a franchise arbitrage opportunity for investors.

It is estimated that by 2020, more than two billion people around the world will join the so-called middle class, and this represents a large market opportunity. Coca-Cola is setting the stage today to take advantage of this projected opportunity, with a plan to invest more than $30 billion in markets around the globe during the next five years—including a $2 billion investment in India within the next five years ($5 billion by 2020), a $4 billion investment in China over the next three years, and a recently announced $1.3 billion investment in Chile to capture a greater share of the South American beverage market. The Coca-Cola Company has a goal to reach $200 billion in annual revenue by 2020—double its $100 billion revenue in 2010. (And investors are worried about KO's short-term stock price fluctuating?)

Ultimately, Coke represents a tremendous global growth story for both customers and shareholders. The company will produce approximately $8.5 billion of cash for shareholders in 2012, up approximately 9% over 2011. Coke currently pays an annual dividend of $1.02 per share, which represents approximately a 2.8% yield, and we think the company will increase its dividend in 2013—to around $1.10 per share (and, as a side note, the stock split 2/1 in 2012). Coca-Cola will also repurchase more than $4 billion of stock during the next year and has authorized another stock repurchase program for an additional 500 million shares. The combined dividend and stock repurchases provides shareholders a 5.25% "look-through" yield at Coke's year-end price. In 2013, we believe Coca-Cola will grow its per-share earnings at around 7%, producing approximately $2.15 per share. Coca-Cola will remain a long-term holding in our portfolio.

PepsiCo

When one thinks of soft drink companies, two names usually come to mind—Coca-Cola and PepsiCo. PepsiCo's beverage business has many of the same attributes as Coke's and is likewise making a large commitment to invest in the global beverage market—and so we won't emphasize PepsiCo's beverage investments in India, China, etc. But it is fair to question why we own both companies.

Although PepsiCo commands a large "number two" share of the global beverage market, its mainstay is its global snack business, which represents more than 60% of the company's operating profits. PepsiCo's dominance in the snack food segment is as prevalent as Coke's in the beverage sector—in fact, PepsiCo's global snack supremacy may be even greater.

To get a flavor of PepsiCo's wide global snack presence, let's look at the company's investment in China. China's snack-food market is expected to reach an estimated 77 billion yuan (about $12 billion) by year-end 2012, up 44% from 2008, according to research firm Euromonitor International. Per capita consumption of potato chips in China is around one small bag every two to four weeks, compared with 15 bags in the same time period inside the U.S.

In an ongoing initiative to take advantage of the growing snack market in China, during 2012 PepsiCo opened a new Lay's Potato Chip plant in the city of Wuhan. This is the sixth snack plant PepsiCo has built in the greater Chinese region as part of the company's three-year, $2.5 billion commitment to this developing market. (PepsiCo now has 700 manufacturing facilities worldwide.)

What is equally interesting is the company's infiltration of Chinese farming. PepsiCo assists local farmers to increase crop yield by introducing new potato irrigation methods. As part of a continuing commitment to Chinese farmers, PepsiCo also signed a memorandum of understanding with the Chinese Ministry of Agriculture to educate local agricultural experts and farmers that are willing to develop new agricultural methods that generate the highest yields from the local climate and growing conditions—a tactic the company also used with orange farms in Punjab, India that produce fruit for Tropicana.

In November 2012, PepsiCo also opened a new R&D center in Shanghai, China, along with a pilot plant designed to accelerate product prototyping to meet Chinese consumer demands as they emerge. Speed is of the essence when it comes to product introduction in emerging markets. PepsiCo's commitment to launching customer-driven products has led to breakthrough Chinese products such as Quaker Congee and Lay's Rice & Wheat Chips. These innovative homegrown products are now being developed in more flavors, including cucumber-flavored chips! Other PepsiCo product development efforts in China include hot-and-sour fish-soup potato chips and white fungus oatmeal.

The snacks business has a great future. In the U.S., the per capita consumption of snacks is the highest in the world—about 8.5 kilos per person. The number-two snack-consuming country is the United Kingdom, at five kilos. In Mexico, per capita consumption of snacks is three kilos, and many emerging markets are at less than one kilo. The emerging markets have been growing at twice the average global growth rate for snacks. The worldwide per capita consumption of snacks—and PepsiCo's share—is likely to increase over the upcoming decades.

PepsiCo moves and sells $32 billion of snacks around the globe and has the largest direct-store delivery system in the world through its snack business. The company touches millions of distribution points every day, and its products are within arm's reach of consumers. PepsiCo's share of the snack market is large and growing. We mentioned last year that PepsiCo has more than 80% market share in Argentina, more than 70% in Mexico and Turkey, 65% in the U.S. and Canada, and more than 50% in emerging markets such as Brazil. PepsiCo has a gripping tenfold relative market share advantage compared to its nearest global snack competitor. We do not see this trend slowing over the long term, given the ongoing investment the company is making in large developing markets such as China and India.

Questions about PepsiCo's future performance fall into the same two categories as those about Coke: First, what is the company doing to adapt to local market tastes, either by continuing to introduce new snack and beverage brands or by tailoring the core PepsiCo brands to local tastes? Second, what is PepsiCo doing to further develop its strong distribution and plant network in developing markets? The answers to these two questions are found in the company's actions, described above, and support long-term investor confidence that PepsiCo will continue to grow its global snack and beverage volume for decades to come—providing a franchise arbitrage opportunity for investors.

In 2012, PepsiCo continued to increase its return to shareholders, raising the annual dividend by more than 4.25%, from $2.06 per share to $2.15 per share. We expect PepsiCo to raise its dividend to approximately $2.25 per share in 2013, which implies a yield of about 3.3% at the year-end stock price. In addition, we anticipate the company will repurchase $2.5 billion of stock in 2013. This action adds another 2.3% return to shareholders, reflecting a 5.6% "look-through" yield. In 2013, we expect PepsiCo to grow its per-share earnings at 10%, producing around $4.40 per share.

In summary, we like the long-term potential and economics of the beverage and snacks businesses and think there is a multi-decade growth opportunity for the dominant companies in this realm. PepsiCo has a large position in these growing areas and will remain a long-term holding in our portfolio.

Procter & Gamble

We have a long-term investment in one of the largest consumer companies in the world—Procter & Gamble (P&G). P&G sells leading brands that we are all familiar with—Pampers, Tide, Ariel, Always, Pantene, Gillette, Bounty, Dawn, Gain, Charmin, Downy, Iams, Crest, Oral-B, Duracell, Olay, Head & Shoulders, Wella, Vicks, and Braun.

P&G's worldwide net sales volume remained relatively flat in 2012 at $83.5 billion, with earnings per share staying even with the previous year—$3.92 per share (excluding impairment charges). The reasons for P&G's slowing performance are twofold; First, rising commodity and energy costs impact P&G more than most consumer companies, given that oil is a large input cost to manufacturing its products. This headwind for P&G continues to place temporary pressure on the company's gross profit margins. Although last year we expected these higher costs to decelerate as 2012 progressed, this did not materialize. We expect the company's earnings drag due to ongoing higher commodities to decelerate as productivity initiatives take hold within P&G during 2013. Second, P&G customers seem to be trading down to lower-priced product alternatives as the company selectively increased prices to offset its higher input costs. This so-called trade-down negatively impacted sales as well as profits. In response to the business challenges it is facing, P&G has announced a plan to strengthen its core business and aggressively reduce costs within the company.

Strengthening P&G's Core Business

The company will focus on its top 40 business units and develop specific plans to generate the highest level of sales and profits within each of these divisions—20 in Household Care and 20 in Beauty & Grooming. P&G will also focus on its top 20 innovative products that offer higher-than-normal growth potential. In addition, the organization will concentrate on developing markets. Why focus on developing markets? Similar to Coke and PepsiCo, accelerating growth momentum in these areas is critical to creating long-term value for shareholders. Between 2010 and 2020, the world's population will grow by 700 million people, and 95% of this population growth will be in developing markets. As we cited previously, during that same period, the world's middle class will increase by up to 2 billion people, with more than 95% of this population concentrated in developing markets. Population and household income growth are primary drivers of a multinational company's business growth and provide a long-term franchise arbitrage opportunity for a company such as P&G.

Improving Productivity and Achieving a Cost Savings

Focusing on growth without managing cost structure can lead to underwhelming profits. Many organizations have a tendency to add too much overhead prior to experiencing growth. This is a common mistake among large bureaucratic companies. We believe that a business should always ensure that expenses chase revenues and not the reverse. If managements kept this in mind, many businesses would be more profitable.

