PENDO LLC

THE VALUE INVESTOR

International Core Value Strategy
Year-End Commentary 2009

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From Our *If Only I Knew Then What I Know Now* Department

We considered giving you an update on our ten largest holdings, the largest being Tsingtao Brewery. We remain committed to Tsingtao and believe that it will continue to provide us with above average long-term returns, despite its recent run up. However, we regularly issue company updates throughout the year, and, by definition, a typical top ten update almost always shows the investments that proved you to be "right." Instead, we're going to give you an update of what we believe to be some of our investment mistakes. They are: **Canadian Natural Resources**, **Beijing Capital International**, and **GigaMedia**.

Canadian Natural Resources (NYSE: CNQ, $71.95) is a Canadian energy company. Over the course of the last few years, the company has nearly doubled output. In the process, it has incurred large capital expenditures and debt. In the summer of 2008, at the peak of energy prices, this investment seemed very attractive. In the fall and winter of 2008, when capital markets were frozen, we had our doubts whether the company would be able to meet its debt obligations. The company brought the new developments to production, dramatically reducing its capital expenditures, and instantly receiving cash flows from the new developments. Since then, oil prices have increased; the company has doubled its output, and it is providing very large amounts of cash flow that it uses to improve its balance sheet. In retrospect, we should not have allowed this company, with such large debt and planned capital expenditures, to become as large of a percentage of the portfolio as we did (6% in June 2008). What we have learned from this is to pay even closer attention to how the companies we own plan to fund expansions.

This is precisely why we eliminated our position in **Imperial Oil** (NYSE: IMO, $38.66). Imperial is also a Canadian energy company, but it is majority-owned by Exxon Mobil and unleveraged. It therefore didn't have the same financial risk as Canadian Natural Resources during the financial crisis. The stock price of IMO reflected this in that it "only" decreased by 50% whereas the stock price of CNQ decreased by 70%. However, in the spring of 2009 the company announced that it planned a major expansion requiring large amounts of capital expenditures. We therefore eliminated this position, and realized capital losses for our clients. For reference, the stock price of CNQ and IMO have appreciated by 150% and 33% since their lows, and currently trade at 12x and 14x 2010 earnings estimates. Now, we continue to hold Canadian Natural Resources and believe that it will prove to be a very good long-term investment.

Beijing Capital International (HK: 794, OTC: BJCHF, $0.64) is the state-owned enterprise (SOE) operating the airport in Beijing. This airport was expanded with a third terminal finished in time for the 2008 Olympics. The much needed expansion resulted in an increase in debt, which is owed to the

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government under very favorable terms. In 2008, the company leased the terminal from the government, at a very high leasing rate, which resulted in negative cash flows. As a result, the share price declined in excess of 80% from the highs in 2007 to the lows in 2009. In hindsight, an investment with such large expansion and expenditure should have been avoided or reduced, especially in light of the financial crisis.

This brings us to a portfolio management problem. In the spring of 2009, the transfer of the third terminal had been completed, and the Beijing Airport stock was trading at a significant discount to book value. There is no rational reason for an airport to trade below its own liquidation value. At the same time, our clients had an 80% loss in this holding. Therefore, instead of adding to this position, we bought a similar company, **Hainan Meilan Airport** (HK: 357, OTC: HMCTF, $1.22). It too is a Chinese airport and also traded well below liquidation value, but without expansion plans and therefore no debt. Since then, Hainan Meilan has provided us with a 145% return, whereas Beijing Airport is "only" up 120%, although still in excess of 50% below cost. It is our opinion that both of these airports, which are increasing traffic every month, will compound earnings, increase book value, and provide shareholders with very attractive long-term returns. Therefore, we continue to hold Beijing Airport, despite our clients having large unrealized losses in their accounts.

Another investment mistake, at least in a sense that we currently have large unrealized losses, is our purchase of **GigaMedia** (NASDAQ: GIGM, $3.27). This is an online gaming software company, operating an online poker platform in Europe, and about 40 online family games in China. We initiated a position in the fall of 2008, at which time the company had a large net cash position on its balance sheet, traded at extremely low valuations based on trailing and estimated earnings, and the company's Chinese online gaming revenues and earnings were growing every quarter. We also felt that its online gaming business in China was fairly recession proof. This proved to be wrong, and our thesis was therefore, in the short-run, incorrect. This investment thus far qualifies as one of our worst; in retrospect it should have been avoided, at least at the time.

