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2011 Fourth Quarter and Annual Portfolio Commentary

January 18, 2012
Michael J. Porro, CFP, EA

"The only function of economic forecasting is to make astrology respectable."
-Ezra Solomon, Economist

"It was never my thinking that made big money for me. It always was my sitting. Got that? My sitting tight!"
-Jesse Livermore

"I can't remember a time when so many quality companies were selling at low prices compared to alternatives."
-Donald Yacktman, Mutual Fund Manager

"I think there's a real difference between entrepreneurial capitalism that creates jobs and when you rig the game and leave behind people who in effect have lost their future because you got richer."
-Newt Gingrich

"It is always economically possible to stop or prevent such a depression simply by reflating the price level."
-Irving Fisher

"The happiest countries are those with progressive taxes, not flat ones. People are happier because it's perceived as a fairer tax system, where people with greater resources pay more but virtually everyone pays something."
-Edward Diener, professor of psychology, University of Illinois

"The level of obstructionism (in our Congress) is unprecedented."
-Adam Jentleson

"As both we and Warren Buffet continue to remind, bonds are perhaps The Biggest Bubble of all time. Interest rates of all stripes have dropped to record lows between their peaks in 1981 and today. They've fallen steadily for the past three decades, the longest period of declining rates since the American Revolution."
-Stock Trader's Almanac

"Only twice since 1850 in America have 30-year bond returns been as close to equity returns as they are today. And both times multi-decade bond-bear markets followed. During these periods the stock market jumped as much as 7-fold."
-Oxford Club newsletter

"The average person today thinks investing in stocks is nothing but a game of chance with only the luckiest ones making money. They don't realize that investing in stocks is usually the fastest way to accumulate wealth and that it can be done with virtually zero risk if given enough time."
-Stock Trader's Almanac

I see acres of diamonds strewn across the equity landscape, ignored by the herd, and waiting to be gathered by he who picks them up and waits for the herd to recognize their value.
-Michael J. Porro, Investment Maven

I will strive to keep this short and focus more attention on those investments that hurt us over the past year, rather than on a global, macro perspective or our winners. In short, 2011 was a difficult one. This was a most interesting year with the Arab uprisings throughout the Middle East, the Japan earthquake, U.S. political theater over our debt-ceiling, the European financial crisis and the Thailand floods all contributing to a dampening of global economic growth. These also helped delay earning advances of the smaller capitalized and technology companies that we own, dragging down our overall performances. Delay is the critical word. Rewards are postponed, not eradicated.

Of the major indexes in 2011, the DJIA was up 5.5%, the NASDAQ was down 1.8% and the S&P 500 was flat. Our overall return for all accounts averaged a loss of 11.4%; the first time in my memory that we did not exceed the returns of these major indexes. As world events unfolded and the U.S. recovery limped along, fear prevailed and investors sought refuge in U.S. Treasuries even as their yields dropped to record lows. Investors, speculators and traders pulled $9.5 billion out of global equity funds in one week in December alone and $38.8 billion out of emerging-market equity funds for the year through December 16th. The stampede out of equities exaggerated the drop in price of our holdings. Today, the 10-year U.S. Treasury note delivers a 1.9% yield today and the thirty-year bond offers only 2.9%. There will be an event that will trigger a reversal and money will pour out of these “safe havens” and back into equities one of these days. It’s only a matter of time. We patiently wait and are positioned to benefit when this occurs.

It was the third quarter that dragged down our annual performance. Our holdings dropped an average of 17.9% between July 1st and September 30. The rest of the year was fine. We were up an average of 4.2% for the first quarter, down 2.5% for the second and up 6% for the fourth. The summer kicked us in the pants, as our Congress and their debt-ceiling antics scared the world into recognizing that the “greatest country” and the largest economy is held hostage to a bunch of elected, quibbling morons. Our European elected brethren, especially the Italians and the Greeks did their best to demonstrate that they are just as good as we Americans at blundering. (Berlusconi, indeed). The economic drag from the Japanese earthquake and the October flooding in Thailand and the subsequent damage to semiconductor production added icing to the cake. Our investment in CGM Focus fund, down 26% for the year, also hurt our smaller accounts again this year. We finally sold virtually all of our positions in this fund in December, having little luck over the past three years waiting for a recovery. It will take some time for our repositioning of the proceeds to provide positive results. Those who owned CFMFX, please be patient.