Given the circumstances, P&G is taking significant steps to accelerate cost savings and create a more cost-focused culture within the company. This plan includes a five-year, $10 billion cost-savings initiative announced in February 2012. The cost-savings program pivots on:

- Reducing approximately 5,700 non-manufacturing overhead positions by the end of fiscal year 2013
- Achieving $1.2 billion in annual cost-of-goods savings across raw materials, manufacturing, and transportation and warehousing expenses
- Generating efficiencies in marketing costs, saving approximately $1 billion over a five-year period

Although P&G is confronting several difficult challenges during this stressful economic environment, the company remains highly profitable and has a terrific future. We expect the company to earn approximately $4.15 per share during calendar 2013 and to return a large portion of its $11.3 billion in profits to shareholders in the form of share repurchases and dividends (dividends are expected to be more than $6 billion, or $2.25 per share—equal to a yield of approximately 3.3% at the year-end stock price). We remain excited about P&G's global opportunities and consider this company to be in the "long-term franchise arbitrage" category, and we will continue to commit capital to this company.

INDUSTRIAL GROUP

Our primary industrial and transportation holdings—United Technologies Corporation (UTC) and Lockheed Martin—were profitable in 2012, and we expect these businesses to produce good results in 2013.

Our industrial group presents an arbitrage opportunity due to a unique business model that provides a substantial competitive advantage. We have stated previously that these companies are focused on product/service innovation and sell high-end 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. UTC and Lockheed are exceptional in that they initially contract to sell their products at a low profit margin and strike high profit-margin contracts to service these products over their life span. For example, when UTC installs the building automation system that controls and monitors heating, cooling, and fire protection equipment for the 80-story landmark 3 World Trade Center (now under construction in New York), the company will also have a long-term contract to service the equipment post-installation. Similarly, once Lockheed Martin constructs and delivers the F-35 fighter jet to the military, high profit-margin servicing contracts associated with this delivery can continue for years. In both cases, it is highly unlikely that these costly items will be replaced any time soon, providing a predictable, long-term revenue annuity.

The investment arbitrage in this case takes two forms: First, the service revenues associated with the contracts are flexible, meaning prices can be increased over time. Second, the cash produced from these service agreements is very high in relation to the original fixed investments, providing an opening for these companies to deploy money to shareholders. The purchase of stock in an infrastructure business with these attributes can be considered similar to a fixed-income arbitrage. For instance, if this infrastructure business produces $5 per share in earnings, close to 100% of the earnings is cash available for shareholders. If the company stock price is trading at $60 per share, investors in this company are receiving an immediate 8.3% return on their investment ($5 ÷ $60 = 8.3%). This yield is significantly higher than alternative investments, including the 10-year U.S. Treasury that offers a year-end 1.78% annual return—providing a good arbitrage opportunity given the 6.5 percentage point difference (called the "spread") between these two alternative investments. A buyer of this security enjoys a margin of safety if interest rates suddenly rise, or a good return if the yield on this investment moves lower due to other investors bidding up the stock price to a point at which the return is more equal to average-yielding securities with comparable qualities.

United Technologies

United Technologies Corporation (UTC) owns firms such as Otis elevators, Carrier air conditioners, Pratt & Whitney jet engines, Hamilton Sundstrand aerospace systems, and Sikorsky helicopters. UTC continues to build on its extensive product portfolio in the commercial and defense market segments, and during 2012 closed on a $16.4 billion acquisition of Goodrich Corporation. This $8 billion business that produces landing gears, wheels, and brakes for the aerospace and defense industry complements UTC's portfolio and gives the company an opportunity to increase its market share of total content provided on leading commercial and military aircraft.

Each of the UTC subsidiary companies has achieved leadership and powerful market entrenchment in their respective areas of expertise. UTC's balanced exposure in aerospace and defense reduces revenue uncertainty and helps the firm ride out the challenges of difficult economic times. Although we would not place UTC in the "long-term franchise arbitrage" category, the company comes very close. For example, UTC's subsidiary, Otis elevators, is in the midst of one of the largest modernization projects in the company's 159-year history—refurbishing the Empire State Building's 68 elevators. This contract was awarded to Otis due to the tremendous service the company provided on the original Otis elevators installed during the 1930s! As part of this project, the company was also awarded a 10-year maintenance agreement. Once this assignment is completed, UTC shareholders can look forward to Otis elevators working with the Empire State Building over the next 80 years.

As this example demonstrates, UTC derives much of its revenue from servicing agreements associated with the sale of its products—aftermarket services generate more than 40% of the company's $57 billion in revenues. In addition, 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, security systems, building air conditioning units, or jet engines failing).

Given the cash annuity stream associated with the long-term servicing agreements, UTC can also be viewed as a long-term fixed-income arbitrage opportunity. The company is expected to produce approximately $6 per share in cash in 2013. When comparing this $6 per share cash stream to the company's year-end stock price of $82 per share, investors are receiving an initial 7.3% yield on their UTC investment—and cash is growing each year. We are excited to own United Technologies and believe we are receiving a fair arbitrage opportunity with our ongoing investment in this company—especially when comparing our somewhat fluctuating 7.3% annual return to the 1.78% earned on an alternative investment in a 10-year U.S. Treasury.

Lockheed Martin

Lockheed Martin is a 100-year-old, $46+ 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. The company is the largest provider of IT services, systems integration, and training to the U.S. government and sells products and services to the governments of other countries as well.

Investments in the defense sector are out of favor due to uncertainty about the impending defense budget. Even though the U.S. recently avoided going over the fiscal cliff, and thus evaded automatic cuts to the defense budget, the defense industry is likely to face imminent U.S. defense budget reductions in the upcoming decade. Despite the possible cuts to defense, the companies we hold have significant projects that we believe will be delivered in the upcoming years. In Lockheed's case, the company is scheduled to supply the F-35 fighter jet to the U.S. military. The F-35 is the single largest Department of Defense project. We emphasized in previous letters that 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 more than 3,000 aircraft to eight countries around the world over the coming decades. In total, this project is worth up to $1 trillion—encompassing $300 billion in new equipment and $700 billion in maintenance contracts. (Again, large aftermarket sales should provide predictable ongoing earnings for Lockheed Martin, despite pressure on the U.S. defense budget).

We also think Lockheed Martin is positioned to widen its expertise in promising IT systems and related businesses. For example, Lockheed's bolt-on acquisition of QTC Holdings—the largest provider of outsourced medical evaluation services to the U.S. Government and Department of Veterans Affairs—expands the company's reach within the federal government. As the number-one supplier of IT services to the federal government, coupling QTC's case management services and healthcare expertise allows Lockheed Martin to help improve healthcare for all government personnel.

Lockheed Martin will produce approximately $8.25 per share in earnings during 2012 and will distribute well over $2.25 billion in reported earnings to shareholders through dividends and share buybacks. Lockheed Martin currently pays an annual dividend of $4.60 per share, which represents approximately a 5% yield at the company's year-end stock price. The company also has repurchased approximately 20% of its stock over the past five years. We believe the high dividend coupled with ongoing share repurchases provides shareholders an 8% look-through yield at the company's year-end stock price. This return represents a fair arbitrage when compared to alternative investment opportunities. Our plan is to remain invested in Lockheed Martin.

HEALTHCARE GROUP

Our primary healthcare holdings—Johnson & Johnson and Medtronic—achieved profitable growth during 2012, and we expect these medical businesses to grow their earnings throughout 2013.

The healthcare industry remains uncertain for investors due to healthcare reform legislation and wrangling over the management of increasing long-term healthcare costs. One of the fundamental causes of the U.S.'s large fiscal imbalance is the significant growth in healthcare spending, which has been growing at a faster rate than the U.S. Gross Domestic Product. This situation is unsustainable and requires, among other measures, the control of Medicare and Medicaid expenditures. One proposed solution to reign in Medicare and Medicaid's cost growth is to leverage the government's buying power to dictate the prices these programs pay to doctors, hospitals, laboratories, home healthcare agencies, nursing homes, and pharmaceutical and device companies. Government-controlled pricing means lower profitability for healthcare industry participants. With all the slated pending changes in the law, and possible future alterations to healthcare, it has become increasingly difficult to predict the future of drug development, medical device, and other healthcare-related companies, and investors are choosing to avoid this sector until a clearer picture emerges.

We believe a long-term arbitrage opportunity now exists due to extreme investor reluctance about healthcare companies. We believe that owning the "right" healthcare companies that do not carry many of the typical risks associated with this sector can provide long-term rewards. Johnson & Johnson and Medtronic are two companies that continue to fit our long-term investment criteria: Each company occupies market niches 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 "fair prices."

Although it would be difficult to place Medtronic in the same category as a Coca-Cola or Procter & Gamble, we think Johnson & Johnson comes fairly close. If one looks at any family home or hospital, Johnson & Johnson products are positioned throughout. From Band-Aids, Listerine, and Tylenol to surgical devices, wound care, and diagnostics, J&J is there. It is our opinion that J&J is a rare healthcare company that can represent a long-term franchise arbitrage. The company's global breadth and reach is still in its infancy, with J&J's sales representing only about 5% share of the total $1.2 trillion market for medical devices, diagnostics, and pharmaceutical and consumer goods—the remaining 95% represents future potential. In other words, we think J&J's prospects can be viewed several decades out, and that the company is likely to continue its 75+-year streak of increased sales for another 75 years.

