

River Capital Advisors, L.C.

Investment Management, Consulting & Wealth Management

The Margin of Safety Quarterly
Spring 2010

Editors - Edward P. Schmitzer, CPA/PFS, CFP®
Mark Saussy, CPA, CFP®, CIMA®
Adam H. Wolf, CPA/PFS, CFP®

Ben Graham, in 1934, when confronted with a like challenge to distill the secret of sound investment into three words, used "margin of safety." This is a critical concept of investing and differentiates an investment from speculation. It applies to individual security valuation and overall liquidity or asset allocation.

Quarterly Investment Commentary

Summary

- The first quarter of 2010 was a good one, with U.S. stocks enjoying healthy gains and bonds earning at least small positive returns.
- We have been expending a huge amount of research effort to thoroughly understand the overall environment and the various ways macro trends could play out. The main story is that the need to reduce spending now, in order to reduce the massive debt built up in previous years, suggests the strong possibility of a sluggish economy for many years to come. Higher taxes are inevitable.
- We believe that risk assets like stocks are not priced attractively enough to fully compensate investors for the risks we see. However, periodic market declines in the years ahead could give us opportunities to improve returns by adding risk assets when we expect to be paid better for taking it on, and this will require patience.

"We strive to protect and grow our clients' capital over the long term by: (1) focusing on individual client goals & objectives; (2) having proper asset allocation to fit a client's volatility/risk tolerance); (3) stress testing short term liquidity needs; (4) investing with value orientation – picking managers who understand the intrinsic value of a business and margin of safety." - Our Goal

Market Performance Review

We were generally very pleased with our equity returns for the quarter. In fact, all domestic equity asset classes had good returns and continued upward for the month of April. The *S&P 500 index* was up 5.4% for the quarter, while the small-cap *Russell 2000 index* gained 8.9% for the first three months. Foreign stocks also posted gains.

Turning to fixed income, the domestic intermediate-term, investment-grade proxy represented by the *Barclays US Government/Credit Intermediate index* posted a positive 1.5% return year-to-date. Developed foreign bonds (as represented by the *Citigroup World Government Bond index*) were down 1.3% for the year. Emerging-markets bonds gained 5.4% for the quarter (as represented by the *JPMorgan GBI-EM Global Diversified index*). High-yield bonds were up 4.8% (as represented by the *Merrill Lynch High Yield Master II index*).

RCA Wealth Management

Asset Management
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Tax Planning & Consulting

River Capital Advisors, L.C.
Smoak, Davis & Nixon LLP

“Recognize reality even when you don’t like it. Especially when you don’t like it.” - Charlie Munger

Looking Ahead - The Macro

We appear to be emerging from the seventh recession of our careers – the great recession and debt crisis. Our best guess is that this emerging recovery will be slower and more uneven than past recoveries due to the large consumer debt overhang and unemployment recovery.

We have several economic scenarios that could play out in the next two years, and there is not a historical “playbook” of the consequences of the substantial stimulus and resulting deficits used to revive the economy. We are attaching an exhibit of both positive and negative issues that impact the current economy and market outlook. We recognize and accept our (or anyone else’s) inability to predict with accuracy what might happen over the near term (or the next few years for that matter), particularly with so many unknowns on the consequences of the Government stimulus and (for now) artificially low interest rates.

The one thing we feel most confident in predicting are higher taxes on earned and unearned income beginning next year. We know what the tax rates will be if Congress does nothing; they will be significantly higher for our clients. We are working on investing strategies to take into account these significantly higher tax rates on dividends and capital gains. More to come on these strategies (hint - total return investing; long term holding so as to compound without taxes.)

Market Valuation Musing

Global Stock Outlook: The equity markets have moved up over 70% since the March 2009 lows. Much of this move was justified, however moving substantially higher from here will require continued improvement in corporate top line as cost cutting can only last so long.

This will require continued “confidence building” to encourage the consumer and corporations to continue to spend and invest rather than hoard cash. We have begun to see increased spending in the last few months. In fact, behavioral finance, or as we call it “animal spirits,” may be more important than “valuation” in the near term (as it usually is in the short term). Even after the big move from the March 2009 low, we don’t think that the market is significantly overvalued, but neither is it undervalued. Of course, we don’t buy the market in this environment but count on our managers to buy individual stocks that are undervalued. We strongly favor U.S. quality companies with a global reach that have a sustainable competitive advantage. We also think this is a “stock pickers’ market”. There is some evidence that environments where overall stock returns are low but individual company returns vary widely are favorable for active managers; we believe we could see such an environment.

Emerging-Markets Local-Currency Bonds: Among other asset classes, emerging-markets local-currency bonds remain a compelling opportunity from a relative-return perspective versus the other major asset classes we track. We think it can generate mid to high single-digit returns in our most likely five-year scenarios—admittedly not spectacular returns but better than any other asset class. The returns are driven by the underlying bond yields plus an expectation of at least mild currency appreciation we expect given the stronger fiscal conditions in much of the developing world.

High-Yield Bonds: We did very intensive work on high-yield bonds in late 2008. Back then we viewed high-yield bonds as an asset class that had better potential than stocks in almost every scenario, and much less risk. Our work left us highly confident in our conclusion and led us to make a big allocation to the asset class. It worked out much more quickly than we expected and we captured a huge return in 2009. High-yield has continued to do well in 2010, though the returns have been much more moderate.

