SIRE LINE Capital Management

Third Quarter 2011

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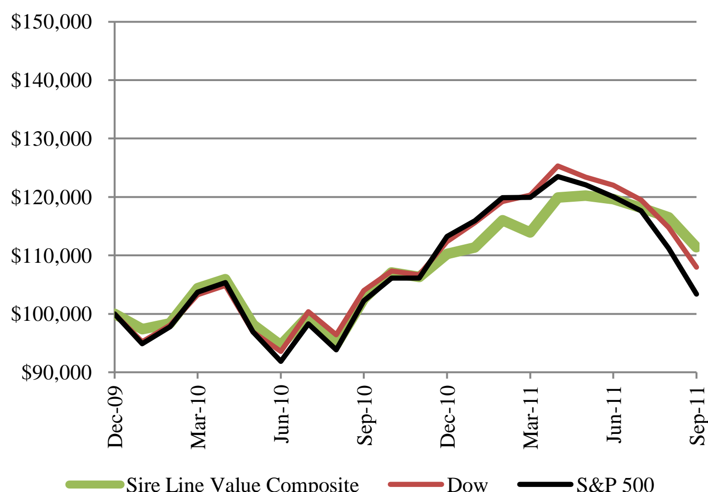
Performance Report from
Daren Taylor, Portfolio Manager

THE VALUE OF A $100,000 INVESTMENT IN THE SIRE LINE VALUE COMPOSITE FROM INCEPTION (1/4/2010) TO PRESENT (9/30/2011) AS COMPARED TO THE S&P 500 INDEX AND THE DOW JONES INDUSTRIAL AVERAGE (UNAUDITED)



NOTE: *Accounts included in this product composite are fully discretionary taxable and tax-exempt portfolios. They are managed under our value style, which invests primarily in high-quality businesses that 1) are simple to understand, 2) have a consistent operating history and favorable long-term prospects, 3) are managed by honest and able managers whose interests are aligned with ours and 4) can be purchased at a significant discount to intrinsic value. The performance of the Sire Line Value Composite is net of fees. All performance figures in the chart above begin as of the close on January 4, 2010.*

Performance Measurement

The objective for all of our portfolios is to outperform all relevant benchmarks over the long term. The chart above shows a comparison of a $100,000 investment in the S&P 500 Index (S&P 500), the Dow Jones Industrial Average (Dow) and the Sire Line Value Composite since inception.

The S&P 500 is an unmanaged, market capitalization weighted index that measures the equity performance of 500 leading companies in the U.S. today. Firms included in the S&P 500 account for approximately 75% of the value of all U.S. stocks. Therefore, it acts as a fairly good proxy for the total market. Clients could easily replicate the performance of the S&P 500 by investing in an index fund at little cost. For discussion purposes below, I will focus on this benchmark to address our relative performance.

Third Quarter Performance

The Sire Line Value Composite (SLVC) experienced a loss of 6.9% in the quarter ended September 30, which compares favorably to the performance of the S&P 500 Index, which declined 13.9%. For the year to date, the SLVC increased just over one percent, which also compares favorably to the loss of 8.7% for the S&P 500 (the Dow declined 3.9%). Our relative outperformance this year has been driven by our lack of exposure to cyclical and commodity-related businesses, which have been weak performers on the year. In addition, our short position in the Russell 2000 Index (small cap companies) combined with our high cash levels helped us to weather the turbulent third quarter in the global financial markets better than most.

While we never like to report a decline in value for any period, volatility is something that every equity investor must accept. If you are a long-term investor, you should actually welcome it. Why? Because it is only during times of great stress and uncertainty in the capital markets that high-quality businesses can be purchased at great prices. It is always important to remember that a decline in the market price of a business does not equate to a decline in its economic value. Putting our money where our mouth is, we took advantage of the volatility in equity markets during the third quarter and purchased a few new names for our portfolios (which we discuss later in this report).

The SLVC has outperformed the S&P 500 by nearly ten percentage points (1.1% vs. -8.7%) so far this year. While I fully expect to outperform the average investor over long periods of time and during down periods for the general market, our relative performance this year has gone well beyond my expectations. Although I won't change one thing about our investment process going forward, such a wide margin of outperformance should not be expected on a regular basis. Nine months is far too short a period to judge the investment performance of a portfolio manager. Wait until I show you at least three years (I would even prefer five years) worth of returns before you form an opinion of my investment management skills. That said, we will take outperformance whenever we can get it and at any magnitude!