Johnson & Johnson

Johnson & Johnson (J&J) encompasses more than 250 companies selling to every country in the world. The company continues to organically increase sales within current businesses and grow through acquisitions. J&J also maintains a decentralized organization structure that allows each business to operate as an entrepreneurial company. This environment provides J&J an opportunity to continue growing within the three healthcare segments in which it competes—consumer, pharmaceutical, and medical devices and diagnostics.

During the past few years, several missteps have temporarily impacted J&J, causing impatient investors to sell their holdings. J&J's McNeil Consumer Healthcare unit, which markets well-known products such as Tylenol and Johnson's baby products, has had 25 product recalls during the last several years, resulting in a complete shutdown of one of its three North American plants. The two remaining plants are operating under a federal consent decree until J&J satisfies regulators that manufacturing facility deficiencies have been fully addressed. The company has not been able to offer a definitive timeline for a complete resolution of the manufacturing issues, and this has led to product shortages for popular items such as children's liquid Tylenol. Adding insult to injury, J&J's medical devices and diagnostics division, which manufactures products such as artificial hips and knees as well as surgical supplies, announced an approximately $3 billion charge to put money aside for lawsuits resulting from artificial hip product recalls from J&J's DePuy Orthopaedics subsidiary. The bottom line: J&J has been dealing with some challenging issues that have impacted the company's performance.

We are not going to sell our position in J&J, as we believe the company will resolve its temporary manufacturing and product issues. J&J has hired a new CEO, Alex Gorsky, to tackle the company's current challenges and to carry out the company's plan for continued global growth. We think Mr. Gorsky possesses the necessary background to fix J&J's issues, including experience running large, complex healthcare-related organizations. Prior to his appointment as CEO in 2012, he led the worldwide medical devices and diagnostics group at Johnson & Johnson. Mr. Gorsky also served as the worldwide chairman of the surgical care group at J&J and as the chairman of the company's pharmaceutical business in Europe, the Middle East, and Africa; and he previously held leadership positions with major pharmaceutical companies. Mr. Gorsky's vast knowledge of J&J and deep leadership experience will, in our opinion, administer the remedy that J&J needs to get back to full health.

In the meantime, J&J continues to broaden its position in the healthcare industry through strategic acquisitions. The company is currently absorbing the $21.3 billion acquisition of Synthes, a leading global medical device company that specializes in instruments, implants, and biomaterials for the surgical fixation, correction, and regeneration of the human skeleton and its soft tissues. With the Synthes addition, J&J now holds the largest medical device business in the world.

J&J's pharmaceutical business is the eighth largest in the world and includes a robust pipeline of products and line extensions that are set to be filed in upcoming years. Several blockbuster-potential products in this roster could surpass revenues of $1 billion each by 2015, including bapineuzumab, an experimental treatment for

Alzheimer's disease that J&J is co-developing with Pfizer; Xarelto, an oral anticoagulant; and Zytiga, a treatment for prostate cancer that could approach $1 billion in sales this year. Another potential home-run product in J&J's pipeline is Telapravir, a treatment for hepatitis C that may add $500 million of revenue by 2015.

J&J will earn approximately $5.10 per share in adjusted earnings in 2012 and should grow earnings at slightly above 7.5% in 2013, to $5.50 per share. The company is expected to generate more than $14 billion of owner earnings in 2013 and will return cash to stockholders through continual share repurchases and more than $6.5 billion of dividends (a 3.4% dividend yield at the year-end stock price). We think J&J remains a tremendous long-term franchise arbitrage, given its current 7% owner earnings yield and multi-decade growth opportunity. J&J remains a very attractive position in our portfolio.

Medtronic

We are maintaining our position in Medtronic, the world's largest medical technology company with a global reach that extends to 120 countries. Medtronic produces 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.

Over the past five years, the stock price of Medtronic has been range-bound. This stems from the belief of many analysts that the company's core franchises in the cardiac rhythm management and spinal businesses are slowing down as patient volume falls off and managed care pushes back on reimbursement. Although this is true, we are still enthusiastic about our long-term investment in Medtronic as the company experiences growth in other areas.

Medtronic continues to evolve as a company and is further developing its favorable position in devices that manage chronic diseases. Much of this change is being brought about through strategic acquisitions that are adding to the company's revenue and profit base. Over the past few years, the company has made several acquisitions, including Ardian, developer of a product that uses low-power RF energy to deactivate the renal sympathetic nerves and reduce hypertension (an epidemic affecting nearly one billion people); and Salient Surgical Technologies, which develops and markets advanced energy devices for haemostatic sealing of soft tissue and bone. Salient's devices are used in a variety of surgical procedures including orthopedic surgery, spine, open abdominal, and thoracic procedures.

With the ongoing changes to Medtronic, the company is expected to grow sales and earnings at 4% in 2012 (calendar earnings should be $3.32 per share). During 2013, we are anticipating Medtronic's sales to rise an additional 4% and earnings to increase 10%—to $3.78 per share. Through the past five years, Medtronic has experienced sales growth of approximately 25%, followed by an earnings increase of 60%—despite the stock staying relatively flat over this same time frame. This demonstrates the wide difference that can occur between the growth of intrinsic business value and price. Medtronic is at a point at which a so-called fixed-income arbitrage opportunity is prevalent. The company's 2013 calendar earnings of $3.78 per share are largely available for distribution to shareholders, representing a 9% yield at the company's year-end price. Medtronic is returning money to shareholders via a $1.04 per share dividend and is also on track to repurchase $2 billion of stock this next year. The combined dividend and stock repurchases provides shareholders a 7%+ look-through yield. Given Medtronic's current franchise strength and future market opportunity for devices that manage chronic diseases, we plan to hold this quality healthcare company in our portfolio over the long term.

TECHNOLOGY GROUP

The information technology sector—in which quick-paced changes are the status quo—is a tough business for both industry participants and investors. The technology graveyard is laden with companies that were successful one day and nonexistent the next. In the past, we have highlighted well-known companies that failed due to their inability to adapt to changing technology. We have cited Xerox, which was the actual inventor of the personal computer, the graphical user interface (GUI) that led to the Apple Macintosh's operating system and subsequently the Windows operating system, and the popular mouse computer input interface. (Xerox's board had deemed the PC and these associated innovations that had been developed at the Xerox Palo Alto Research Center to be "something not worth pursuing," and Steve Jobs (Apple) brought to market variations on these innovations—and then Bill Gates (Microsoft) copied Apple.)

We can also look at Kodak, which dominated the film industry for more than a century, only to be eclipsed by the digital revolution that took place over the past 10 years. In early 2012, when virtually everyone was using their phones to take digital pictures and post them instantaneously for family and friends to see, Kodak filed for bankruptcy. Film is dead, and the major beneficiaries of this digital revolution are companies such as Facebook and Twitter—nothing like Kodak.

Technology is currently in a complete state of flux, and it is very difficult to determine what companies will succeed or fail in an industry characterized by warp-speed change. Apple has been the primary disrupter in the latest technology cycle through its introduction of the iPhone and iPad. The downsizing of computerization has provided the opportunity to fit a powerful computer device into the palm of one's hand, driving a new generation of products that empower every individual to stay connected to the world at all times. This speed of connectivity has shaken the old-fashioned computer device makers such as Dell and Hewlett-Packard. The so-called "new space" competitors are the ones that manufacture small, flexible devices and create an environment that enables individuals to stay connected. Companies such as Apple, Samsung, Facebook, Amazon.com, IBM, Google, Cisco, Oracle and Microsoft are all competing in this area.

Who will win in the information technology ecosystem is anyone's guess. But we do believe an arbitrage opportunity exists as investors "throw out" the traditional/older companies in favor of the new emerging companies that are popularized via the Internet. The difference in price versus value is rather wide with selective technology companies that maintain a strong competitive position in an evolving technology landscape.

Companies that provide the backbone of new technology infrastructure to support these new technologies could emerge with a competitive advantage. Players in this space may not be as "consumer oriented" but will nonetheless play an increasingly important role in this rapidly changing industry. With this in mind, we seek to invest in undervalued technology companies that are in the "center" of providing technology infrastructure that all participants will need. Our two largest technology companies—Microsoft and Intel—are positioned to play a large role in the new technology environment.

Microsoft

Microsoft, our largest technology holding, had very good business results in 2012, and we expect the company's growth to continue in 2013. The investment market is still underappreciating the strides this technology powerhouse is making in the marketplace, however—especially with regard to its forceful move into cloud computing, which figures large in the new technology environment.

