

PENDO LLC



THE VALUE INVESTOR

**Pendo International Strategy
Quarterly Commentary Q4 2011
and
Year-End Review**

January 11, 2012

It's All in the Timing; Greedy or Fearful?

Our performance over the previous twelve months has been a disappointment. Although foreign markets in general were hit much harder than the US (see below), our performance falls short of the standards that we have set for ourselves and that you, our clients, have come to expect from us. That being said, we remain optimistic going forward; we returned 8.9% and outperformed for the fourth quarter and continue to outperform for our longer-term full business cycle targets (three-year and inception). Additionally, the portfolio continues to trade at attractive multiples not seen since the bottom of the world markets in the spring of 2009. We believe an inevitable reversion to the mean and general realization of inherent value will eventually provide us with rewards to the upside and adequately compensate us for the natural time premium.

Our portfolio currently trades at 11.3x trailing and 10.0x estimated (2012) earnings, for a 10% earnings yield. It further trades at 1.4x book value, and is quite well-capitalized with a 0.2 debt-to-capitalization ratio. The current dividend yield is 3.9%. We continue to hold on to companies with a competitive advantage that are compounding earnings and have a consistent, steady growth and ROE. They are in businesses (energy, agriculture, metals, tobacco, etc.) that also have favorable long-term growth prospects. We remain value investors, and view the market as either behaving rationally or irrationally in how it prices any particular company on a case-by-case basis at any particular point in time. We do not treat the market as a casino with ourselves as croupiers.

History has shown that in uncertain times like these it is important for investors not to over-react. To paraphrase Warren Buffett, "be fearful when others are greedy and greedy when others are fearful." We look at market dislocations as opportunities, and the time to invest in what are likely to be only temporary bargains. We invite you to consider the same.

Much of our underperformance was due not to weak fundamentals or what would be long-term impairments, but rather to short-term cyclical factors and incidents (local debt crises, natural disaster, currency fluctuation, etc.). Some was due to our mistakes or misjudgments. This will also be addressed.

US Dollar: Strong, but How Long?

Foreign market's under-performance versus the US as a whole was partially due to a flight to relative safety rather than a search for growth. This was only part of a one-two punch, with a strengthening dollar (for the same reason) further hindering performance in foreign stocks once they are converted to dollars. In fact, as mentioned in our [Q3 commentary](#), we own some companies that had positive returns on their local exchange, but turned negative when currency moves were figured. We discussed currency in last month's interim commentary:

In addition to other macro-economic factors, a major detriment to [performance] has been currency depreciation vs. the US dollar. As instability in both debt and equity rises, sovereign and institutional money gets parked where it will be safest from loss/default, and remain liquid enough in order to be available when circumstances change. The traditional "safe havens" have been the US dollar, Swiss franc, and Japanese yen. In short, Japan faces more problems and larger debt/GDP than the US; though still relatively (and counter intuitively) strong, more cash is being diverted to this side of the Pacific. On September 6th the Swiss National Bank announced an unprecedented *de facto* devaluation of the franc, causing the Swiss franc to collapse over 9% *within 15 minutes* of the announcement, driving the "risk off" money across the Atlantic. Temporarily at least, the USD is the healthiest horse in the glue factory. We do not believe that this will continue indefinitely. The US faces massive amounts of debt and has responded by printing massive amounts of dollars. The 100 year trend of depreciation will again take hold and assert itself.

The worst performing currencies versus the US dollar were the South African Rand, Indian Rupee, Brazilian Real and Argentinean Peso. Had we calculated the performance for the locally listed securities of our investments in those currencies alone, our performance would have been approximately 5% higher. The one company that had the widest discrepancy between its local price in local currency (up 29% for the year) versus the ADR in US dollars (up 6%), was **Tiger Brands (OTC: TBLMY)**. As a South African version of a Kraft/General Mills, this company is well positioned to benefit from the continued development of sub-Saharan Africa.

The major stumbling block was the international climate in general. Adjusted for currency, approximate returns for the major index of some the countries in which we invest were as follows:

Argentina:	-35.5%
Brazil:	-25.7%
China:	-21.7%
Hong Kong:	-20.0%
India:	-36.0%

We do believe that foreign and developing markets will continue to grow at a faster aggregate rate than the US in the long-term over continuous business cycles, as developing economies continue to bring tens of millions of people out of poverty and into a consuming middle class on an annual basis.