That being said, we believe at this time and this current price, the company trades below cash and the value of its remaining 40% of the European poker business, with a negative value awarded to the Chinese business. We therefore believe that at the current price, with the current balance sheet, and the sale of the less attractive European poker business behind us, this company's Chinese online gaming business will provide us with a very attractive long-term return.

IT WAS NOT THE BEST OF TIMES, IT WAS NOT THE WORST OF TIMES…

With apologies to Mr. Dickens, we mean that we do not agree with the consensus view that a major domestic recovery is at hand. Neither do we believe that it began a quarter or two ago, as do some of the more animated financial cable chat characters. We also do not believe that there is only a slight chance of any relapse. In fact, to even discuss a relapse or "double dip" would seem to imply that the recession has in fact ended.

We remain decidedly bearish with regard to the domestic front, as much for the policies being unleashed as for the fundamentals. For example: nearly one year into his first executive job, unemployment seemed to have struck a chord, and thus President Obama convened a "Jobs Summit" on December 3rd. Although we have high hopes that this will ultimately yield such great benefits as did the renowned "Beer Summit," based on what is transpiring, we have our doubts. According to *The Wall Street Journal* (12/9/09):

> "[While speaking at the Brookings Institution yesterday] President Obama stressed that the main goal is to encourage the growth of the small businesses that create most new American jobs."

Yet, pointedly, representatives from neither the U.S. Chamber of Commerce nor the National Federation of Independent Business were invited to join the many union leaders present at the preceding confab. In a somewhat disturbing turn, the *Journal* reported in the same article that:

> "House Democrats apparently have other priorities… Pennsylvania Democrat Paul Kanjorski plans to introduce an amendment that would apply the most onerous Sarbanes-Oxley regulations to the smallest public companies. Supported by House Financial Services Chairman Barney Frank, this amendment to the financial re-regulation bill now moving through the House would inflict millions of dollars in compliance costs upon thousands of companies… Unable to stop regulatory relief in his own committee, Mr. Frank now believes he can rally enough Democrats to kill it on the floor… Securities and Exchange Commission data show that Sarbox discourages companies from listing their shares on America's stock exchanges. When young companies aren't tapping the public equity markets, their growth opportunities are curtailed, dreams go unfulfilled, and jobs are not created. The market data firm Dealogic has found that even though financial markets have rebounded this year, initial public offerings in the United States are on track to fall below even the levels of the dot-com bust of 2001-2003."

So, we have a President who believes (rightly) that small business is a main driver in jobs creation and employment (approximately 65%), while his Congress vows to implement the exact measures to thwart it, much like industrial strength weed killer on the proverbial green shoot. This kind of instability and uncertainty is precisely what frightens and paralyzes employers and markets.

On the plus side, the cash-for-clunkers success (only Washington would consider as successful a program that demolished affordable cars, cannibalized future sales, encouraged over-leveraged people to take on more debt during a credit crisis caused by a debt explosion amidst rising unemployment and foreclosure, and cost three times as was budgeted) did "stimulate" GM to hire thousands more workers. In Canada.

A similar program was extended for housing, in an effort to support prices, which by the way offers no job creation or future production. Rebates were guaranteed, rates kept low, down payments minimized, and Fannie and Freddie backed by the FHA, so no risk for them! In other words, housing prices were kept inflated, out of reach to those who might finally have been able to afford them, and rebates were offered on low mortgages with as little as 3.5% down (www.hud.gov) and up to 10% of the purchase price (www.fha.com) available in cash grants (yes, we will pay you to buy a house!), to people who otherwise ("realistically") wouldn't be able to afford them. If they fail, the government has promised to re-pay 100% of the loan. Has anyone else seen this movie before, and remembers how it ends?