The following table summarizes the historical performance of the S&P 500, the Dow and the Sire Line Value Composite:

	TOTAL RETURN (1)		
Annual	S&P 500 (2)	Dow (3)	**SLVC (4)**
2010	13.2%	12.4%	**10.3%**
2011 YTD	-8.7%	-3.9%	**1.1%**
Cumulative:			
2010	13.2%	12.4%	**10.3%**
2010-2011 YTD	3.4%	8.0%	**11.4%**
Annual Compounded Rate:	1.9%	4.5%	**6.4%**

(Footnotes to table above)
(1) All performance figures begin as of the close on January 4, 2010.
(2) Based on changes in the value of the S&P 500 plus dividends (reinvested) that would have been received through ownership of the Index during the period.
(3) Based on changes in the value of the Dow Jones Industrial Average plus dividends (reinvested) that would have been received through ownership of the Index during the period.
(4) Based on changes in the value of the Sire Line Value Composite including dividends and after all fees and expenses.

Winners and Losers

During the third quarter, all of our positions declined in sympathy with the overall market with the exception of three names: Berkshire Hathaway (+4%), Google (0%) and our short position in the Russell 2000 Index (+21%). Year to date, Viacom (+29%) and Automatic Data Processing (+12%) have been our biggest winners, while Bank of NY Mellon (-38%) and Best Buy (-26%) have been our biggest detractors.

Changes to Our Portfolios

During the third quarter we added four new names to the portfolios: Berkshire Hathaway (property & casualty insurance), Google (Internet search), Bank of America (financial services) and Lab. Corp. of America (diagnostic testing).

Berkshire Hathaway needs little introduction as most people know it as Warren Buffett's investment vehicle. You would think that someone who invests like Buffett would always own stock in Berkshire. However, I have only owned it once in the past as it is usually difficult to find trading at a bargain price. Thanks to the recent selloff this summer we were able to buy it at close to reported book value. Buffett is one of the best allocators of capital and he should be able to grow Berkshire's book somewhere between 10% and 15% on average going forward. And our timing couldn't have been any better. A week after we reached our full position in the stock Buffett himself disclosed that Berkshire would begin its first ever stock buyback program due to its cheap valuation. We couldn't agree more.

Google is a fantastic company that generates significant amounts of excess cash. On average over the last five years, 25% of the company's revenues have been converted to free cash flow after all costs and capital expenses have been paid. Your Portfolio Manager's professor at Columbia Business School, Bruce Greenwald, best described the company's secret to success in his book entitled *The Curse of the Mogul*. In the book Greenwald says, "Google is the rare company that seems to have strong elements of all three of the most important sources of competitive advantage identified—economies of scale, customer captivity, and cost." Great companies like Google are rarely available at what we would consider bargain prices. However, thanks to the volatility in the market this summer we believe we were able to buy shares in the company for the value of its current earnings power while paying little for its future growth.

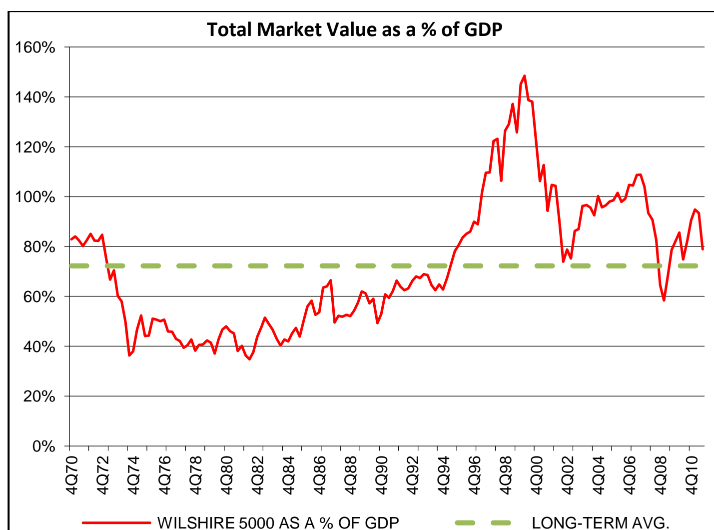
Bank of America's stock has declined over 50% in 2011 and now trades for less than 60% of the company's tangible equity value. Investors are fearful that potential losses related to mortgage putback and litigation activities, as well as the company's exposure to the European debt crisis, will overwhelm the company's financial position and likely force the company to raise additional capital. While there is a small possibility of this happening, we don't believe it will be the eventual outcome. The reason is that most of the potential liabilities associated with these legacy mortgage-related activities will be spread out over many years in the future, which gives the company plenty of time to continue to build capital through its operations. Currently, four of the company's five operating segments are generating positive cash flow, credit trends are improving, and the company has significant earnings power. On a pre-tax, pre-provision (for bad loans) basis, the company has over $30 billion in earnings power—nearly half of its current equity market value. That said, given that banks are highly leveraged entities (which we usually dislike), our Bank of America holdings are, and will remain, a small position in our portfolio.

