SIRE LINE
Capital Management

Second Quarter 2012

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Performance Report from
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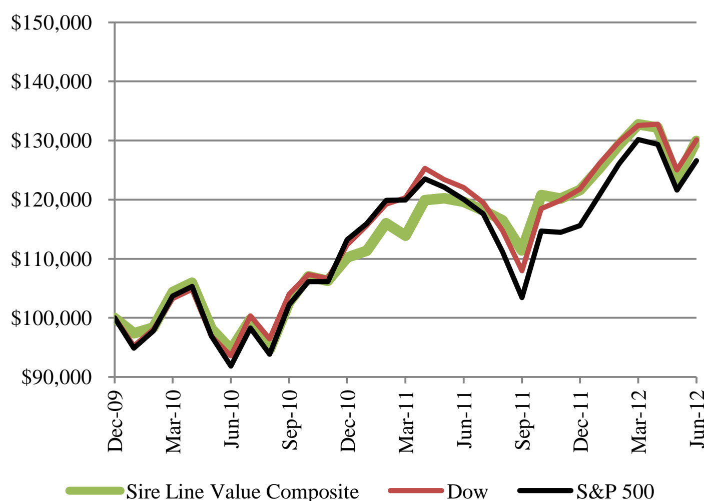
THE VALUE OF A $100,000 INVESTMENT IN THE SIRE LINE VALUE COMPOSITE FROM INCEPTION (1/4/2010) TO PRESENT (6/30/2012) AS COMPARED TO THE S&P 500 INDEX AND THE DOW JONES INDUSTRIAL AVERAGE (UNAUDITED)



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.

Second Quarter Performance

The Sire Line Value Composite (SLVC) experienced a loss of 2.1% in the second quarter, which was a little better than the 2.8% loss for the S&P 500 Index (the Dow lost 1.9%) and much better than the 4.6% loss for the average U.S. diversified equity mutual fund. Year to date, the SLVC is up 6.8% vs. a gain of 9.5% for the S&P 500 (+6.8% for the Dow).

Global economic growth is decelerating. The broadening recession and sovereign debt crisis in Europe is a primary driver, while here at home the U.S. economy is only expected to grow around 2% for the remainder of the year. Economic growth in China, while still much higher than other parts of the world, is also decelerating. However, this is to be expected since much of that country's economy is based on exports to Europe and America. While low growth in the U.S. is better than no growth, it is not enough to bring down our high unemployment rate. In addition, higher tax rates across the board, which are expected to kick in at the beginning of 2013, will no doubt slow U.S. growth even further in the new year. Happy New Year!

All of the above help to create added uncertainty, which investors don't like. U.S. Treasury bonds, which are considered "free from risk," have become popular among investors seeking safety. Bond prices are also being supported by Mr. Bernanke at the Federal Reserve, who continues to fight the good fight against deflation by artificially inflating the value of bonds (through bond purchases), which helps to keep borrowing costs low (bond yields are inversely related to bond prices). Treasury bonds appear to be the bubble du jour and will likely underperform most other assets over the next decade. As one smart-aleck investor recently quipped, "When you buy a Treasury bond today you are not receiving a risk-free return, but rather a return-free risk." We would agree. The reason is because long-term inflation will likely be higher than the after-tax coupon on today's long-term treasury bonds, resulting in a loss of purchasing power for the investor.

On the positive side, oil prices have come down, the housing market has stabilized and large U.S. corporations are financially stronger than they have been in many years.

Instead of making investment decisions based on whether or not we believe a U.S. recession will occur, or speculate about the near-term direction of financial markets, we believe a better investment strategy involves purchasing, at a rational price, high-quality businesses whose earnings are virtually certain to be higher five, ten and twenty years from now. Warren Buffett put it best when he said, "I never

attempt to make money on the stock market. I buy with the assumption that they could close the (stock) market the next day and not reopen it for five years."

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

	TOTAL RETURN (1)		
Annual	S&P 500 (2)	Dow (3)	**SLVC (4)**
2010	13.2%	12.4%	**10.3%**
2011	2.1%	8.4%	**10.3%**
2012 YTD	9.5%	6.8%	**6.8%**
Cumulative:			
2010	13.2%	12.4%	**10.3%**
2010-2011	15.6%	21.8%	**21.7%**
2010-2012 YTD	26.6%	30.1%	**29.9%**
Annual Compounded Rate:	9.9%	11.1%	**11.0%**

(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

Our best performers in the quarter were Scripps Networks, eBay Inc. and Anheuser-Busch Inbev, all of which increased over 10%. Our worst performers, which were each down over 20%, were Dell and JPMorgan Chase.