Fundamentally, we believe that much data is being grossly misinterpreted. Some economists cite the 3Q 2009 GDP number finally turning positive at +2.2 (though revised downward 37% from the initial report of +3.5%) as proof that we've turned a corner. Let's never mind that $100 billion in government spending one-offs and transfers accounted for nearly 90% of that number (historically, first-positive quarter growth is +7.3%). By this measure, the Great Depression ended in 1933. And again in 1938. In fact, GDP growth

in 1934 was over 10%. For what it's worth, Japan has had over 50 positive quarters in the last two decades.

Also misinterpreted is the axiom that unemployment is a lagging indicator to a recovery from recession. In the past that has been true in almost all cases where the recession is caused by an excess in production and inventory (manufacturing), and Fed tightening. These have occurred in cycles of overall expanding credit. Recoveries come sooner, and memories fade quicker. In a typical modern (post-war) manufacturing squeeze, unemployment lags by about one quarter. Historically this is not so when, as now, a downturn is caused by a prolonged period of credit contraction and asset deflation, coupled with a systemic banking crisis; 1-2 years is historically correct (and if this lagging indicator is good news, should we now be pessimistic if the unemployment rate reaches 4.5% again?). Another take on this is offered in a study by the Kansas City Federal Reserve (www.kc.frb.org):

> "…labor markets have changed fundamentally since the early 1980s. Two labor market changes, in particular, have garnered considerable attention from economists. First, the pattern of layoffs has moved away from temporary layoffs - in which workers expect to return to their old job when conditions improve - toward more permanent layoffs. Second, just-in-time employment practices have risen in prominence. These practices include the use of overtime hours, part-time workers, and various forms of outsourcing - through contracting with temporary help ("temp") firms or consulting firms - that have given firms more flexibility and have contributed to leaner staffing of permanent, full-time workers."

In the credit/asset scenario, long-lasting secular changes take place in personal beliefs, attitudes and behaviors, sometimes life-long; think Depression "survivors." These changes affect discretionary spending, saving, loans and lending, employment, owning/renting, size of mortgage/down payment, investing practices, (see this year's massive retail investor net out-flows from equities and into bonds), use of cash/credit, etc. Wages remain down, spending (and thus profits) low, businesses run at high efficiency (bare-bones; unit cost of labor is at an all-time low) doing more with less, and less capital and loans available to start new or expand existing businesses.

Today, we have the same number of jobs as ten years ago, but with 13 million more people vying for them. We have a record 15.3 million unemployed, and a record 5.6 million being dropped from greatly extended relief (up to two years in some states!). If you are unemployed for over 18 months, you then magically disappear from the unemployment statistics. Tax revenues are down. Trillions in personal wealth have vanished, and private investment is negative. 1 in 7 American mortgages are in arrears or the foreclosure process, and 1 in 8 Americans are on food stamps. We have printed enough money to double the supply since Ben Bernanke took over in 2006. There is massive government borrowing, and the taxpayer-supported debt projected to be created between 2009-2012 (those estimates are never understated, are they?) is at a level to match the entire accumulation of government debt since George W.'s first term. Washington that is. 234 years ago. All in an effort to artificially increase demand. These actions should normally lead to massive inflation, but we are forced to keep interest rates low (to try and spur investment) and the dollar cheap (to compete internationally), leading to a current period of relative deflation. When the economy does turn around, the government will have to be extremely careful and precise in its actions regarding fiscal and monetary policy, or massive dislocation and inflation could result. Our belief is that this Keynesian game is similar to playing *Russian Roulette* with five bullets: it's possible to emerge unscathed, but every outside factor must align just right in order to do so.

The recent run-up in the markets is touted as a positive leading indicator, never mind that equities hit new highs in October of 2007, mere weeks before the worst economic collapse in 70 years. We have also seen the S&P rise 65% off its lows at the same time that nearly 4 million jobs were lost. 7.6 million jobs were lost over the last two years, many permanently. This is 67% more full time jobs lost than in any other recession, and the numbers are increasing. Wall Street cheers that the rate of job losses is slowing, even as the total continues to increase (by that logic, 100% unemployment would also be good news, since job losses would cease entirely!). Currently, we see 6 unemployed persons competing for each job opening.