We discussed the emergence of cloud computing—the delivery of computing as a service instead of as a product—in last year's letter. Using cloud computing, customers share resources, software, and information that are provided to personal computers and other devices as a metered service over the Internet. Cloud computing is analogous to an electric utility, whereby the power station delivers power to the electrical grid, and consumers draw down on that power as they need it—and are charged based on their usage. The infrastructure that supports cloud computing comprises large data centers ("server farms") that are owned and operated by companies such as Microsoft, Google, IBM, Rackspace, and Amazon.com. Obviously, cloud computing offers businesses an opportunity to reorganize their IT infrastructure and decrease their reliance on corporate servers—resulting in overall savings to their IT spending budgets.

Cloud computing is becoming a large part of the global computing infrastructure, representing a $50 billion business within the next few years and, according to Forrester research, a potential $240 billion business by 2020. In a Microsoft-sponsored 2011 *Harvard Business Review* survey of 1,500 business and technology leaders, 85% stated that their organizations would be using cloud computing tools moderately to extensively within the next three years, representing more than double their current use. It is our opinion that decisions by companies to "move to the cloud" will not be "all or nothing." Cloud computing is a complement to normal computing that offers increased flexibility, scalability, and affordability to companies—especially small- and medium-size businesses—that seek to improve computing efficiency and productivity.

Many think that cloud computing is a "commodity" business, with hundreds of competitors seeking to gain scale in this easy-entry business. We somewhat disagree—just look at the oil-refining business in the early part of the 20th century, or the utility business. These are industries in which scale and "control of the middle" has been important—and based on past experience with this business model, we believe Microsoft is positioned to emerge as a dominant player in this space. [A side note: Warren Buffett also sees this opportunity and has broken with his technology-shy nature and invested more than $13 billion in IBM during the past few years.] We believe the “utilitization” of computing will offer a tremendous revenue and profit annuity for companies such as Microsoft and IBM.

Microsoft has an annual R&D budget of approximately $10 billion, and a large portion of this is slotted for cloud computing. [A side note—approximately 35% of Microsoft’s 94,000 employees are in product research and development.] Examples of recent Microsoft cloud-based computing offerings include:

- Microsoft Office 365, an online suite that enables people to work from virtually anywhere at any time with collaboration and communication solutions, including Microsoft Office, Exchange, SharePoint, and Lync
- Xbox LIVE service, which enables online gaming, social networking, and access to a wide range of video, gaming, and entertainment content
- Microsoft Dynamics CRM online customer relationship management services for sales, service, and marketing professionals provided through a Microsoft Outlook interface
- Bing, the Microsoft Internet search engine that finds and organizes the answers people need so they can make faster, more informed decisions
- Skype, which allows users to connect with friends, family, clients, and colleagues through a variety of devices
- the Azure family of platform and database services that helps developers connect applications and services in the cloud or on-premise. Services include Windows Azure—a scalable operating system with computing, storage, hosting, and management capabilities—and Microsoft SQL Azure, a relational database.

In October, Microsoft released its Windows 8 operating system. Far from a routine operating system upgrade, Windows 8 is a new platform that will run on both x86 and ARM architecture, enabling an even wider range of devices that run Windows. Windows 8 is available for personal computers, tablets, and phones and has the capability to take advantage of mobile computing with touch and pen capabilities. This new operating system allows for an interconnected ecosystem and dovetails with Microsoft’s emphasis on cloud-based computing. We think that computing is transitioning to a new “center” and that Microsoft will re-emerge as a different and stronger company in this emerging space.

In the meantime, Microsoft will earn approximately $2.90 per share in its fiscal year-end (June 2013) and should grow earnings at approximately 10% the following year, to approximately $3.20 per share. The company will generate more than $25 billion of owner earnings and will return this cash to stockholders through net share repurchases of $10 billion and around $7 billion of dividends (an approximate 7.5% look-through 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.

Intel

During the past year, we have been adding Intel to our portfolio. Intel designs, manufactures, and sells computer components and related products. The company’s major products include microprocessors, chipsets, flash memory and graphics products, and network and communications products. Intel holds about 80% of market share for microprocessors that are used in desktop and laptop computers as well as computer servers.

Why invest in Intel?

In 2011, Intel had a tremendous year despite a tough macro-economic environment. The company set records in virtually all categories—platform unit sales, revenue, and earnings. The high demand for Intel’s products led to revenue growth of 24%, to $54 billion, and net income growth of 13%, to $12.9 billion. The company’s growth was highly influenced by strong PC demand, especially from emerging markets such as China. The year 2011 marked the first time total PC sales in China exceeded sales in every other country, followed by the U.S., Brazil, and Russia. Intel’s Data Center Group, which develops technology for a range of applications—from cloud computing and mission-critical servers to high performance computing—was another growth area. In 2011, this business segment experienced year-over-year revenue growth of 17%, topping $10.1 billion.

The past year has been a different story for Intel. During 2012, global PC demand has declined as consumers moved to mobile devices. Since Intel has a minor presence in the mobile device area, the company has been generating lower-than-expected revenues and profits. It is our opinion that this is a temporary phenomenon and that Intel will continue its infiltration of the overall computing market for several reasons. First, Intel’s microprocessors form the backbone of the Internet and cloud-based computing. According to Data Center Map, approximately 2,575 co-located data centers in 89 countries make up what we can call the “global computing platform.” These data centers collectively contain more than 50 million computer servers, most of which are running on Intel products. Although this is a large number, the amount of computer servers that are needed to manage the growth of global computing will likely double by 2020—and we expect Intel to be at the forefront of providing technology to help operate this network efficiently. Second, Intel is transforming and broadening its scope from a primary focus on designing and manufacturing microprocessors for PCs and servers to include delivery of multiple hardware and software platform solutions. As the number and variety of devices connected to the Internet grows, and computing becomes an even more interactive experience, customers will increasingly want their devices to connect seamlessly and effortlessly to the Internet and to each other. In the end, we believe Intel will play an important role in the utilitization of computing and will obtain a terrific revenue and profit annuity in future years through its multi-product offering.

Intel will earn approximately $2.10 per share in 2012 and will likely produce approximately $2 of earnings in 2013. We expect the company to resume earnings growth in 2014. We are willing to be patient with Intel, as its stagnant earnings growth is reflected in the current stock price. We believe the company will generate approximately $9 billion of owner earnings and will return this cash to shareholders through share repurchases of $4.5 billion, plus $4.5 billion of dividends—Intel’s dividend yield is 4.35% at the year-end stock price, and the look-through yield is 8.7% when including share repurchases. This is a very fair investment given the current return to owners of this company, along with its optimistic future. We are happy to have Intel as part of our portfolio.

FINANCIAL SERVICES GROUP

Berkshire Hathaway

Our largest financial services holding, Berkshire Hathaway, experienced good growth in book value during 2012. This year’s approximate 13% rise in per-share book value follows a 4.6% and 13% increase in per-share book value in 2011 and 2010, respectively. What is more interesting: Even though Berkshire’s per-share book value has now grown around 44% since the end of 2007, the company’s stock price has remained flat over the same time frame, continuing what we believe to be a disparity between the company’s price and intrinsic value. Berkshire continues to trade where many weaker financial entities are trading right now—at around the company’s liquidation value. It is our opinion, however, that Berkshire is worth more than its current stock price—like our UConn basketball example, we think Berkshire represents a $35 ticket whose intrinsic value is $50. (Mr. Buffett agrees with our assumption about Berkshire’s low valuation and recently raised the price at which he will repurchase Berkshire’s shares from investors that are willing to sell.)

Berkshire is a treasure chest of theoretical “hidden” arbitrage opportunities that could add tremendous value to the company:

> *Arbitrage # 1:* Over the decades, Berkshire has continually accumulated low-cost funds “borrowed” from customers through its collection of insurance premiums and, due to the nature of its insurance business, this so-called float “sticks” within the company for many years—i.e., Berkshire maintains this money for a long time. Berkshire primarily generates its float by providing insurance directly to individuals (GEICO), as well as by providing other insurance companies coverage against very large catastrophic-loss events such as hurricanes or earthquakes (this is known as “reinsurance”).
>
> On the money-generating side of the equation, the long length of time over which Berkshire holds customer funds gives Mr. Buffett the benefit of investing float with a long-term horizon—to obtain a highly probable rate of return on this money. The funds are invested in understandable assets and, in many cases, in wholly owned businesses that will remain a part of Berkshire indefinitely. Simply stated: Borrowing money at 0% and then turning around and investing it to generate annual returns of 10%+ is a great equation.
>
> An update on the Bank of America deal serves as a good investment example:
>
> As you may recall, in August 2011, Bank of America entered into an agreement with Berkshire Hathaway whereby Berkshire agreed to purchase $5 billion of Bank of America 6% Cumulative Perpetual Preferred Stock. As part of this transaction, Berkshire also received a warrant to purchase

700,000,000 shares of Bank of America, exercisable at Berkshire's option at any time for 10 years. The exercise price is around of $7.14 per share of Bank of America Common Stock.

