Session 1: Prepared by John O'Shaughnessy, CPA  John@rbcpa.com

Introduction:

Investing for “long term” and “value investing”
-buy and hold does not mean buy and never think about it again
-when we buy shares we are investing in the business so we need to understand the business
-rely upon our analyses of the financial statements heavily but not the sole reason to invest in a company
-some of the items we look for include book value, future earnings potential, and cash flow
-looking for companies that are on sale currently and have potential to grow
-we review companies independently and share our thoughts on the company. We don't always agree with each other

Investing vs. trading
-trading is a bet on the direction of a stock price and that is difficult to do consistently over a long period of time
-reason why television is on mute most of the day
-shorting, in general, is a trade

Dollar cost averaging
-take advantage of lower prices
-lower prices seem to be exactly when investors scale back on purchases or stop adding to their accounts and that is not the case with everything else we buy – we look for sale items and lower prices when shopping for groceries or clothes. Why not with investments?

I compared regular monthly investments in a savings account to an investment in the S&P 500 to see how dollar cost averaging would have worked over the past year, given the extremely volatile market.
EFFECT OF REGULAR MONTHLY INVESTMENTS

Comparison of monthly investments in the S&P 500 etf vs. monthly deposits into savings

Assumptions:
1. Started with $1,000 on October 1, 2008.
2. Monthly deposits of $100 were made on the first of each month into savings account beginning on Oct. 1, 2008 and continued through Oct. 1, 2009.
3. Annual interest rate of 1% was used on savings account balance.
4. Monthly purchases of $100 of an etf tracking the S&P 500 (SPY) were made on the first of each month at the opening price beginning Oct. 1, 2008 and continuing through Oct. 1, 2009.

On October 1, 2008 the S&P 500 etf was $115.27 per share and on October 31, 2009 the etf was $103.56 per share, a decline of 10.2%. By investing on a regular basis, without regard for the price, an investor would have taken advantage of lower prices during the year and ended with a balance in excess of the amount in a savings account, even with the decline in the share price. An investor would have had 3% more, $2,377, in the S&P on Oct. 31, 2009 than the $2,319 in a savings account, even though the S&P average declined over 10% during that time period.
General thoughts on the economy and the market averages
-Jeremy Siegel in an article said, “There is absolutely no reason to be pessimistic about either the U.S. or the world economy.”
-What happens when government programs (Cash for clunkers, credit for homebuyers) end?
-Cash for clunkers did nothing to increase demand; it only moved future demand to this year.
-Homeowners’ equity declined from 58.7% in 2005 to 43% today—and that includes the one-third of all households that do not have a mortgage.
-The Fed has been buying mortgages. Is that keeping mortgage rates artificially low?
-Consumer is in the process of re-setting. Future focus on needs rather than wants?
-Unemployment rate over 10%.

-Prior to the past two years, I took for granted that the economy would remain constant, with ups and downs, and therefore an investor could look at specific companies and not place too much emphasis on the worldwide economy. Dramatic changes in the economy cannot be ignored. Our focus continues to be on company specific research but with much more of an appreciation of the general economy.

-DOW Industrial average is now about 30% below its all-time high, and 60% above its March low.
-Much harder to find now but there still seems to be value in some “blue-chip” companies.
-Market seems to be mispricing risk. Weaker companies seem to have unrealistic valuations – Twitter reportedly valued at $1B yet it has virtually no revenue.
Introducing and Principles of Investing with Redfield, Blonsky:

1. We formally started our investment management practice on December 31, 1995. Prior to that date, we were selectively advising clients. Our Assets under Management has grown from under $2M in 1995 to over $43M as of today.

2. Why do people use us? Typically, we would be employed by clients who feel that we are the best accumulators and protectors of their capital for a long period of time. We are unbiased in our approach to investing. We do intensive amounts of research. We look for values. We use our accounting expertise to help us decipher financial statements. We feel that the long term returns of investing will be greater with more diligent and competent research.

3. We use a low cost approach to investing.

4. We take a long-term approach to investing. We consider long-term to be in the area of 5 to 10 years, or more.

5. We eat our own cooking. Ron and John have most of their investable net-worth invested in the same fashion as our clients.

6. We try to have as few positions in our portfolio as possible. We would ideally like to have 8 to 10 common stock positions. We try to keep portfolio activity to a minimum. We believe that less trading is preferred to frequent trading. On the other hand, our fixed income positions will often have greater trading frequency. Sometimes we feel a specific fixed income situation is a bargain at a certain price. We will be buyers, while we perceive that a bargain exists. At other times we will sell when we feel that the “bargain” has subsided.