All was not bad, however. We enjoyed significant gains in our Canadian Government’s Zero’s (up 14%), Cedar Fair LP (up 41.8%), Intel (up 15.4%), Goodrich (up 40.5%), Provident Energy (up 21.9%), Wyndham Worldwide (up 26.3%), Celera (up 27%) and Timber west (71.7 %). These helped offset our losses in our other holdings.

Let’s look into several of our disappointments and our expectations for these.

Pace Oil

Pace Oil & Gas Ltd. (PACEF) is a small oil and gas exploration and production company based in Alberta, Canada. This company is the result of Provident Energy spinning off its upstream exploration division in 2010 and a subsequent merger with Midnight Oil Exploration Ltd. This company is off the radar of most large investment bank firms. It is too small to follow and is a Canadian firm to boot. We only are aware of it because of the Provident spinoff. We've owned Provident (PVX) for several years. Pace holds a land inventory of over 800,000 acres in western Canada and reserves (proven and probable) valued at over $15 per share (and this is with the current low prices of natural gas). This company should earn .45 cents for 2011, giving it a PE ration of only 9. Earnings for 2012 are projected to grow to .63 cents, or a 40% increase! It holds equity of $9.17 per share and trades at $4.06 today. For us, this appears to be money in the bank awaiting maturity. We own PACEF due to the Provident spin-off and subsequent purchases. While this was down 48.9% in 2011, we find this worthy of additional purchases at these levels. Patience is required. Oil exploration and drilling in the frosty Northwest isn't a job for sissys and apparently is taking some time for fruition. You will find additional information by visiting their website. Google PACE OIL.

Anadigics
ANAD's strength is performance power amplifiers. Called by Paul McWilliams of Next Inning, "the highest (in) performance…with substantial advantages for the increasingly critical need to lower power consumption… (to)…sustain solid connectivity between towers and handsets." Multi-band power amplification is an ANAD specialty. Its patented Indium Gallium Phosphide technology enables cell phones to operate 20-25% longer than those powered by Aluminum Gallium Arsenide. Research-In -Motion accounted for 26% of 2010 sales. While the company has been working stridently to reduce its reliance on RIMM (it grew its business outside of RIMM by 33% in 2011), ANAD fell along with the misfortunes of Research-in-Motion last year. Samsung and LG are two end users that are growing rapidly in importance. ANAD, in 2011, also entered into a relationship with Qualcomm as a "primary reference design partner." ANAD's product focus is in the 3G/4G cell phone sector. In South Korea, ANAD has tripled the number of device qualifications year-over-year. It won the power amp on the Droid Charge and the power amp design on the LG Revolution. ANAD was named the top RF supplier at Huawei and the dominant supplier at ZTE, both major China cell phone players. ANAD is the only qualified source for the Qualcomm Fusion LTE reference design platform and the source for RF on the Qualcomm Gobi platform.

We initially nibbled into Anadigics for a few accounts in 2006 and added aggressively during the early months of 2011 for all accounts when the stock fell under $5. Collectively, our clients now own 35,500 shares of ANAD. Unfortunately, environmental events in Asia did have an impact on the rollout of 4G networks and economic growth worldwide during 2011. Also, Research-In-Motion was wacked with negative news and ANAD's stock price fell to the $2.50 range where it sits today (January 17th). This 47% decline hurt our near term performance for 2011. Nevertheless, we see the weakness as an opportunity to accumulate more of the stock for clients who have the stomach to double up and for new cash designated for growth. While, Valueline is no Holy Grail, this service points to a price in the $5-9 range within 3 years or a 22-44% annual total return. Black Rock Inc. owns 10.4% and Wellington Management (advisor to several Vanguard funds) owns 5.4% of the stock. Officers and directors own 3.5%. So, we are in good company. Anadigics is based in Warren, NJ.