And finally, Lab. Corp. of America is one of two companies (Quest Diagnostics being the other) that dominate the business of diagnostic testing in the U.S. Because of this, the business generates significant returns on invested capital. The business is recession resistant and the long-term opportunities are favorable given our nation's demographic profile (people over 65 years of age need lab tests 4-to-6 times more than people under 65). I get very excited when I think about the future prospects for all of our new purchases.

During the quarter I completely eliminated our short position in the Russell 2000 Index, which turned out to be a successful hedge to protect our portfolio from a significant decline in the broad financial markets. As of the end of September we held no short positions in the portfolio.

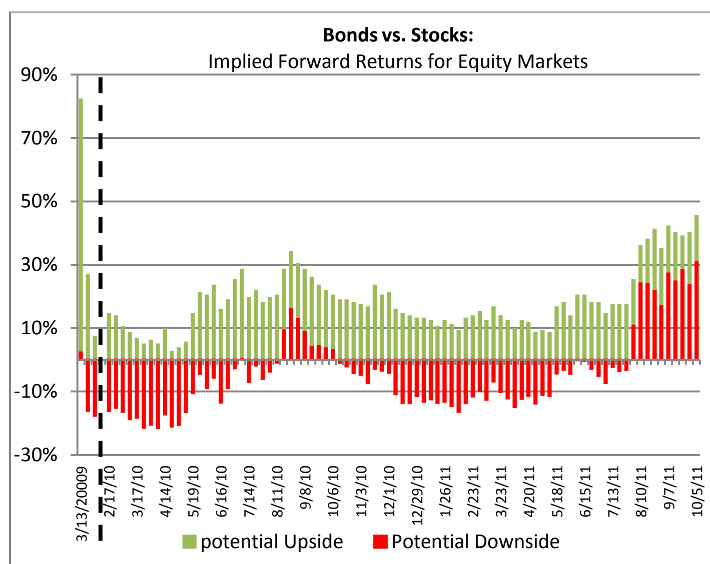
U.S. Equity Markets: Cheap or Expensive?

While we are stock pickers first and foremost, we recognize that it is also important to keep an eye on the overall value of the equity market. One relationship that we track closely is the value of all publically traded securities in the U.S. (as measured by the Wilshire 5000 Index) vs. U.S. GDP (gross domestic product). Think of this relationship as the price-to-sales ratio for the overall equity market. Over the last three months this measurement has declined from 94% at the end of June to 79% at the end of September, which is a sizable move in such a short period of time. The long-term average is below 80%, suggesting that the current equity market is close to fair value. The best news is that we are nowhere near the all-time high of 150%, which was reached at the peak of the technology bubble in 2000. You can see this better in the following chart:



Another measurement that we believe is a good indicator of whether U.S. equity markets are cheap or expensive is the relationship between the yield on U.S. investment grade corporate bonds and the earnings yield for the equity market. (Arnold Van Den Berg is one of our favorite investors and this is one of his favorite valuation measurements). The reason that this relationship is important is because bonds and stocks are always in competition for investor dollars. Investors will always gravitate toward the asset that offers a higher risk-adjusted return.

Based on the historical relationship between these two yields, the current relationship implies that the risks in the equity market strongly favor the upside (potential upside of 45%!). You can see this better in the chart below. (Simplistically, positive green/red means stocks are relatively more attractive than bonds, while negative red/green means stocks are less attractive than bonds.)



Equity markets in general appear to be significantly undervalued when measured against bonds and fairly valued when measured against GDP. As we have already mentioned in this report, we are currently finding good opportunities to add high-quality businesses to our portfolios at very attractive forward rates of return (read: cheap prices!).

As always, thank you for your continued loyalty and support.

With appreciation,

Daren Taylor, CFA

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