What does all this mean? Berkshire lent $5 billion to Bank of America at an interest rate of 6% and has a 10-year option to purchase 700 million shares of Bank of America stock at a price of $7.14 per share. At the end of 2012, Bank of America's stock price was $11.61, and the warrant to purchase 700 million shares was worth approximately $3.1 billion. Berkshire has now earned around $3.5 billion on the initial $5 billion investment—not a bad return.

Arbitrage # 2: Berkshire owns common stock and whole businesses that are currently priced at a discount to their intrinsic value. When evaluating just the publicly traded securities in the company's portfolio, our guesstimate is that the intrinsic value of these collective securities can be up to 15% greater than the market price reflected on Berkshire's balance sheet.

It is also our opinion that the wholly owned companies of Berkshire are trading at a discounted value. For example, the BNSF railroad's intrinsic value represents approximately 25% of Berkshire's total market price. If this is the case, the remaining 67 non-insurance companies that Berkshire owns—including MidAmerican Energy, Shaw Industries, Marmon Group, Benjamin Moore, and many others—would be priced at a significant discount to their current value.

Arbitrage # 3: Berkshire has an approximately $45 billion deferred tax liability on its balance sheet that is recognized as a liability but, in fact, a portion could be considered an asset. Deferred taxes occur when taxes are owed but have not yet been paid. In Berkshire's circumstance, a considerable amount of the deferred tax liability is represented by capital gains in securities owned that the company will have to pay taxes on when eventually sold. However, in Berkshire's case, a share of this deferred tax liability is associated with gains on companies such as Coca-Cola, American Express, and Wells Fargo stock. It is highly likely that Berkshire will never sell its positions in these companies—conceptually making their percentage of the deferred taxes an asset, not a liability. This growing asset adds to Berkshire's capital strength and complements its fortress balance sheet that can take advantage of a hard insurance market when it occurs. Basically, Berkshire is packing a lot of insurance underwriting firepower if and when the market becomes advantageous.

In addition, although this may not be considered arbitrage by nature, Berkshire is now sitting on approximately $45 billion in cash. This is a large investment opportunity that is earning virtually 0% today but could increase Berkshire's earnings significantly when put to use.

In summary, Berkshire's business model pivots on making investments in and/or buying good companies at attractive valuations with low-cost funding. Mr. Buffett has been 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 good arbitrageur who understands disparities and how to pick up $1 of value for the price of 65¢. Given the current low valuation of Berkshire and Mr. Buffett's ongoing intelligent allocation of capital, we will continue to be enthusiastic holders of Berkshire Hathaway and look forward to watching the intrinsic value of this holding grow in upcoming years.

Fairfax Financial Holdings

Our second-largest financial services investment is Fairfax Financial Holdings. We discussed in last year's letter how Chairman and Chief Executive Officer Prem Watsa is building Fairfax's insurance and reinsurance business. Like Berkshire Hathaway, Fairfax operates on a decentralized basis. Each Fairfax subsidiary insurance company provides a range of property and casualty products, maintaining a diversified portfolio of risks across all classes of business, geographic regions, and types of insureds. Most important, autonomous management teams are focused on underwriting profitably in their respective markets.

A study of Fairfax and Prem Watsa—who many consider to be the Warren Buffett of Canada—is very instructive for anyone interested in the insurance business. Like Berkshire Hathaway, we would place Mr. Watsa and his investment team in the expert arbitrage group. Fairfax is extremely adept at recognizing large disparities in price and value, so much so that we would classify its investment activity under the "large arbitrage transactions" category. This has led to an envious long-term performance for the company, as Fairfax Financial Holdings' book value has grown at a compounded rate of approximately 22% per year since the company's founding in 1985. With this said, the annual results can be very lumpy, with embedded returns on investments not reflected for several years through the company's income statement and balance sheet. We are more than happy to be patient as long as we understand the so-called arbitrage activity taking place at Fairfax through the company's disciplined accumulation of low-cost float, the ability to have float stick within the company for a long period of time, and management's capability to allocate capital in a favorable manner for shareholders. Fairfax currently has all three legs of this insurance investment stool, and we are excited about its future prospects.

Arbitrage # 1: Like Berkshire, Fairfax has consistently produced a lower-than-average cost of borrowed customer funds over the decades compared to competitors in the insurance industry. Although the company's yearly weighted average cost of float was more than zero (slightly above 2.5% since the company's inception), we believe the cost of these funds will come down over time. Since 2008, Fairfax's cost of float has been higher than normal due to several acquisitions that faced larger reserve requirements once on board, coupled with a few large catastrophic events (Thailand floods and Japan earthquake/tsunami) that impacted the company's short-term insurance results. As Fairfax gains full control of acquired insurance companies, these subsidiaries' reserves for losses and underwriting discipline is improving over time. It is our opinion that this is occurring due to Fairfax's extreme sensitivity to underwriting profitably to achieve its historical low cost of funds—the company's annual cost of float was less than zero from 1985 to 2007. A long-term lower cost of float will add further value to Fairfax shareholders, given the company's ability to invest capital at higher-than-average rates of return. In addition, Fairfax is accumulating float that is sticking within the company for a longer period of time. In our estimation, the average holding period for Fairfax's funds has nearly doubled in the past 12 years. The longer "tail" (in insurance parlance) that results from Fairfax holding customer premiums for a greater length of time allows Mr. Watsa and his team the opportunity to invest low-cost borrowed funds over a lengthier time horizon. In layman's terms, Fairfax is now borrowing $15 billion (and growing) of customer funds at a low cost, and holding these funds for a greater length of time—providing the company greater investment flexibility. We think of Fairfax as a "baby Berkshire."

On the money-generating side of the equation, Fairfax's float is now invested in understandable assets, including non-insurance companies that Fairfax is purchasing outright. With this said, there are some cases where investments have been made by Fairfax that are "not so understandable" to the average individual. We believe we understand these more esoteric investments, however, and are extremely comfortable with the capital allocation by Mr. Watsa and his team. To give you comfort, we should cite examples of what we consider to be Fairfax's esoteric investment activity.

Arbitrage # 2: In the past, Fairfax has made counterintuitive investment wagers that many would consider "gambles." For example, for several years leading up to 2008, Fairfax aggressively utilized derivatives and swaps to insure the company's net worth in case of a severe stock market decline. To the average individual, this looked like outright gambling, but to an insurance aficionado this wager could be viewed as "cheap insurance," whereby Fairfax paid a low price to protect its portfolio from a catastrophic market event. The counterparties to this transaction were complacent and sold portfolio protection inexpensively, thinking that a negative stock market event would not occur. Mr. Watsa and his team were not 100% sure that a negative stock market event would take place; however, the lack of market volatility at the time created an environment where the "price" for insuring against a market catastrophe became too low—thus Fairfax decided to purchase a lot of insurance. Of course, the financial earthquake erupted in 2008/2009, and Fairfax Financial Holdings made a lot of money. In a single year, Fairfax's common shareholders' equity increased from $4.9 billion at December 31, 2008 to $7.4 billion at December 31, 2009—an increase of $2.5 billion.

Today, Fairfax has again taken similar derivative and swap positions to protect the company's net worth in case of market turmoil, but has added one more inexpensive insurance transaction that provides a good example of its investment prowess. In the past few years, Mr. Watsa and his team purchased something called CPI-linked derivatives, whereby Fairfax purchased derivative contracts that protect the company from deflation that may possibly occur in the European Union, United States, and United Kingdom. These contracts specify that in the event of annual cumulative deflation occurring over a weighted average period of the next 7.5 years, Fairfax would be protected from the adverse financial impact of decreasing pricing levels. Conceptually, this is important today given that the company is experiencing overall underwriting results whereby they are paying policyholders slightly more than the premiums received. In a deflationary environment, you do not want a scenario in which your liabilities stay the same or increase while the value of your assets deteriorates significantly—this is a very bad equation.

What is most interesting about this contract is not the thought behind the protection—that is common sense. What stands out is the price Fairfax paid for this protection. The company purchased *$46+ billion* (notional value) of deflation protection over a remaining life of 7.5 years, for a price of roughly *$440 million*. To get a sense of this contract, it pays to first value its sensitivity, and then to look at it from the counterparty's perspective.

These CPI-linked derivative contracts are extremely sensitive and are valued via "cumulative deflation"—meaning that for every 1% in cumulative deflation, Fairfax will receive 1% of the notional amount of the derivative contracts. For example: If, on average, the EU, U.S., and U.K experience just 1% of cumulative deflation over the contract period, Fairfax will receive around $463 million on the $46.3 billion of notional contract value.

The U.S. in the 1930s and Japan in the 2000s experienced cumulative deflation of 14%. If we experienced just one quarter of this amount, Fairfax will gain more than $1.6 billion in the next 7.5 years from these derivatives alone. This displays the sensitive nature of these contracts—we won't point out the value of these contracts to Fairfax if we repeat a 1930s or Japan 2000s scenario. What we will point out is the deal itself—a lesson in insurance.