Trading versus Investing

As you know, we invest in established companies that meet our investment criteria of high returns on invested capital, high barriers to entry, a sustainable business model, and trade at a discounted price to what we believe to be their intrinsic value. We also take into consideration the company's debt-load, as well as their respective dividend yield. Our searches often lead us to underfollowed companies, which are more likely to be mispriced and therefore trading at a discount. This is usually because an individual company is relatively unknown or too small for a larger fund, too obscure geographically or generally misunderstood. More recently, a particular company's exclusion from an ETF is, with some exceptions, also a (positive) factor. The reasoning for the latter is that we feel that the vast amount of ETFs currently available and their arbitrary rebalancing mandates, in particular the leveraged "double/triple" products, coupled with synthetic programmed computer trading strategies, could eventually create great problems. These are most likely to be irrational and not based on the true value of any individual company; unfortunately, these lucrative (for the industry) products are not likely to be scrutinized until a great problem occurs. We discussed this in our August interim commentary:

Throwing gasoline on the fire are high-frequency and programmed traders, who use complex technical and algorithmic trading platforms to take advantage of (and exacerbate) temporary -sometimes measured in fractions of a second- price dislocations. These trades use no fundamental basis of support, and are not considered an "investment" in traditional terms by their practitioners. During current times of already low volume, some experts have estimated these speculators to comprise as much as 70% of the daily trading volume. Back-to-back multi-percentage point moves in opposite directions no longer make headlines. In the midst of this, our portfolio has also been assaulted and battered by the volatile whims of the market. Pendo believes that in order to achieve positive long-term results, it is now more important than ever to truly *invest* in fundamentally solid *businesses*, which should eventually survive any short-term dislocations and thrive when cooler heads prevail and more rational valuations are realized. We've learned over time that volatility, no matter how long, is temporary, and valuations do eventually revert to the mean. We realize that it is of little comfort in the near-term to point to our long-term time frame. Nevertheless, the fact remains that since many of our businesses do not have exposure to the systemic risks causing many of these current dislocations, eventually more realistic re-valuations should occur.

The Good, the Bad, and the Tsunami

The worst performing sector for the year was financials, followed by materials, energy, industrials and consumer discretionary.

The financial sector has been extraordinarily volatile over the past few years due to subprime lending concerns and exposure to risky sovereign debts. Although our businesses are not exposed to these

problems, they are still technically lumped together within the broad category of “financials,” and as such have suffered in the short-term; guilt by association if you will. For the most part, we remain invested in subsectors with little-to-no exposure to these risks: exchanges, real estate investment companies, asset managers and life insurers. The exchanges have virtually no capital requirement, very low fixed costs, and are often so rich in earnings that they have cash on their balance sheets. The exchange operators may have other issues, such as diminishing barriers to entry due to deregulation, low volume, low stock prices or unfavorable securities issuance markets, but they do not have any financial risk. Our investments in the real estate sector, which are also classified as financials, are very carefully selected, are underleveraged, and trade below book value. Their respective REIT divisions have near full-occupancy rates with pricing power and their development divisions are booked at cost, not at market value. Both are extremely well capitalized, with debt to total capitalization ratios of 0.2 (each). The life insurers have minimal exposure to either subprime lending (less than 1% according to company filings) or to sovereign debts.

The second-worst performing sector was materials. This was primarily due to **Cameco Corp. (NYSE: CCJ)**, which was also our bottom performing individual stock. Our biggest mistake of the year involved Cameco. Increasing the holding in itself was not the mistake, but rather the timing, which was just before the earthquake and subsequent tsunami in Japan. Had we not increased the position when we did, we would probably have done so on March 18, 2011, the day of the catastrophes, due to the attractive price at that time. Although the price had indeed fallen, the timing *still* would have been off, as events conspired to suppress the price further still. Anti-nuclear activists used the disaster to attack and wreak havoc on the industry as much as possible. It influenced elections and extracted concessions throughout Europe and Japan, causing the price of uranium to plummet. It had a much greater impact on the rest of the world than we had initially anticipated. We are quite confident that Cameco, the world’s largest uranium mining company, is very well positioned and will flourish going forward, but the sentiment towards the industry has been temporarily dampened. Cameco sells uranium through long-term futures contracts. China and India, the two countries with the largest estimated needs for energy and the largest planned nuclear energy programs, are still firmly on track to see these projects to fruition. Japan, currently Cameco’s largest customer, has tightened its nuclear energy program regulations, but has confirmed that it will continue to develop nuclear energy as an important source in a country that must import virtually 100% of its fuel needs. Cameco itself has confirmed that it has not received any contract cancellations; just one of its customers requested a delay in delivery.