7. We attempt to be tax efficient.
8. Historically, we typically, but not always, outperformed the stock averages in down years, and underperformed the same averages when they have strong years. Past performance is not necessarily indicative of future results.

9. Clients will often ask us to give a market prediction. Our typical answer is that we have no clue what the stock market will do over a short period. Over the short term (short term being 5 years or less), anything can happen. In the book, The Money Game, Adam Smith pointed out when J. P. Morgan was asked what the market would do, he said, “It will fluctuate.”

10. We have discretion over the accounts we manage. We charge 1% of assets managed.

11. We do not focus a great deal on the day-to-day “noise” in the markets. We attempt to focus on the information that will have a long-term impact on our current investments and potential investments.

12. We are cognizant and respectful of the immense fiduciary responsibility we have in the stewardship of your capital. We stay focused on protecting and growing your hard-earned money.

**Top 5 Common Equity Holdings (Fixed Income and Stocks sold short not included)**

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The following are current examples of our allocations as of November 10, 2009. Not all portfolios look exactly the same. Yet, the following allocations are fairly typical. Please refer to our investor presentation for performance results and disclaimers. 


**Typical allocation of an account that allows for short selling. These are typically taxable accounts (‘Portfolio A’ in our Presentation)**

- Fixed Income: 10.3%
- Cash: 31.5%
- Bear Market H.: 1.3%
- Common Stocks: 58.9%

**Typical allocation of an account that does NOT allow for short selling. These are typically tax-deferred accounts (‘Portfolio B’ in our Presentation)**

- Fixed Income: 20.9%
- Cash: 5.7%
- Bear Market H.: 5.7%
- Common Stocks: 73.4%
What do we look for in an investment?

We look for an investment to be a value. We attempt to find a company, that is conservatively capitalized, can withstand stress scenarios, generates cash flows in a fairly reliable and a somewhat predictable manner.

We look in the nooks and crannies of the financial statements. We try to determine if there might be fundamental reasons a company’s business model and organization is sustainable.

Very simply we figure out how much cash does a business bring in. How much does it pay out? What is left? After we figure that out, we determine how much we will pay for those re-occurring earnings and cash flows. We also factor in their existing assets and liabilities.

Of course determining the above is not easy. Nor is it a science. We do not believe that valuations or how much a company is worth can ever be a precise figure.

We focus on cash generation, free cash flow and try to project, without precision future cash flows. We have a road map, and that map adjusts as time goes on. We attempt to assess the upside and the potential downside in an investment. We focus on our best ideas.

We are not immune to price swings in the market. Yet, we feel that our portfolios, over the long-term, will not suffer a permanent loss of capital. Of course if the system America has known for the last 234 years fails, then our portfolios would have great concerns. Yet in that scenario, I think money in the bank and every day life we are accustomed to would change dramatically.

We review companies’ cash flows fairly closely. We are often considering various bad scenarios. We want to try and envision flaws or changes in our thesis. How much cash is left over to the owners after all bills have been paid? Is the company generating cash in a sustainable manner? How much cash is coming in via non business streams? One example might be cash received from employees exercising stock options. As CPA’s we feel we have an edge in determining sustainable cash flows. We have a fairly in depth knowledge of interpreting financial statements and footnotes.

We avoid investing around noise and macro issues. There are a lot of what appear to be natural occurrences in the world. These include disruptions via wars, elections, major world events, weather, booms, inflation, transportation, communication and so forth. We do not try to predict these events. Yet, when there is a paradigm shift, we will do our best to embrace it.
When researching companies, we review SEC reports, conference calls, investor presentations, news articles and other research reports. As we study the companies and their financials we look for areas that are susceptible. These could include:

A. Frequent extraordinary expenses.
B. Deferred Tax Assets (will they be used?)
C. Goodwill and other intangibles.
D. Hiding expenses in the balance sheet.
E. Comparing reported earnings to reported cash flows.
F. Look at debt covenants (when available).
G. Think about areas that management could be aggressive in.
H. Interpreting Capital Expenditures via the footnotes. Sometimes Capital Expenditures will not show up on the Statement of Cash Flows.

**Other items we pay close attention to:**

A. Price.
B. Market Capitalization.
C. Enterprise Value (Market Cap. – Cash and Equivalents + Long-Term Debt).
D. Total Debt.
E. Debt / Equity ratios.
F. Will earnings and cash flow be able to generate enough to comfortably pay principal and interest? This is referred to as ‘Interest Coverage Ratio.’
G. Return on Equity.
H. Dividends and Dividend Pay-out ratios. Is the dividend sustainable? Can it grow?
I. Insider Activity - Are insiders buying or selling their own stock.
J. Company buy-backs (not just buy-back announcements).