The S&P currently trades at about 20x earnings, vs. 14x historical; this, despite all of the previously mentioned negative data. 2009's earnings came in somewhere around $56, and the S&P was rewarded with a 25% return, despite the fact that the one year ago estimates were for $77 EPS, and each quarter were downgraded. Then, Wall Street gave a mighty cheer each time the (newly downsized) profits were reached. This year, consensus estimates are again $77, which represents a 38% growth. To see 38% growth in earnings in this climate would be remarkable, to say the least, especially when an average year can see a 7% increase. If profits indeed rise "only" 10% to $62 EPS, then the market is trading roughly 30% over value at 18x. In other words, the most optimistic scenario has already been factored in. Any surprise going forward would likely be a bad surprise. What is often mentioned as one of the main contributors to, and saviors of the S&P's EPS, are foreign profits to US companies that operate globally. Unfortunately, most foreign countries, save for the BRIC countries, are still doing poorly and are far from "recovered." The BRIC's impact is barely 1% of the US economy.

It is doubtful that interest rates will be significantly raised anytime soon. Massive residential mortgage refinancings are coming this year, and the US government has approximately $2,500,000,000,000 (maybe people would take "trillion" more seriously if we started using the zeros) of debt in bills/notes/bonds (nearly 35% of its total outstanding obligations) to refinance in 2010. In commercial real estate, $4,200,000,000,000 of combined leveraged loans and debt comes due in 2011. It wouldn't be completely out of the question for the Fed to be forced to keep its toolbox closed for close to two years; it would not be unreasonable to expect default rates to climb.

In the *Ripley's Believe It or Not©,* "Jobs Created or Saved" division, the US Census has begun hiring up to 1.3 million workers to conduct this decade's census, through the fall of 2010. The average work-week is expected to be 20-40 hours. It will be interesting to see how they are measured (FT/PT) regarding the unemployment figures; if the government is aggressive, that could lop up to a full percentage point (temporarily) off of the unemployment numbers, gaining the most impact in the fall (just in time for mid-term elections!). Created or saved indeed…

"Plus Ça Change…"

From our Q4 2008 Commentary: *"On a good note, 2008 is over, and we are eager and optimistic about the opportunities that are presented by 2009. We feel that we are very well positioned for a market turnaround. Our portfolio is very well diversified, comprised of extremely high quality businesses selling at huge discounts. The companies themselves are very well capitalized and almost indiscriminately trade at irrationally depressed prices…"*

Other than our more pleasant memories of 2009 than of 2008 (and that the majority of the foreign markets where we are invested have turned around), we could reasonably recycle the preceding paragraph for this

past year leading into 2010. The companies that we own fit our ideal profile: necessary businesses such as infrastructure, utilities and energy, with low debt; non-cyclical long product life-cycles, consistently able to generate a compounding cash-flow, and trading at attractive multiples/discount to intrinsic value (though thankfully not quite as attractive as one year ago).

The Chinese economy rebounded in a big way, with the SSE Composite Index (Shanghai) posting a gain of approximately 80% versus last year's loss of approximately 65%. This leaves the index roughly 45% below its October 2007 highs. To answer the question that Pendo most often hears, "yes," we believe there is still significant value and growth in China, especially for select companies. We do not discount the fact that a growing, and in their case emerging, economy can be volatile, but we do not subscribe to the latest trend meme that China as a whole is mired in an unsustainable bubble. We would like to point out that there has already been a correction of sorts, with the SSE contracting 25% last summer; indeed, the closing number in December was still 6% below its high in August.

Emerging economies such as China (and Brazil) are prone to higher volatility. Markets and industries are still developing, and companies are less closely studied than in developed countries; often times, if they are followed at all, it will be by a junior analyst. Misunderstandings and misinterpretations are bound to occur. This is good news for us, as our method of purchasing companies below intrinsic value is to find them when they are distressed, out of favor, or misunderstood. While high volatility can certainly cause you to lose sleep in the short term (and at Pendo, we are thinking of replacing our trademarked column with an eye with bags under it), in the long term, it can lead to tremendous opportunity. Nevertheless, we are keenly aware that "markets can remain irrational longer than you can remain solvent," and that is the advantage of having an actively managed portfolio, which is continuously monitored. Another advantage we have over other managers is our size: it is much easier to move quickly with millions than with billions. There is always the possibility of short-term set back, with credit having expanded greatly, but we have little doubt about the long-term prospects, or secular growth ahead of China. China's consumption as a percentage of GDP is the lowest of any major economy at 33%. It is hard to imagine it remaining so low going forward.