The question is: If we were in the business of providing insurance coverage, would we be pleased with collecting a $440 million premium to invest over eight to 10 years, with a probability of paying out billions of dollars to someone if a severe deflationary environment were encountered over the same period? No matter what financial models are used, we would come to the conclusion that an agreement of this type would present a very bad deal, as it would expose us to a near-unlimited loss, compared to the buyer of this contract, which limited its forfeiture to $440 million over the same period of time. Fairfax is the "buyer" of this contract, and we feel sorry for the "seller"—not because of a loss that hasn't actually materialized, but due to the exposure that could literally financially bankrupt an entity. In summary, the payoff of this contract to Fairfax is uncertain, but the exposure to the counterparties of this contract is absolutely certain. [A side note: In this agreement, the parties are required to put up collateral as they incur losses on the contract, further protecting Fairfax from "counterparty risk."]

Fairfax currently has an approximate market capitalization of $7.2 billion and maintains around $8 billion of cash on hand. The company is selling for less than the cash on its balance sheet. Like Berkshire and most financial companies, Fairfax Financial Holdings is currently trading around the company's liquidation value. It is our opinion, however, that Fairfax Financial Holdings is worth more than its current stock price. We are excited about our investment in Fairfax, and we may further increase our commitment to this company over time.

RETAIL GROUP

Our major retail holdings—Home Depot and Walgreens—each had a good year in 2012 as retail purchases continue to recover after the recession. Retailing is a tough business that requires understanding of four essential elements to success:

1. **Excellent customer service:** If an individual walks into your store and gets a whiff of poor customer service, they will likely choose to turn around and shop elsewhere. Customer service is paramount in this business, and not something a retailer can compromise on.
2. **Product selection and superiority:** A retailer must constantly ensure it is offering the right selection of products at the best possible price. You can provide a great service to your customer with attentive associates and a wonderful retail atmosphere, and then deliver a disservice by stocking the right products at the wrong price, the wrong products at the right price, or, worse yet—the wrong products at the wrong price.
3. **Value creation:** It is tough to make money in retail—product turnover, day-to-day revenue and expense management, and long-term capital allocation decisions all play into value creation.

4. **How to blend one's so-called "bricks and mortar" offering with the new "online channel:"** Interconnected retail has added a new dimension to this industry.

Clearly, retailing has many moving variables that require tending each and every day. Inattention to any of these details can lead to disaster—just ask mega retailers of the past, like Woolworth and Sears.

Nevertheless, we remain interested in large, industry-specific retailers that gain economic value as their industries consolidate over the long term—Home Depot and Walgreens fit this description. These retailers are adding value as their specialty segments continue to undergo consolidation and small competitors fall by the wayside, a dynamic that has accelerated during the recent difficult economic times. The retail areas in which we are invested focus on 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 and will likely gain further ground in upcoming years. We have not changed our view: It is virtually impossible for new competitors to gain a foothold in these specialized retail segments that require substantial infrastructure and real estate development.

Home Depot

Despite the home repair and remodeling slowdown resulting from the recession and housing downturn, Home Depot's business performance continues to be stellar. As the economic challenges became part of everyday life over the past five years, Home Depot set out to focus on what we have called the four legs of a great retailer:

1. *Customer Service:* When the economic crisis took hold in 2008, Home Depot took an unprecedented step to introduce and train all U.S. associates on new customer service expectations. The "Customers First" initiative was very detailed and was designed to clarify customer service expectation according to each specific associate position—such as Hardware, Paint, Garden, or Plumbing. During this year, Home Depot set out to reinvigorate its customer service focus to take advantage of increased customer foot traffic during the spring season. As a result, the company retrained *all* its associates under a very aggressive timeline: Within a six-week period, Home Depot had retrained all 250,000 U.S. stores associates on its continued commitment to customer service. This is the type of detailed customer attention that is needed to maintain a competitive advantage, and few retailers are willing to make such a commitment during tough economic times.

2. *Product/Price Selection:* Until 2007, Home Depot's store operations were designed to allow practically every associate inside each store to order products to meet customers' needs. As a result, more than 75% of the company's cost of goods were shipped direct from the vendor to the stores. There was no coordination between supply chain and the stores, leading to a logistical nightmare given Home Depot's size. Just imagine random amounts of freight flowing to various stores at haphazard delivery times. In this environment, inventory management, coordinated product placement, and price management issues surfaced—impacting Home Depot's customer service as well as its profitability.

   As a result of this confusion, Home Depot launched its Rapid Deployment Centers (RDCs), which were at the epicenter of the company's plan to reduce its cost structure and improve sales. The RDCs 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 results are now in: With the company's systemwide transformation, Home Depot has improved the percentage of merchandise allocated automatically through central replenishment from 20% five years ago to around 85% today. The systems enhancements are creating opportunities for Home Depot to increase sales and profits through better in-stocks, improved assortment planning, and more customer interaction.

3. *Revenue & Expense Management/Capital Allocation:* Through operating efficiency programs, better supply chain management, and focused purchasing initiatives, Home Depot is dedicated to lowering expenses, given expected ongoing economic challenges. The company's first focus is on working capital. For example, Home Depot has a goal to further increase inventory productivity to generate additional cash by 2015. The company is on a path to grow inventory turns from the 4.3 times it reported in fiscal 2011 to five times by the end of fiscal 2015.

As the retail landscape changes, Home Depot is also prioritizing capital spending with a focus on defending, maintaining, and growing its business. The company's point of view is unlike that of many retailers, as Home Depot does not need to shrink stores or look to relocate stores to urban areas. In the U.S., Home Depot stores are working warehouses. Given this fact, the company isn't planning any major store remodels or new store formats. In addition, new store openings will be few and far between during these challenging economic times. The concentration on effective capital management leads to more cash for shareholders—we like that.

4. *Interconnected Retail:* Home Depot is taking a unique approach to its online activity. Not only does Home Depot provide customers the opportunity to order goods through its online channel, but the company is leveraging the Internet to augment customer service and drive traffic to its local stores. For example, the company now has more than 2,500 project and product videos posted online, along with 400 downloadable project guides to assist customers with their home improvement needs. As a result of this initiative to add value for the customer, individuals can make online appointments with in-store experts to evaluate their home improvement projects. Home Depot views project management as an opportunity to interconnect the online and bricks-and-mortar retail experience. The company also sees this interaction as a means to deepen its relationship with the customer.

We expect Home Depot to earn approximately $2.93 per share in calendar 2012 and to increase its earnings 16% in calendar 2013—to $3.40 per share. As a result of the actions described above, we expect Home Depot to continue to produce significant amounts of cash that will be distributed to shareholders. The company will generate more than $5 billion of owner earnings and will return this cash to stockholders through share repurchases of $3.5 billion and approximately $1.8 billion of dividends (a 5.7% look-through yield at the year-end stock price). We are pleased with the company's focused approach to customers and shareholders and plan to remain committed owners of Home Depot.

Walgreen Company

Similar to Home Depot in the home improvement specialty retail segment, Walgreens is a dominant retail firm that is gaining ground amid changes in global healthcare. The company's large, expanding store base offers consumers unmatched convenience. Its brand name is one of the most recognized in the retail pharmacy business—there is a Walgreens store within five miles of 70% of U.S. households. We continue to believe 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.

During this past year, Walgreens faced a challenging situation when management opted to let the company's agreement with Express Scripts (one of the largest Pharmacy Benefit Management organizations) expire at the beginning of 2012. For the first nine months of this year, the pricing dispute between Walgreens and Express Scripts impacted Walgreen's performance; Express Scripts customers were no longer able to fulfill their subscriptions at Walgreens stores. As a result of this disagreement, Walgreens lost approximately $4 billion in sales, and the company's profits fell more than 15%. We are pleased to report that during the fourth quarter, the two companies reached a new agreement, and Walgreens' pricing dispute with Express Scripts was resolved. We believe Walgreens is now positioned to benefit from its renewed agreement with Express Scripts and will resume its long-term growth plans.

Like Home Depot, Walgreens has a consistent focus on the four-legged stool of retailing success:

1. *Customer Service:* In 2012, Walgreens completed its three-year plan to refresh stores as part of a "customer-centric retailing" initiative. The company's stores have improved the shopper's experience, leading to higher customer satisfaction and increased sales. The company is also changing the way it views the customer. Walgreens is aggressively rolling out groundbreaking "Well Experience" pilot stores and store formats in select markets. Designed around customer needs, Well Experience stores include several drugstore innovations: Pharmacists are located in front of the pharmacy, are out from behind the counter, and offer enhanced, more personal patient interaction and consultation. Nurse practitioners located adjacent to the pharmacies provide broader healthcare services, from vaccinations and health testing to non-emergency medical treatment. Well Experience stores also feature expanded fresh food selections as well as enhanced

beauty departments with an array of prestige and niche cosmetic, skincare, and haircare brands. Through 2012, the company opened or converted nearly 350 Walgreens locations with the Well Experience format. This new initiative demonstrates how the company is evolving to meet changing customer needs and to improve service.