K. Tangible and Intangible Book Values. We examine that ratio as well.

L. Management compensation and stock ownership.

M. Dilution and stock options.


O. We try to project future growth rates.

P. We look closely at the financial statement footnotes.

Q. Is the company reliant on continued financing and debt markets?

R. Have there been ratings agency actions?

S. Is the underlying company facing economic, demographic, technological or political competitive headwinds? How about tailwinds?

T. Does the company under-promise and over-deliver?

U. Have we stress tested our assumptions and valuations for unforeseen circumstances? Have we considered recessions? Will the company be able to withstand stress without materially hurting shareholders?

V. What is our expected Return on Investment (ROI)?

W. Is the stock in a forced selling or buying mode?

X. Is our investment liquid? If not, are we prepared for such an investment? We have learned some hard lessons with liquidity. I need to emphasize that the illiquidity needs to be fully comprehended. Current illiquidity can produce great future profits.

Y. We will study the industry, the competitors, the suppliers, the customers and the management. We like to invest in companies or situations where the management’s livelihoods are in sync with the shareholders.
Z. We look for a “Margin of Safety.” What if our analysis is wrong? What if things don’t go as planned?

**How do we stay focused and keep our eye on the ball?**

We recognize that investing requires patience. We realize that the world has unexpected events. We attempt to typically find companies or investments that are financially strong enough to withstand such events, without impairing their long-term operational goals.

We only worry about our client’s capital. We can not alter our process to please our clients. We stay focused on the investment and the process. We are always doing what we think is best for our clients long term portfolio. A well respected portfolio manager, Jean-Marie Eveillard, has said, “We would rather lose half of our clients than lose half of our client’s money.”

We try to get our clients to understand and expect certain times of underperformance. Periodic underperformance has always been a trait of value investing.

We look for competence, honesty and a hard work ethic in our employees. We value intellectual curiosity and investment honesty. We thrive on inverting investment scenarios. An example of this would be asking ourselves the following question on an investment we were keen on. “Why would we not want to own this investment?”

We are always reminded of Buffett’s discussion in regards to the most important factors of investing are identified in the book ‘Intelligent Investor’ written by Benjamin Graham. Buffett has on many occasions said that Chapters 8 and 20 of the book are crucial to successful investing. Chapter 8 discusses ‘Investing, the Investor and Market Fluctuations.’ Chapter 20 emphasizes the concept of “A Margin of Safety.”

**How do we find new ideas?**

We might come across a company via a friend, observations of our children, work and family. If an idea looks interesting, we will look into the investment. We will apply the methods that are discussed throughout this handout.

Other ideas might come from our daily readings of papers, articles, SEC filings, other investors, clients, other investment advisers and just general life observations.
We will study the industry, the competitors, the suppliers, the customers and the management. We like to invest in companies or situations where the management’s livelihoods are in sync with the shareholders.

**Random Quotes and Notes:**

"I guarantee you, three years from now; our brick, carpet, and our insulation company, will be employing far more people than now." Warren Buffett 10/09

"He, who goes borrowing, goes sorrowing." - Benjamin Franklin. "US is spending tomorrow’s money today." Cheng Siwei - Chinese Economist 10/09

Buffett said in September 2009, he would look at following if had to choose a few indicators. The Fed Balance sheet, freight car loadings and truck tonnage moved.

Interesting graph on effective tax rates in various countries. This is from The Economist, September 2009.

**Effective tax rates**

On gross income of $100,000, May 2009, %

- Income tax
- Employee social security

Source: KPMG

"Rallies on low or declining volume are historic warning signals. False alarm this time? Decade long habits are hard to shake." Art Cashin

"America's best years lie ahead; there is no question about that." Warren Buffett on CNBC in regard American economy on November 3, 2009.
“A rolling loan gathers no loss” Banking adage. Pondering this as I think of loan extensions, loans to value, cap rates, etc

"The [market] is ahead of itself, we'll let the party continue-I'm just not going to partake in the tainted food." Art Cashin 9/16/09 CNBC

Why long-term investing? 1st 5 years, Tom Landry of the Cowboys had losing seasons. He built a foundation. Long-term patience was crucial.

"Learn by your mistakes. Treat past losses as an educational sunk cost". Ronald R. Redfield

Templeton always carried reading materials. He claims the short time spent reading adds up quickly.

"If something is unsustainable, then it will stop." Herb Stein (father of economist/writer/actor Ben Stein

“Mr. Market is your servant, not your master.” Benjamin Graham

Buying out Time Warner, AOL had a market cap > GM, Ford and the entire US steel industry combined.