During the quarter Dell announced disappointing quarterly results, which the market did not take kindly to. The critics on Dell highlight the personal computer (PC) segment as being a low-quality business without giving credit to the company's other attractive business segments. To say that Dell is strictly a PC manufacturer would be far from accurate. Over the past several years management has quietly been transforming the company into a trusted enterprise solutions and services provider to small and medium-size businesses. Management has taken a page out of the IBM playbook, resulting in Dell becoming less about hardware (PCs) and more about software, services and solutions. Enterprise solutions and services, which now account for over half of Dell's total profits, is expected to grow to over 60% by 2016. This segment has high margins and low capital intensity, which means it generates very attractive returns on invested capital. Chairman and CEO Michael Dell is engaged in the business and is very good at allocating capital. Despite the weak operating performance in the most recent quarter, the company has generated over $4 billion ($2.40 per share) in free cash flow over the past year. With a current market value of roughly $20 billion ($12.40 per share), that implies a free cash flow yield of 20%. If you were to exclude the nearly $5.00 per share in net cash on the company's balance sheet, the free cash flow yield jumps to over 30%!

In May, JPMorgan Chase announced that one of its investment departments had experienced a trading loss of over $2 billion related to a hedge position in synthetic derivative securities (don't ask) that were initially designed to reduce credit risk. Management indicated that the ultimate loss could be as high as $9 billion as they work to get out of these positions over the next few months. Investors assumed the worst and quickly knocked some $25 billion off of the company's market value. The trading loss, which sounds like a large number by itself, is actually relatively small when compared to the company's solid balance sheet and earnings power. The company has close to $130 billion in tangible equity capital and should be able to earn over $20 billion in a normal year. While we agree that some management credibility has been lost due to this silly operating stumble, we still view JPMorgan's Chairman and CEO, Jamie Dimon, as one of the best in the industry. As a result of the significant decline in the company's stock due to what we believe is a short-term issue, we have added to our position.

Changes to our Portfolio

During the first half of the year I initiated new positions in Apple Inc., Scripps Networks and Walgreens, and eliminated our positions in Broadridge Financial Solutions and H&R Block.

I discussed our investment in Apple in our first quarter report. Scripps Networks is a lifestyle-based multimedia company with such high-quality brands as the Food Network, HGTV, Travel Channel, DIY Network and Cooking Channel. The company generates revenues primarily from the sale of advertising time on their television networks and websites, as well as from affiliate fees they receive from cable television and satellite companies. The company's networks attract a highly desirable audience for advertisers. In addition, the content that the networks produce (food, home and travel) is universal, which should translate into attractive international growth opportunities in the future.

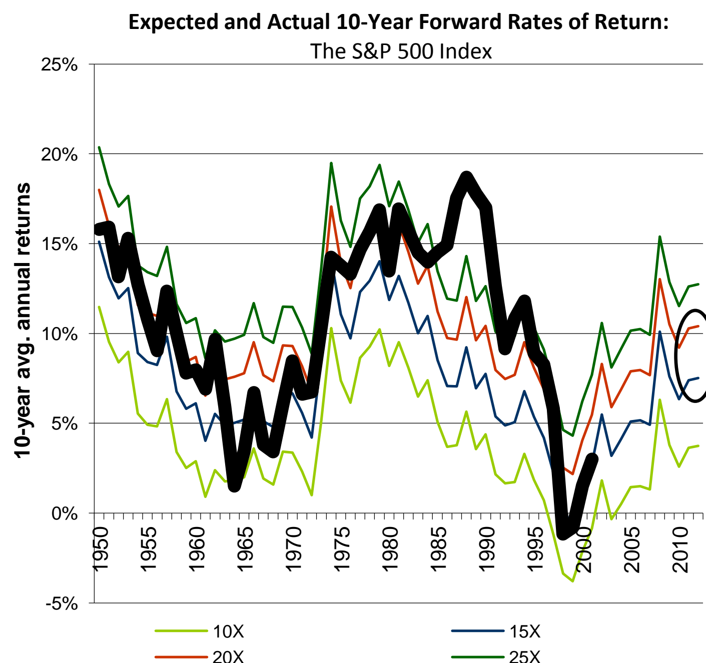
Walgreens is the largest drugstore chain in the U.S. Operating results for the company have been soft in 2012 due to the loss of a large PBM (pharmacy benefits manager) client. On top of that, Walgreens announced late in the quarter that it is buying Alliance Boots, a leading retail pharmacy provider and drug distributor in Europe. The structure of the transaction, which will take place in two separate stages over the next three years, is complex and the combination gives Walgreens new exposure to the issues in Europe, neither of which the market appreciated very much. That said, Walgreens' stock is now down over 40% from its all-time high of $52 reached back in 2006. The company has a free cash flow yield over 10% and a dividend yield of 3.7%, both of which are extremely attractive to us relative to the 1.6% yield on the current 10-year Treasury bond and the 2% dividend yield on the S&P 500 Index. We also believe that it is only a matter of time before the lost PBM contract is renegotiated as both parties will eventually realize that they need each other.