Companhia Siderurgica Nacional ADR
Trading under the NYSE symbol SID, Companhia Siderurgica Nacional is one of Brazil's largest steel producers. It makes cans and other metal products, galvanized steel of construction and industrial use. The company also owns iron ore, limestone and dolomite mines and is a major supplier to the Brazilian automobile industry. SID owns stakes in two railroads, a cement company and energy generation projects. It expects to eventually be totally self-sufficient in generating energy. The company also supplies China. We took a large position in SID in January 2011 when the stock traded in the $17.50 range. In addition to the above mentioned virtues, we expected SID to benefit from the infrastructure build-out in Brazil in preparation for the 2014 World Cup and 2016 Olympics. What happened? You got me. Some knuckle heads (analysts from Goldman Sach no less), recognizing a slowdown in the global steel market called for a sell of the stock. Hiccups in China's and Brazil's growth rates, and overall investor aversion to anything other

than "safe" holdings, contributed to the fall in the stock price. Overdone? I think so. The company should post earnings of $2.24 per share in 2011, a 27% increase over 2010 and a small 2.7% decrease for 2012. It should eventually benefit from the infrastructure build-out over the next several years and pays out a dividend of .64 cents, or 7.5%. We're down 47% in this position and are looking to accumulate more at these levels. We look forward to the appreciation of our SID shares and their contribution to improving our returns in 2012 and beyond. Meanwhile, the 7.5% dividend is a pleasure to pocket.

Dragonwave

We wrote briefly about DRWI in our 2011 Second Quarter commentary. You may recall that this company provides microwave backhaul to the wireless industry. Dragonwave's fortunes are presently closely tied to those of Clearwire's and have been punished for delays in Clearwire's expansion plans. Global delays in wireless broadband rollouts due to the earthquakes, floods, financial crisis's, potential mergers (AT&T and T-Mobile and their postponement of major purchases) contributed. Company related matters such as Sprint's note offering and refocusing, Dragonwave's purchase of Nokia Siemens Networks' microwave backhaul business and LightSquareds' legal issues added to the deferment of earnings. As with our other small capitalized technology positions, this delay and the drop in stock price has presented the opportunity to accumulate more shares at low prices. As 3G and 4G bandwidths grow in demand (Smart phones require these levels of bandwidth) broadband backhaul demand will increase too. Microwave backhaul is the only other alternative to fiber optics. "Best in breed" Dragonwave should see its' backhaul expand in India, Africa, the Middle East, Japan, China, Latin America and the Caribbean. Earnings per quarter, once the industry moves forward, should move into the .20 quarterly range or .80 cents annually. This gives DRWI a forward PE of only 4.5 at today's price. We began accumulating DRWI on 2010 and continued as the stock weakened in 2011. We look towards a double digit stock price within the next few years. In our view, the time to accumulate such potential long-term winners is when others are fearful to do so. At $3.60 a share, this costs less than a Latte at Starbucks and should prove to be a better allocation of money over time.

MIPS Technology

MIPS is another wireless technology related company that took a beating during 2011. Remember, as the "animal spirits" are hibernating, there is little investor appetite for emerging companies. Delays in earnings growth served to punish stock prices severely over the past year. MIPs was no exception.

MIPS makes compact semiconductor processors used in DVD players, set-top-boxes, Blu-ray players, cellular base stations, Internet routers, high-performance data-networking switches, smartphones and tablets. While its' chief rival is ARM Holdings of Apple iPhone fame, MIPS, as a smaller and more versatile company, offers an alternative to ARM. It competes with Intel too, but MIPS designs are more pliable than those of Intel and ARM Holdings. The demand for processors that can weave together graphics to create "systems on a chip" (SoC) grows along with the demand for better smart phones. As smart phone demand increases, the multi-thread technology that MIPS has delivered for years comes more into play. This is MIPS' niche. MIPS and ARMH "rule" the mobile space according to analyst Szymon Slupik. However MIPs chips have distinct advantages that will give it an edge over ARMH as 4G broadband expands. It delivers higher performance per Megahertz: Its chips are multithreaded and thus can manage more than one active processing thread at a time without resorting to memory swap routines: and its core processors are smaller and occupy less silicon area, thus freeing up more space on a single chip for other functions. MIPS provides chips to Cavium Networks, Ingenic (a Chinese semiconductor company that sells tablets through Best Buy, Wal-Mart and Amazon among others), Broadcom, PMC-Sierra and Microchip Technology, among others. The company received "early release" status for the Google Android 3.0 operating system in April of 2011. MIPS smaller size relative to ARMH and INTC also gives it an advantage. It only has to increase its royalties from about 600M new chips by 600M to double its size. ARMH would have to increase sales by 6 Billion chips to accomplish the same growth. We see MIPS, the smaller and more agile brother, with greater growth potential. MIPS presently is working with the Chinese government to develop a new PC architecture based on MIPS processing cores. "The real story here is we're going to see demand for powerful processors expand rapidly during the next few years…we're going to see a very significant rising tide for all three (INTC, ARMH and MIPS) of these processor companies.." according to Paul McWilliams of Next Inning. In December, Ainovo announced the release of its new Novo7 tablet that uses Google's newest operating system, Ice Cream Sandwich. This tablet is powered by an application processor from Igenic and uses a MIPS processor core instead of one from ARM Holdings. MIPS is projected to earn around .60 cents for fiscal 2012, giving it a PE ratio of only 9. While we sit with an unrealized loss with our MIPS investment today, we see significant promise with this company as the 4G broadband rolls out worldwide. This stock should rebound over the next two years as fast as it fell during 2011. We expect it to. Meanwhile, we'll keep on top of new developments with MIPS.