When people mention problems within the Chinese economy, invariably their shrinking export revenue from the US is brought up (it must be mentioned that the issue of exports does not directly relate to our portfolio, as our Chinese businesses conduct virtually no business with the United States; indeed in most cases, the majority of their revenues are derived in China, in Chinese currency). China has made a conscious effort to expand domestic consumer activity, in order to be less reliant on exports and be able to gain more direct control of their future, and mine the 1.3 billion consumers within their borders. This has contributed the most to this year's GDP increase, which is on target to come in at 8% or a fraction above. Domestic demand accounted for 100% of GDP growth through the first 3 quarters. In fact, according to noted Asian markets expert Eswar S. Prasad, Senior Professor of Trade Policy at Cornell University:

> "…the direct contribution of net exports to Chinese GDP growth amounted to only 1.1 percentage points a year over 2000-08, or just a tenth of overall GDP growth, because the country is also a huge importer."

The Chinese government has also begun to spend large sums on education (they already produce more engineers than the US), healthcare, and retirement programs, in order to entice people to ease away from their 30-40% savings rate, and to encourage an expansion of consumption. The intention is to provide the social safety net now missing, and end the need for such a high rate of savings.

As stated previously, our companies in general are in industries that are necessary, and not discretionary. In fact, our only consumer product in China is Tsingtao Brewery, which is considered a staple, and last quarter grew 70% YoY. Tsingtao is the leader in the industry, which is in the early stages of consolidation, much as the US brewery industry was half a century ago. This would be comparable to owning Anheuser-Busch in the 1950s.

The real estate market and lending practices in general are also a topic of discussion. China is actively addressing these issues, and recently raised interest rates in order to keep growth manageable and see that it does not in fact become unmanageable. As reported by the *Financial Times*:

> "China is now tightening monetary policy to damp its over-charged recovery and will cease to provide liquidity to global asset markets."

China has the third largest total GDP in the world, but by per capita it only ranks at 133 (CIA World Fact Book: www.cia.gov). We do not see this remaining so for long. China has a rate of urbanization of 2.7% on a population of 1.3 billion people, versus the United States population of 300 million urbanizing at a rate of 1.3%. This means that on an annual basis, over 35,000,000 people are trading more rural lives for urban living. This is the equivalent of the state of California needing new housing, services, infrastructure, energy, etc., as they join the expanding middle class as was first planned by Deng Xiaoping during the "revolution" of 1980 that officially ended the ill-named *Great Leap Forward* of the previous 150 years. Overall, 900 million more increasingly affluent Chinese consumers are expected to join the middle class over the next couple of decades. These people will fill the cities currently under construction, including the "empty cities" that are cited as examples of impending doom. We'd like to point out that this has been successfully going on intermittently for the last decade. Also, much construction was indeed planned as "make work" projects as a part of their $586 billion stimulus, just as we had been promised would happen here. However, they actually put people to work on useful projects, improving infrastructure and building cities that will be needed to accommodate close to a billion people. The main difference is that China can afford this. They did not have to go into debt, or print money. They have $2.3 trillion dollars in foreign reserves, and own an additional $800 billion of US debt obligations. They also stand ready with an additional $586 billion in stimulus funds if need be, but at this point do not expect to call on it.

Deng Xiaoping strongly encouraged the transformation from an agriculturally based society to one based on business and manufacturing (cribbing what he learned from studying the US transformation in the 1900s), the ending of collective farms, and establishing free markets by reintroducing capitalism to the Chinese economy. Already, China has more cell phone subscribers, more internet users, and purchases more cars than the US. The average Chinese family has a larger flat screen television than the average American.

As we have stated regarding the US, smart fiscal and monetary policy will be needed as China eventually withdraws from their stimulus. There certainly are risks as they rein in the credit expansion. They are just in a much more enviable position, with low debt, expanding GDP, foreign reserves, and have much more room and pent-up demand for growth in front of them. They also don't have to take into account election cycles, special interest groups and union donors when making decisions.