2. *Product/Price Selection:* Walgreens is also focused on meeting customer needs by offering innovative products at affordable prices. The company continues to expand its selection of private-label health and daily living brands that deliver tremendous value to consumers. For example, one of the company's newest private brands, Nice!, offers more than 400 high-quality grocery and household products at prices up to 30% below other national brands. Walgreens also offers prepared meals for immediate consumption by on-the-go consumers; expanded grocery items for quick, convenient pickup; and a growing selection of fresh produce and healthy food choices that are crucial to communities that lack convenient, affordable nutrition options. As part of her "Let's Move!" initiative focused on helping to fight childhood obesity, First Lady Michelle Obama visited a Walgreens and commended the company's health-conscious initiatives.

3. *Revenue & Expense Management/Capital Allocation:* Walgreens is committed to operating more efficiently, achieving economies of scale through improved product and inventory management, and leveraging its purchasing power. The company has achieved a goal of delivering more than $1 billion in annual pre-tax cost savings from 2008 to 2011 and is continuing a cost-containment program that has become part of its corporate DNA.

   Walgreens is also allocating capital to develop a global pharmacy for customers and to continue building an unmatched network in the healthcare industry. As part of this effort, Walgreens exchanged $4 billion in cash and 83.4 million shares of stock for a 45% equity ownership stake in Alliance Boots, the leading pharmacy-led health and beauty group in Europe. Walgreens will have the option to proceed with a full combination by acquiring the remaining 55% of Alliance Boots within the next three years. The Walgreens–Alliance Boots partnership accelerates a strategy to transform the traditional drugstore and creates a company platform for selling and distributing products in 26 countries. Walgreens also has a goal for the combined companies to achieve synergies that deliver $100 million to $150 million in savings the first year, and $1 billion by the end of 2016.

4. *Interconnected Retail:* Like Home Depot, Walgreens is breaking new ground with e-commerce, leveraging traditional bricks-and-mortar locations with online options. Leveraging mobile applications, the company is providing a broader selection of products and services to customers, including delivery to their homes and making orders available for pickup at the store. Walgreens has also launched new interactive technologies for customers: The company sends a text message to patients when their prescriptions are due for refill, which patients can complete with a simple "refill" reply text. This convenient ongoing interaction deepens Walgreens' relationship with the customer and increases interdependency over time.

We continue to see that the Walgreens of the future is shaping up to be much more than a typical retail pharmacy. We think the company's planned evolution to offer global consumers a more integrated package of healthcare services will create significant value for shareholders.

In the meantime, we believe that the company will produce positive results in 2013 as its new strategy develops and the renewed Express Scripts agreement is implemented. The company earned approximately $2.43 per share in its fiscal year-end, August 2012, and should grow earnings at approximately 22% in calendar 2013, to approximately $2.82 per share. Walgreens will generate approximately $2.8 billion of owner earnings and is expected to return cash to stockholders through share repurchases and dividends of approximately $2.1 billion (a 6% look-through yield at the year-end stock price).

MEDIA GROUP

We continue to believe that the media and communications industry is an extremely competitive and dynamic business due to its reliance on changing technology infrastructure (internet, cable, etc.). Due to the vast channels of content distribution, it is paramount that media companies create and distribute "great content" to attract customers and advertisers. In no other business can a customer or advertiser 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 chosen the best media business in the industry—Disney.

Walt Disney Company

We consider Disney a one-of-a-kind media company and place this business in the "franchise arbitrage" category. Bob Iger, Disney's current CEO, has done a tremendous job creating shareholder value during his tenure. He has the company focused on three main pillars:

1) Creating and building great content
2) Seeking broad distribution of global content
3) Embracing disruptive technology as a way to enhance Disney's content for consumers.

Creating and Building Great Content

Disney's unmatched content (films, characters, etc.) is like an oil well that, once built, keeps producing oil: Each time the company develops an animated film, much of the film development is expensed at the time of its introduction. In future years when the company re-launches these classic films in updated formats (DVD, 3D, etc.), however, Disney attains additional revenues and profits without incurring the expense of developing an animated film. We refer to these re-launches from the company's film library as "accessing the Disney vault." In the past, we have cited the power of this vault and its ability to deliver ongoing profits to shareholders. For example, each year we ask college students in our investing course to name 10 Disney films. The answers come back quickly: *Snow White and the Seven Dwarfs, Pinocchio, Bambi, Cinderella, Alice in Wonderland, Peter Pan, The Little Mermaid, Beauty and the Beast, The Lion King, Aladdin, 101 Dalmatians....* The amazing part occurs when we ask the same students to name 10 films from another studio. They usually struggle to come up with three. From this exercise, the students learn one thing: Our grandchildren's grandchildren will most likely be watching these famous Disney films in the upcoming decades (plus new Disney films), no matter what medium the content is delivered on—movie theater, computer, 3D television, etc. The value of the Disney vault is incalculable because of the 100-year annuity associated with reissuing many Disney films as new delivery mediums emerge.

Since becoming CEO in 2005, Mr. Iger has managed to add significant franchise films to the Disney vault through the acquisition of Pixar and Marvel Entertainment—and this continued in 2012. During the 4th quarter, the company announced a $4 billion acquisition of Lucasfilm—developer of the Star Wars franchise. This acquisition adds to the depth of Disney's vault that keeps on giving over time.

Disney also continued to deliver great original film content in 2012. *Wreck-It Ralph, Lincoln*, and the 3D release of *Monsters, Inc.* should contribute to the outperformance of Disney toward the end of this year. During 2013, Disney is set to launch another string of robust films, including Marvel's *Iron Man 3*, Pixar's *Monsters University*, *Oz the Great and Powerful*, and *The Lone Ranger*. The Disney library just keeps on growing.

Seeking Broad Global Distribution of Content

Disney has a goal to create a platform to entrench and distribute its content to markets throughout the world. The company accomplishes this by reinforcing Disney characters and films through its amusement parks and by touching consumers through the Disney Channel cable network. Disney is currently building its sixth theme park, in mainland China. Positioned in Shanghai's eastern Pudong district, the amusement will be a Magic Kingdom-style theme park tailored to the Shanghai area. The 963-acre park will cost approximately $3.75 billion to build and represents one of the largest direct investments by a U.S. company in the Chinese market. Once completed, this park is expected to draw 7.5 million visitors per year. In addition to theme parks, Disney reaches consumers through the Disney Channel, which has played a critical part in building the company's brand internationally. For example, the recently launched free-to-air Disney Channel in Russia will reach 75% of that country's viewers. With the Russian launch, the company now has more than 100 worldwide channels in its Disney Channel portfolio, up from 19 a decade ago. Disney's distribution strength keeps growing.

Embracing Disruptive Technology

Disney has an Interactive Media Group that creates and delivers branded entertainment and lifestyle content across interactive media platforms. The primary operating businesses of the Interactive Media Group are Games, which creates multi-platform games for global distribution; and Online, which produces Internet websites in the U.S. and internationally (such as Disney.com and Disney Family Network). Disney Games business offers online games such as "LEGO Pirates of the Caribbean," "Epic Mickey," "Disney's Club Penguin," and "Disney Fairies Pixie Hollow." The Interactive Media Group also develops interactive games for social networking websites, including "Gardens of Time." Disney is clearly committed to embracing new mediums to further strengthen its brand and broaden its reach to consumers.

We remain confident in Disney's management team and 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 will allow the company to extend its global reach for many years to come.

Disney earned $3.17 per share in its fiscal year-end, September 29, 2012, and should grow earnings at 8.5% in the next year, to approximately $3.44 per share. The company will generate more than $4.25 billion of owner earnings and is expected to return a large portion of this cash to stockholders through share repurchases of approximately $3 billion and $1.3 billion of dividends. Given the ever-increasing value this franchise is creating, we remain excited long-term holders of Disney.

COMMODITIES GROUP

Our Commodity Holdings include Barrick Gold, Central Fund of Canada, Chevron, ConocoPhillips, and Royal Dutch Shell, along with smaller positions in several other oil companies. We have held commodities and commodity-based positions since 2004, primarily investing in gold, silver, and oil. At the time, we were concerned about the possible deterioration of worldwide currencies, given governments' historical propensity to print money to stem the impact of any financial crisis in their countries. Of course, a financial crisis did occur in 2008/2009, and since then we have been facing an ongoing financial predicament as governments figure out how to work out of the global financial quagmire. There is now tremendous debate (as well as emotion) about commodities as an investment and their reaction to currency debasement. Well-known money managers have faced off in this debate, weighing in about various commodity investments, especially gold.