Ironically, the portfolio’s second-worst performing sector, materials, also included the best performing individual security. In December of 2010, we initiated a position in **Sandstorm Gold Ltd. (OTC: SNDXF)**, a Vancouver-based gold stream company. At that time, the company had six gold stream agreements in place, three of which were in production. Although one can make a fairly reasonable prediction of future cash flows as determined by these contracts, Sandstorm’s contracted mines had only started production toward the end of 2010. Hence, Sandstorm’s 2010 gold receipt was a modest 2,300 oz of gold for only \$3.1 million in revenue. Therefore, we took a fairly small position. The company’s gold stream receipts are expected to have increased to 17,000 oz of gold in 2011 followed by 40,000 in 2012. With four out of its seven projects having reached production, the company’s 2011 revenue is estimated to have been \$26.5 million. Sandstorm expects that its last three mines in contract will reach production by 2014.

Sandstorm currently trades at 29.5x 2011 earnings estimates and 11.8x 2012 estimates. Despite its stock price appreciating by 48% for the year, we believe that the future cash flow is such that the company, which has grown to be a larger portion of our portfolio, continues to have an attractive risk/reward profile at the current price. We believe that the streaming companies have an advantage over the miners in that

they have the reward of a potential increase in gold price, but without the risk associated with mining operations. Sandstorm enters into gold purchase agreements with companies that have mines in advanced stages of development. The company makes an advance payment for the right to purchase a percentage of a mine's gold production, at a fixed price per ounce for the duration of the life of the mine. Current contracts are fixed at approximately \$400/ounce. The company is dedicated to acquiring gold streams from mines with low production costs along with compelling exploration potential and strong management teams.

Could You Use More Energy?

The third worst performing sector was energy, primarily due to the decline in crude oil prices. Oil prices have declined based on the assumption that the developed countries are or may enter into a recession, therefore requiring less energy. Although this could reflexively occur in the short-term, we find this scenario quite short-sighted and temporary. We continue to believe that with the continued massive urbanization and growth of the developing regions of the globe, the world will continue to need more energy, not less. Even considering all of the "newer" ways of extracting oil and gas, such as oil sands and "fracking," we are far from a supply surplus or long-term glut. In retrospect, we wish that we had reduced our energy investments when oil prices were reaching new highs in February and these investments started approaching our short-term target prices. As we've written in the past about our investment process, although we are committed to a long-term investment timeframe (generally 3-5 years), we do actively manage the portfolio. Simplified, what this means is that if a company has a significant run-up and reaches a particular price ahead of our short-term goal, we may sell down a part of the position to guard against a correction in the price. If it pulls back to an attractive level and we remain committed to the company, we may then purchase more shares. This would involve further analysis and is on a case by case basis. Unfortunately, we did not follow our own guidelines in this particular case. It is from mistakes like these that we learn how crucial it is to stick to our tested investment philosophy.

The utilities sector was the strategy's top performing sector for the year. This is quite ironic as we only own one utility in the portfolio. We wrote about the company in September because its share price had declined substantially while its fundamentals had not. At the time, there was a 20% discrepancy between the share price of the local shares in local currency and the ADR. In the beginning of October, when the price had declined by a total of 25% from the July highs, we increased the position.

This proved to be a rewarding decision that ultimately led to its position as top sector performer and the security itself as the third-top contributor to our portfolio. The company is **CEMIG (NYSE: CIG)**, the Brazilian utility, which we continue to hold. We believe that the risk/reward profile is quite attractive for this company. It currently trades at 1.6x BV, 8x trailing and 9.7x 2012 estimated earnings. Based on the company's dividend policy and 2011 anticipated earnings, we expect its dividend yield to be at least 5.6% based on the year-end price.