Another question posed to us is about the accuracy of China's numbers. While we are pessimists by nature, we do not believe that they are significantly more suspect than in the US or elsewhere (Pendo uses

public filings and CIA statistics, among others). In order for a Chinese company to be listed on the Hong Kong Stock Exchange, companies must comply with IFRS (International Financial Reporting Standards, developed by the *American Institute of CPAs*). The Chinese government is making a concerted effort to be able to compete internationally, and they take a very long-term (decades) approach. Consistently and materially manipulating numbers works against their determined best interest. Again, this is not to say that it is not done. In fact, we are particularly vigilant when it comes to Chinese numbers. It is just that we have found no proof that there are any significant discrepancies between their numbers and any others. As a bonus, they take malfeasance by government officials and businessmen quite seriously; a record number of malefactors were executed there last year. Here, Michael Milken sold a DVD.

All told, we certainly are not wearing blinders when it comes to any numbers, but we would like to pose a question in return. Would one be more comfortable with the numbers out of Enron, Bear Stearns, Fannie, Freddy, Citi, and Lehman? Or our own government's numbers, that are constantly in need of revising (downward, to boot)? The same government that spent, and now cannot trace, stimulus money for "shovel-ready" jobs in zip-codes and congressional districts that don't exist? (For addition discussion on China, please see our Q1 2009 commentary linked here: http://www.pendollc.com/images/2009q1.pdf)

Brazil is another economy we expect to reap huge long-term rewards from. They are currently the world's eighth largest economy, and growing rapidly. Like China, considered an "emerging" country, so we must wonder: at what point will the decision be made that the 3rd and 8th largest economies have "emerged?" They too have adopted a comprehensive long-term outlook. Unlike the US, which has pledged since the 1970's energy crisis to become energy independent, and this time we mean it, Brazil recently joined the exclusive club of countries that are net-exporters of energy (China is expected to join them shortly). As a rapidly growing economy with an expanding middle class, they have growing needs for energy, utilities and communications, infrastructure and agriculture, all areas in which our investments (PBR, CIG, TNE) actively participate. Brazil comprises approximately 11% of the current portfolio; if we include CRESY, an Argentine agricultural/land management firm with a 56% stake in BrasilAgro, the number increases.
(For more in-depth information on Brazil, please see our Q2 2009 commentary linked here: http://www.pendollc.com/images/2009q2.pdf)

Pendo is certainly happy about the portfolio's performance last year, particularly in light of 2008. We don't foresee a return to the world-wide confluence of factors that led to 2008's historic rumble. However, we must caution our clients to not be overly optimistic and expect a regular return of nearly 60%, as happened this year. In fact, it is precisely because of 2008's irrational massive sell-off that 2009's bounty was achieved. Having said that, we continue to remain very optimistic going forward, and are excited about the opportunities and value still available to us; we still see significant upside ahead. We are invested in strong companies in strong, expanding economies. Many have active government support, and benefit from competent long-term planning. As managers without a restrictive mandate, we do not "hug" an index, or constrain our investments by artificial limits such as market cap, industry, sector, geography, etc. Our only restriction is that companies must be foreign with as little-to-no correlation to the US market and currency as possible. Therefore, we have available to us a much larger universe of possible investments. Currently, emerging market countries account for roughly 50% of the strategy; this certainly

may change. We do not intentionally buy "emerging" or "developed" markets; we simply buy "value." (For more information on our management style and company in general, please refer to our website: PendoLLC.com)

The rest of the investing community seems to have recently discovered the path we began back in 2007. Investors, institutional and other, are dramatically increasing their foreign exposure. In 2009, domestic equity funds had net out-flows of nearly $5 billion in spite of a 20+% up-market. Emerging market equity funds had world-wide inflows of a record $80 billion ($34B in the US), effectively reversing last year's $50 billion in redemptions. Emerging markets returned 75% last year versus 28% in developed markets. For the past decade, China returned 140% and Brazil 300%. In the same timeframe, the S&P had a loss of just less than 1%, and the MSCI EAFE a gain of just over 1%.

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

Please feel free to call and speak to us directly at **212.880.6446**. We are sure that you must be every bit as concerned about your financial well-being as we are, and we look forward to hearing from you.

Sincerely,

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