"..Stocks can get very cheap, even absurdly cheap, although the absurdity is obvious only in retrospect." James Grant

"Read history. Read history." Advice Charles Munger gave Robert Rodriguez (of FPA Capital) on how to be a better investor.

"Investors should stress secure income, bonds and stable dividend equities. Consumer Cuisinart consumption is a relic of the past." Bill Gross

"Unless you read different points of view. Your mind will eventually close. You become a prisoner to a point of view you'll never question." Mohamed El-Erian

Cap rates were 4-6%, now 7-11%. Will cause opportunity to new investors and great pain for current owners who can not manage their debt. Ronald R. Redfield March 2009

“Money is made when the crop is planted, not when it is harvested,” Seth Klarman from Baupost Group.

"The payoff to fundamental analysis rises proportionately with the difficulty of performing it." Klarman 6/97

Doubt has been a central theme of our firm for many years. “Doubt is Central to Understanding.”

Schroeder writes Buffett estimates value, calculates risk using a margin of safety, stays in circle of competence and concentrates the position.

Buffett/Munger said they would not want a manager that went to cash. They’d exclude such managers. Not for us. (Won’t do well long term.)

Charlie Munger said there are plenty of people who have died that we can study.

"Investing is an arrogant act. A buyer is saying that he knows more than the seller and more than other prospective buyers." Seth Klarman

“A market downturn is the true test of an investment philosophy.” Seth Klarman

"**Prediction:** Commercial real estate (CRE) will settle at cap rates of near 10%. CRE prices will decrease by 50% from the peak." Ronald R. Redfield April 2009.


Buffett metric for valuing a bank? "It's quality of earnings on assets, as long as they're being achieved in a conservative way."

“You make most of your money in a bear market; you just don’t realize it at the time.” Shelby Davis

"**Back of envelope method to value real estate:** Take all annual costs, Interest if new mortgage (assume 20% down), repairs, capex, maintenance, etc and multiply by 10." Ronald R. Redfield April 2009.

"Investing isn't simply about being sure you are right, but about making sure you are protected if you are wrong." Jason Zweig

"Value Investing is like buying a snowboard in July". Ronald R. Redfield April 2009.

“The formula for value was handed down from 600 BC by a guy named Aesop. A bird in the hand is worth two in the bush. Investing is about laying out a bird now to get two or more out of the bush. The keys are to only look at the bushes you like and identify how long it will take to get them out.” “Think about what
the asset will produce. Look at the asset, not the beta.” Warren Buffett, February 2009.

The following quotes are from Richard Bernstein a respected market strategist. He relayed these on his last day at Merrill Lynch in April 2009.

“Balance sheets are generally more important than are income or cash flow statements.”

“Investors should focus strongly on GAAP accounting, and should pay little attention to “pro forma” or “unaudited” financial statements.”

“Investors should research financial history as much as possible.”

“Leverage gives the illusion of wealth. Saving is wealth.”

Some Charts and Graphs

![Crude Oil Spot Prices Chart](image)
1. Industrial production, capacity, and utilization

![Graph showing industrial production, capacity, and utilization over time.]

Notes: The shaded areas are periods of business recession as defined by the National Bureau of Economic Research (NBER). The last shaded area begins with the peak as defined by the NBER and ends at the trough of a 3-month moving average of manufacturing IP.
**Final thoughts:**

Read anything by Seth Klarman. This is easier said than done, as his awesome book, “Margin of Safety,” is out of print. Here is a page we keep on Seth Klarman. [http://rbcpa.com/Klarman.html](http://rbcpa.com/Klarman.html)

We have an extensive section on our website with items related to Warren Buffett. [http://www.rbcpa.com/WEB.html](http://www.rbcpa.com/WEB.html)

Please visit our website for a wealth of information. I have designed it to be a financial hub. [www.rbcpa.com](http://www.rbcpa.com)

Investments, like children need nurturing. Be patient. Look at your investments over the long term. We stress that 5 years is only long-term for the impatient investor. On the other hand, constantly monitor investment philosophy.

Invest when others are fearful, sell when others are giddy.

Arnold Van Den Berg said the following about buying value stocks in the August 2006 issue of Outstanding Investors Digest. "You never feel good about buying a great bargain. When you buy a great bargain, you're doing it with sweaty palms, you're leaning against the crowd, engaging in contrary thinking, and you're pretty much alone."

Always ask difficult questions. Your money is at stake. Do not worry about insulting anyone. Exercise doubt!
Disclaimer:

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