Let's close it up now, Michael.

Whoops! I notice that what was to have been a short letter is now dragging unto its sixth page. I'll stop elaborating on our positions that did not work well in 2011 and work to close. The same overall theme carried through to Quicklogic, STMicroelectionics, PMC-Sierra, Harmonic, Marvel Technology and Cellcom. All were punished as investors ran from equities. All have significant upside potential going forward. We hold, we buy more, and wait. Should you wish me to elaborate further on any of your holdings that I did not cover here, please let me know. We'll discuss these over the phone or during a meeting in our office.

We enjoyed several takeovers during the year, including TelMex International, Telefonos de Mexico, Timberwest and Goodrich (not consummated yet). Telmex gave us a 146% gain over our purchase price and Telefonos a 49% gain. Timberwest gave us a 71.7% gain relative to its 12/31/10 value and Goodrich a 653% gain over its cost.

I think that the events in 2012 should surprise us positively, because too much negativity is reflected in the markets. And yet, the earnings environment for equities seems better than it has in many years. The United States is climbing out of the 2008 debacle, slowly but surely. Inventories are low, setting up the start of a classic business cycle. ISM's index of manufacturing industries rose again in December to 53.9%, up from 52.7% in November. The Service sector, including retail, transportation and insurance grew in December, the 25th straight month of growth. We added the most jobs last year since 2006. The Conference Board's Consumer Confidence Index rose to 64.5 in December, up from 40.9 in October. Spending on equipment and software hit an all-time high in the third quarter of 2011. Hugh advances in technology have allowed businesses to do more with less. The National Federation of Independent Business's index climbed to 93.8 in December, the highest level since February. Unemployment fell to 8.5% in December, the lowest level since 2009. The American Staffing Association monthly report showed their temp staffing index increased to 93, the highest reading all year. Housing is limping along with starts increasing 9.3% in November from October and one of the strongest housing starts reading in three years. Capacity utilization, at 77.8% in November, remains close to its best reading since July 2008. Corporations held a record $2.1 trillion of cash at the end of September. The average company has enough cash to fund its operations for 26 weeks, the highest level since the 1960's, according to CNNMoney. This will eventually be put to work in hiring, capital improvements or acquisitions. "The operating environment is the best of the past four years," states Hudson Riehle of the National Restaurant Assn. Restaurant industry sales in 2011 are estimated to reach a record high of $604 billion. Restaurant employment added 230,000 jobs, growing at a 1.9% pace, the strongest gain in five years.

the smaller and more agile brother The fair market value of the S&P is 20-30% higher than the S&P today, says finance Professor Jeremy Siegel of the Wharton School. Outperformance potential for equities is higher than it was last year, he continues in a recent interview with Robert Huebscher. “I don’t see bonds as being attractive for years and years and years,” he finishes.

All isn’t rosy, remember, many doom and gloomers continue to harp about the glass one quarter full and political noise about the failures of the present administration in this election year will keep a lid on enthusiasm. Also, the drag of the European turmoil will continue to bring uncertainty to the markets. The EU may lose Greece, Portugal and Ireland (although, I doubt it). Labor’s share of corporate income in the U.S. is at its lowest level since 1947 and this troublesome to those who think that corporations will not be able to squeeze additional profits from operations. I find it positive insofar as more cash should then be distributed to employees, who will spend the money. China and the U.S. may face off increasingly for dominance in the Pacific region and the Indian Ocean. The Middle East may find the Arab Spring turning bleak. Iran and the U.S. may blow up into open armed conflict. The world may actually come to an end by December 2012. I say, “Whatever. Same old, same old,” and continue to gather diamonds.

We’ll continue to add to our positions. Our 2011 losers will turn into winners sooner than later.

Drop a line to discuss and questions you may have. Thanks as always for your continued confidence and business.

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