A Walk in the Country

Our top contributing country for the year was not a country at all, but fits into what we call "other." The reason for this definition is that we consider where a company conducts its business versus where it is physically headquartered. This company is located and listed in the US, but 100% of its business is

conducted in some 180 other countries around the world. With Russia as its largest market, it is one of those investments that are so attractive and so difficult to define that it seems to be in every index, mutual fund and ETF imaginable. The company is **Philip Morris International (NYSE: PM)**. The industry itself is a lightning rod for controversy as the anti-smoking groups are much more vocal and better funded than the smokers-rights groups. What was once a common (if dangerous and dirty) habit has over the past three decades become so politically incorrect, it is not uncommon for smoking to be forbidden out of doors in some places. However, for the past 50 years, the tobacco industry has been one of the best and most consistent stock market performers. Some analysts predict that the industry will not exist in 50 years. We will avoid making half-century predictions, but we continue to think that Philip Morris's pricing power and increasing market share outweighs its risks, certainly for the next 3-5 years, if not for the next decade or decades. Since year-end we cut this holding by one third because it had met our short-term target price. It remains a top-ten holding.

Our worst performing countries for the year were China, Hong Kong, Canada and Argentina, in that order. It may not come as a surprise that China was the worst performer since this has been one of the media's favorite pile-on stories for the year, discussing China's slowing GDP growth (expected to come in at 9.2%). The negative contribution from Canada is primarily due to Cameco and the Canadian energy companies. We only have one investment in Argentina, **CRESUD (NASDAQ: CRESY)**, but it is one of the country's most diversified investment holding companies and conducts business in areas as varied as agricultural commodities and real estate. Argentina's inflation worries have taken a tremendous short-term toll on their stock market as well as the peso versus the US dollar, contributing factors in making CRESY one of our worst performing stocks for the year.

Our top performing individual investments for the year were Philip Morris, GlaxoSmithKline, CEMIG, Sandstorm Gold and Foster's. Of these five, we sold Foster's after it agreed to be bought out for cash.

Changes We've Made

We did indeed make some changes in the portfolio. All were in line with our investment philosophy and all were made in an attempt to eliminate certain risks and participate in other opportunities as they arose. We made some new investments, increased some of our existing holdings and eliminated or reduced some other holdings. One general theme this year was that we increased our defensive holdings such as CEMIG, GlaxoSmithKline and Philip Morris (we define "defensive" as businesses that are of a less discretionary nature which should do well in an economic downturn: consumer staples, utilities and high-dividend paying companies). In addition, we made two new defensive investments: **Foster's Group** and **Teva Pharmaceuticals (NASDAQ: TEVA)**. Subsequent to our investment, Foster's was acquired by SABMiller, resulting in an approximate gain of 42% in the position. Teva is still below our initial cost, and only slightly above our average cost. We feel that Teva presents us with an attractive investment opportunity with 180 product registrations awaiting final FDA approvals, of which 44 have already received tentative approvals. It trades at 7.1x this year's earnings estimates, just initiated a large buy-back program, and has a new CEO taking over in May.

We eliminated **Huaneng Power (NYSE: HNP)** because the regulatory side of the industry has changed, countering some aspects of our initial investment thesis. We continue to have no doubt that there will be a growing demand for electricity in China; in fact, the [company's preliminary statistics](#) show that their 2011 power generation and sales within China increased by 22.03% and 22.30%, respectively. However, the regulators, as a part of their (so far successful) fight against inflation have disallowed utilities from passing on any of their increased costs of electricity generation. Despite several changes to how the utilities were able to pass on their costs in the past, we were not convinced that an acceptable pricing scheme would be introduced in a reasonable timeframe as a long-term solution to this dilemma. Therefore, we made a decision to eliminate the investment despite it being below cost.

We at Pendo LLC hope that this review is helpful to you, and will better enable you to understand our thinking and strategy.

As always, please feel free to call and speak to us directly at 212.880.6446.

Sincerely,



Tina Larsson
Chief Investment Officer
Pendo LLC



Mark J. Foley
President
Pendo LLC

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