Our small positions in Broadridge Financial and H&R Block were sold and used as a source of funds for our purchases.

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 equity markets. One measurement that we believe is a good indicator of whether U.S. equity markets are cheap or expensive is the expected 10-year forward rate of return on the equity market vs. the yield on the 10-year Treasury bond (the risk-free rate). Forward rates of return for the stock market can be implied by using its current valuation as a starting point and assuming a conservative rate of earnings growth and a range of ending valuation multiples. A 10-year time period is used to make sure that the model captures an entire economic cycle.

In the following chart, the thin colored lines represent expected 10-year forward rates of return for the S&P 500 Index assuming an average annual earnings growth rate of 5% and a range of ending price-to-earnings (P/E) multiples (between 10x and 25x). The heavy black line shows the actual 10-year forward rate of return for the S&P 500. Based on this analysis, the 10-year forward rate of return for the S&P 500 Index is expected to be in the range of 7.5%-10.5%, assuming an ending P/E multiple of between 15x and 20x (circled on far right of the graph).



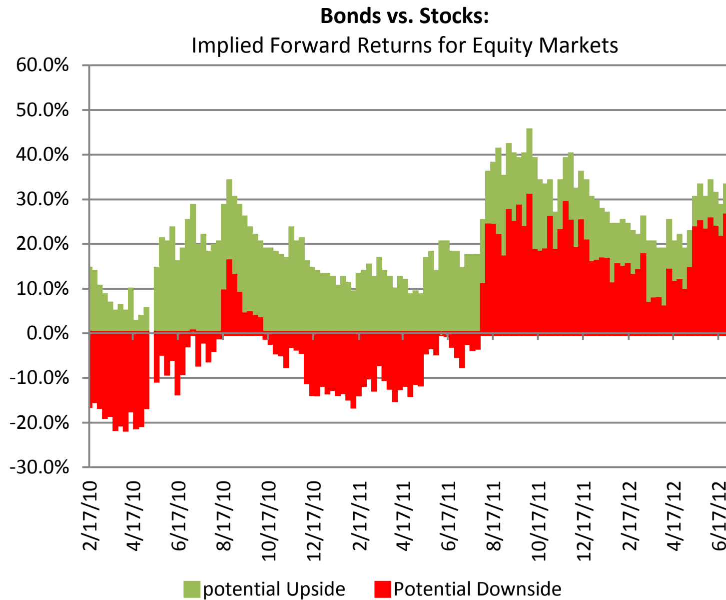
Even if one were to assume a worst case scenario (an ending P/E multiple of only 10x), the expected rate of return for the market would still be higher than the current yield on the 10-year Treasury bond (3.7% for the S&P 500 vs. only 1.6% for the 10-year Treasury bond).

What is interesting to note is the negative actual 10-year forward rate of return for the stock market back in 1998 and 1999 (see how the thick black line dips below 0%). If you look closely at the thin colored lines during that time, the model actually predicted a negative rate of return for two of the scenarios (ending P/E multiples of 10x and 15x), while the most optimistic scenario (ending P/E of 25x) in 1999 only implied a forward rate of return of 4.3%. Keep in mind that back in 1999, the yield on the risk-free 10-year Treasury bond was over 6%! This means that investors in the S&P 500 Index back in the late 1990s and early 2000s were not being compensated for taking the risk of owning stocks over bonds.

Another measurement that we track closely is the relationship between the yield on U.S. investment grade corporate bonds and the earnings yield for the equity market. 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 class 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 continue to favor the upside (potential upside

of 33%). 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.)



Our Portfolio's Expected Rate of Return

As I write this report, the weighted average expected forward rate of return on our portfolios (based on free cash flow yield) is in the mid-teens. This compares favorably to our calculation of the forward rate of return for the S&P 500 Index of roughly 7%-10%, as well as the current 1.6% yield on the "return-free risky" 10-year Treasury bond.

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

With appreciation,

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