

## **Second Quarter 2011 Commentary**

Welcome to your first quarterly portfolio review from Inkwell Capital. We thank you for the fiduciary trust you have placed in us, and we look forward to serving your investment needs.

After the close of each calendar quarter, we will send you a packet of information similar to this one. It will contain a letter from us which briefly discusses the stock market in general and highlights the specific situations of some of the stocks in your account, followed by a few pages with charts and graphs detailing the recent performance of your account.

Since we just started managing your portfolio and our discretionary authority started less than a month before the end of the quarter, this letter will be a little different from our normal format. We will withhold our usual market-related commentary and focus instead on the bigger picture. We believe this letter, which will be somewhat longer than our usual quarterly communication, contains vital information pertaining to your investment expectations and financial peace of mind.

### **A Word About Expectations**

We hope that this is the beginning of a long and mutually-fulfilling relationship. Charlie Munger has said that, in order to have a long-lasting marriage, the most important quality a spouse can possess is not love or loyalty, but low expectations. Following a similar, but less extreme, prescription, we want our clients to step into our adviser-client relationship with not low, but realistic, expectations. To that end, we want to minimize the potential for disappointment on either end by clearly spelling out what expectations we should have of each other.

#### *What You Can Expect From Us*

An Unwavering Investment Philosophy: Our website and our Form ADV Part 2 provide details of our investment philosophy in the year 2011. As it happens, this will be our same investment philosophy in 2021, and in 2031, and in 2041, and so on. We have developed this system over time by studying investing luminaries, testing the principles in our own portfolios, and professionally managing client assets. We will not alter this approach to follow the crowd in chasing after the next hot sector or the latest Internet IPO.

Investing, Not Speculating: A core tenet of our investment philosophy is that we view investing not as the arbitrary trading of slips of paper with three- or four-letter ticker symbols on them, but as the part-ownership of actual businesses. Investing is different from speculating. To borrow Warren Buffett's definition, investing is the act of seeking value at least sufficient to justify the amount paid. Consciously paying more for a stock than its calculated value—in the hope that it can soon be sold for a still-higher price—is speculation. When we buy the stock of a specific company, we do so with the expectation that we will hold that stock for several years, so that we



can benefit from its natural growth and profitable economics. Short-term trading racks up higher commissions and taxes, so a long-term focus naturally reduces those frictional costs to your portfolio.

Honest Communication: There is no hitter in baseball who bats 1.000, and there is no investor in the world that picks a winner every time. We will be forthright in telling you when we made a mistake, and we will attempt to learn from our mistakes so that we will be continually improving as investors. To continue the analogy, our patience in waiting for investment pitches that are well within our sweet spot will allow us to have a higher success rate than if we were to swing wildly at any ball near the plate. After all, there are no called strikes in investing.

No Market Forecasts: John Kenneth Galbraith once said, “The only function of economic forecasting is to make astrology look respectable.” If you ever get the urge to call us up and ask us, “What do you think the market will do in the next quarter or two?”, let us save you the time by giving you our answer now: “We don't know.” We really don't. The stock market is driven in the short term by human emotions such as fear, greed, and envy. Instead of attempting to forecast the general market, we focus our attention on individual stocks and finding undervalued securities.

Investment on the Basis of Value, Not Popularity: Frequently, money managers invest with the herd, where the cozy atmosphere of the crowd trumps business valuations. That is not our modus operandi. As Warren Buffett has said, “You pay a very high price in the stock market for a cheery consensus.” The sine qua non of our operation is buying stocks where there is a margin of safety in the price paid. That often entails buying stocks that are unpopular due to neglect or negative headlines. A given security may be out of favor for a season or even two, but—if it has sufficient value based on its assets or cash flow—the market will eventually reward its shareholders with a higher and more sensible price.

We Eat Our Own Cooking: We manage our personal accounts in the same way we manage our client portfolios. Our interests are therefore aligned with yours, and we will not invest your portfolio in a way that we would not be comfortable investing our own accounts. We cannot promise results, but we can promise a common destiny.

### *What We Will Expect From You*

Let us know if your circumstances change: When you signed our Investment Management Agreement, you detailed your current financial position in life. We have built a customized investment program for you based on those circumstances. However, a 30-year old at the beginning of her career has different investment needs than a 70-year old at the end of his. If you experience any significant life changes that could have an impact on the way we manage your investments, please let us know. This could include needing cash for big events such as sending a child to college, paying for a wedding or divorce, or nearing the end of your working career.



Judge us by the same yardstick: We measure our performance against the general behavior of securities, as measured by the S&P 500, an index of 500 of the largest public companies in the U.S. A good year would not be determined by whether we are up or down for the year, but whether our after-fee returns were better than that yardstick. We would consider a year in which we are down 10% and the S&P 500 declined 20% to be superior to a year when both our portfolios and the S&P 500 gained 15%. We expect you to evaluate us the same way.

Judge us on the long term: Because of our long-term focus, we need you to judge our results based on our long-term results and not on how we perform from quarter to quarter. While we would prefer to be judged based on a five-year horizon, we ask that you at least withhold judgment of our performance for an absolute minimum of three years. Value investing sometimes under-performs the market average for a year or two at a time (and sometimes more), but history has shown that value is recognized over the long haul. As Benjamin Graham said, "In the short run the market is a voting machine, but in the long run it is a weighing machine."

Read our communications: We will use our letters to tell you what is on our minds and to reinforce your understanding of how we think. We feel that the more you understand our investment philosophy and our way of thinking, the more comfortable you will be with our investment decisions. We will do our part by writing, but we hope you do your part by reading. Don't worry, there will not be a quiz at the end of our letters and we don't expect you to be mesmerized by our prose (which can be long-winded, as this letter may attest).

## Conclusion

We are blessed to be doing what we love to do. While others may enjoy watching *American Idol* or reading a gossip magazine, we love reading annual reports and analyzing financial statements. There is nothing more joyful, and rewarding, to us than discovering overlooked, undervalued securities which can increase our clients' net worth.

Thank you again for your confidence in us. Please do not hesitate to contact us if you have any questions or comments. We look forward to reporting to you again in three months.

Sincerely,



Felipe Garcia, CFA  
Chief Investment Officer  
INKWELL CAPITAL LLC



Aaron Byrd, CFA  
President  
INKWELL CAPITAL LLC