On one side of the (gold or silver) coin, detractors of gold as an investment state that gold has no utility and is a nonproductive asset. If you purchase an ounce of gold today and hold it for 100 years, you will own that same ounce of gold—nothing more. Alternatively, if you owned an equivalent amount of farmland over the next century, your acres would produce a large amount of crops—all of which you could sell and profit from on an ongoing basis.

On the other side of the coin, some individuals believe gold to be an investment alternative to paper money. In this case, there is a question regarding holding cash as a store of value—especially as governments devalue their currencies via the printing press. As governments print money, the price of commodities such as gold increases as the currency deteriorates (i.e., it costs more currency to purchase an ounce of gold). The argument for holding sterile cash is similar to that of investors who believe gold to be an unproductive relic: If one took a stack of $100 bills and held this pile for 100 years, it would produce nothing, and its value would actually deteriorate due to inflation. In fact, given a scenario of long-term high inflation, that cash may end up being worthless. (Of course, unlike gold, you could burn it to stay warm.)

What do we think?

We think both arguments are correct, and we would love nothing more than to hold the most productive companies in the world—particularly the ones that are the equivalent of investing in farmland that will produce a bountiful harvest (i.e., money) over the next 100 years. Of course, we feel we already own many of these great producing companies.

Nevertheless, we remain concerned about the global financial system that seems to be encountering ongoing stress. In 2004, our original concerns stemmed from a few areas, and this anxiety has not abated:

- Given the growing U.S. debt, in 2004 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 strength relative to other world currencies, gold and silver have respectively risen to around $1,675/oz. and $30.25/oz.

  We have stated before that changes in the dollar's value will not be the only factor 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 a slow-motion train wreck that is way off track as countries such as Portugal, Italy, Greece, and Spain face mounting debt problems. It is our opinion that the European Central Bank will have 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.

- A long-term imbalance continues to grow between commodity supply and demand. For example, daily worldwide oil consumption is now around 89 million barrels of oil per day, exceeding pre-recession levels of approximately 86 million barrels of oil per day. In 2013, world oil demand is expected to rise another 800,000 barrels per day. It is our opinion that "safe" worldwide oil production capabilities are about equal to current demand. Yet the total marginal cost for the largest oil and gas companies to produce the next barrel of oil to meet growing demand is running between $85 and $100 per barrel, including the shale oil that is being extracted in the U.S. It is our opinion that this is the price for which a barrel of oil is currently determined. Demand for energy is increasing, however, as emerging economies grow at a rapid pace—putting pressure on global oil prices that continue to dally around $100 per barrel.

Gold & Silver

Gold as an investment vehicle makes little to zero economic sense. As stated previously, this metal has no utility—all the gold produced from the beginning of time still exists. Gold 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.

Given the utilitization question regarding gold, we will revisit our thoughts from last year's letter: 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, which meant that gold was 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 continues to wane 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 the 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 (and governments) around the world begin to understand that paper currency is losing its utility, they are attempting to find new utility in the time-tested currencies of gold and silver. Many individuals and central banks have now become net buyers of this metal to protect themselves against deteriorating global currencies.

Our continued investment in gold and silver is an attempt to find alternative monetary utility, given the ongoing debasement of global currencies. Since 2004 we have invested in Barrick Gold Corporation, the world's largest gold producer. The company is scheduled to produce approximately 7.5 million ounces of gold in 2012, and has been attempting to increase their annual gold production to 9 million ounces within five years. However, due to high costs associated with building out new mines, and significant increases in capital expenditures, Barrick recently scaled back their annual gold production objective by one million ounces. Despite this announced cutback, the company is still facing enormous capital commitments in upcoming years to reach their adjusted annual gold production goal of 8 million ounces. Needless to say, this is an extremely capital intensive business. As a result, even though there has been a substantial increase in the price of gold over the past five years, this rise has not translated into Barrick's commensurate ability to generate large amounts of cash for shareholders. Given the necessity for Barrick to continue taking 100% of their profits to meet their increased gold production objective, we now anticipate that the company's capability to share capital with owners in the future will be rather limited. The bottom line – we have not seen a corresponding increase in the value of Barrick's stock with the appreciation in the price of gold. At the time we were writing this year-end letter, we were evaluating our alternatives to Barrick, and were searching for another commodity-sensitive business that meets our goal of providing consistent rewards to shareholders through higher dividends and share repurchases. After the first of the year, we found a substitute for Barrick through an investment in CSX railroad. Since this trade took place in 2013, we will be reporting on CSX in our 1st quarter letter.

We also maintain 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 $5.3 billion, represented by approximately 55% gold bullion and certificates, and 45% silver bullion and certificates (the remaining 1% is in cash and equivalent assets).

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 by the lax monetary policies of global central banks. 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. We now have a rather large investment in the energy sector and anticipate oil trading at a price exceeding $85 a barrel, given that the marginal cost of producing a barrel of oil is in this range.

In the meantime, our combined oil holdings are gushing cash. The average dividend being paid by our integrated oil companies is greater than 4%— in this case, we are essentially being "paid" for our insurance against any future inflation.

FIXED-INCOME INVESTMENTS

The Morningstar taxable bond index was up 7.0% in 2012. This positive result follows gains of 5.9% in 2011, 7.7% in 2010, and 14% in 2009. The credit market continued to rise in price this past year, with investors aggressively purchasing fixed-income securities. Individuals continue to be skittish with the stock market since the credit crisis and, as a result, they have poured their savings into bond funds. We stated last year that investors are losing business perspective and chasing returns in the credit market, while remaining leery of the stock market. When evaluating the current fixed-income market, however, individuals would be *far* better off taking a business approach to their investing.

Once again, if individuals stepped back and looked at their fixed-income investments in a similar manner to an investment in a business, they would become skeptical about their future returns. Let's say that a business with zero debt is able to produce a steady 10% return on equity. If management elects to retain the annual earnings of this business and plow these funds back into the company, investors can expect to see their so-called equity bond double in a little more than seven years.

Now let's look at a bond in a similar business light. If you purchase a bond that produces a 10% coupon and choose to retain the annual earnings from this bond and reinvest this money into the same bond at par, you will also double your money in a little more than seven years—producing a similar result to our business example.

After reviewing this example, it is our opinion that individuals purchasing bonds today are not taking a business perspective. For example, if we purchased a 30-year U.S. Treasury bond at the year-end 2.95% yield, and chose to reinvest the coupon payments into these same bonds at par, it would take almost 25 years to double our money. If we presented our clients with a similar arrangement to invest in a business that produces a 2.95% return on equity and retains all the proceeds to repeat this poor return, our judgment would be questioned, regardless of whether the business was assured survivability.

At this point, we can't help but point out the "best case" scenario for investors purchasing a long-term U.S. Treasury Bond. Under the circumstance whereby the rates on long-term U.S. Treasuries goes to *zero percent*, the most an investor could hope to make over the next 10 years would be in the range of 6% per year. (Consider the "bad" case—i.e., a recently issued 10-year Treasury bond would lose more than 25% of its paper value if interest rates rose to 6%, and a 30-year bond would fall more than 55%—and many think stocks are risky?!) There are currently businesses that can be purchased near book value that produce a consistent 10% or more return on equity. But financial advisors adhering to "portfolio management theory" are placing a greater-than-average portion of their clients' assets in *un*businesslike opportunities.

We continue to emphasize several points that concern us about fixed-income instruments: Besides the poor returns being offered in this area, looming risks associated with this "secure investment vehicle" include the possibility of future rising interest rates and even greater chances of default. We remain concerned about the low*er* long-term market interest rates, which may move upward as the Federal Reserve begins to struggle with maintaining a low interest rate environment, along with high liquidity in the market. However unlikely, 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 hand: If incoming data show additional 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. 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 2012, we have had several tranches of municipal and corporate bonds come due. We have maintained a businesslike attitude toward our fixed-income investments, carefully allocating money to securities that offer a fair risk and return over the duration of their holding. We are avoiding speculative investment activity such as chasing returns and/or buying what we consider junk. We are maintaining our attitude of finding the best-yielding securities and 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**

* * *

OUR FINAL THOUGHT

At Founders Capital Management, we believe that the best way to approach investments is with a businesslike view. Although there were (and will continue to be) challenges, we will keep our focus on what's in front of us—adhering to our value-based investment principles. We will fully understand what we are investing in and why, and we will maintain a view on the intrinsic value of our holdings. As such, we continue to invest in higher-yielding stocks and bonds—and then watch the value of our investments grow.

In this age of ongoing 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 and being greedy when prudence should prevail.

We remain 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 2013.

* * *

The examples and descriptions of investments in this client letter do not represent all of the investments purchased, sold, or recommended by Founders and instead represent:

1. *(1) the 10 largest equity positions held by Founders' clients;*
2. *(2) the two largest equity positions in each industry group to which Founders has allocated capital; and*
3. *(3) all equity positions that account for 3% or more of the total funds allocated by Founders to equity holdings.*

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.

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