As high-yield has rallied, we have gradually reduced our exposure including a reduction earlier this year. We no longer view the asset class as clearly superior to equities (both have low expected returns in most scenarios). High-yield could continue to generate decent returns in the short to intermediate term if the economy continues to gradually improve and interest rates remain low. But the huge increase in prices of high-yield bonds (now at or approaching par for most of the high-yield universe) means that our expectations for returns over our five-year investment horizon have fallen and we could be close to unwinding our remaining positions.

Flexible Fixed-Income Strategies: Eighteen months ago there were many table-pounding opportunities in the fixed-income market as everything outside of the government-backed market was in the bargain bin. Since that time every fixed-income sector except for government bonds has rung up big returns and that has been one of the key drivers of our strong performance. Now, however, the opportunities are not so compelling, though on a five-year basis the return potential is higher in non-government bonds. So for the most part we hold funds that have a high degree of flexibility. The focus of these funds varies—several will take some non-U.S. bond exposure, they will take some corporate bond and

non-agency mortgage exposure, they may manage their duration (maturity strategy) more flexibly, or they may have expertise in a specific slice of the market. Overall we believe our fixed-income exposure will be subject to materially less inflation/rising interest rate risk than the overall bond market and has higher return potential. It also gives us some defensive ballast, though less in a double-dip recession scenario than the overall bond market. That is the compromise, but we make up for that in other ways at the portfolio level.

“The American economy is an amazing engine of growth over time. We may try to mess it up occasionally as we go to excesses and make mistakes. This Country works. It is a mistake to bet against it.” - Warren Buffett

Lincoln's Guidelines

We believe that the following guidelines, often attributed to President Lincoln, represent what made this Country great and will lead us back to prosperity, no matter which side of the aisle you are on. After all, we are all Americans first, and we care about our great Country. We are hopeful that America will eventually get its act together!

Lincoln's Ten Guidelines

You cannot bring about prosperity by discouraging thrift.

You cannot help small men by tearing down big men.

You cannot strengthen the weak by weakening the strong.

You cannot lift the wage earner by pulling down the wage payer.

You cannot help the poor by destroying the rich.

You cannot keep out of trouble by spending more than your income.

You cannot further brotherhood of man by inciting class hatred.

You cannot establish security on borrowed money.

You cannot build character and courage by taking away a man's initiative and independence.

You cannot help men permanently by doing for them what they could and should do for themselves.

In Closing

On May 1 our team traveled to Omaha for the Berkshire Hathaway meeting. This is our annual trip to hear from the "Oracle" (Warren Buffett not Jimmy), and his sidekick, our favorite, Charlie Munger. After this month we plan to follow up this letter with our notes from the meeting.

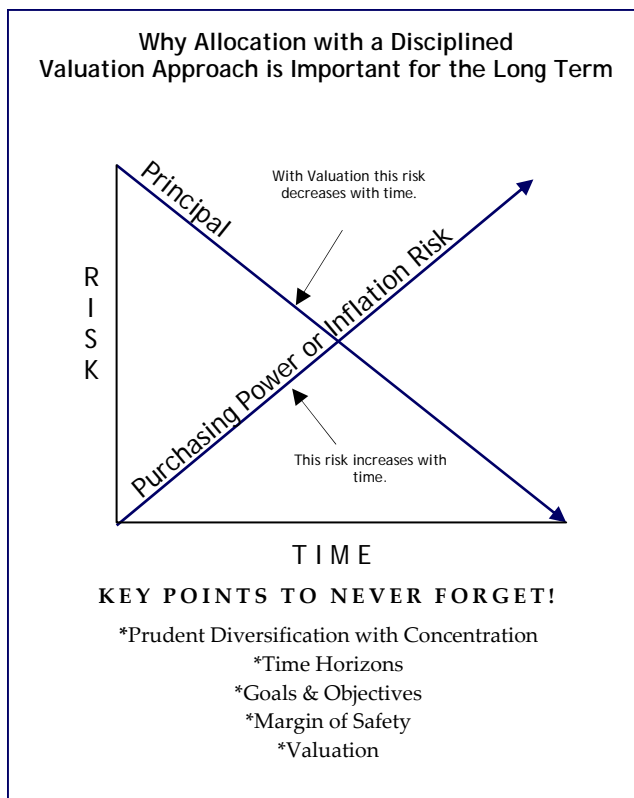
Finally, we would like to thank all of our clients who have continued confidence and trust in us as their personal Chief Financial Officer (CFO) and financial fiduciary. In the mean time, please call us should we need to meet to review your goals and objectives or changes that might be needed in your personal investment policy.



River Capital Advisors, L.C.

5011 Gate Parkway
Building 100, Suite 300
Jacksonville, FL 32256
(904) 398-2075
rcawealth@sdnllp.com

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Macro Issues

April 2010

Macro Concerns

- Debt bubble has shifted from private to public sector globally
- After a 70% plus rally, market overbought (?)
- Valuation less cheap relative to March 2009
- Commercial mortgage back security losses loom, potential double dip
- Budget Deficit (Federal, State and Local)
- Asia inflation / bubble risk (?)
- Rising tax rates; Big increases on dividends
- Unemployment rate remains elevated
- Potential Consequences of Stimulus
 - Higher inflation
 - Higher interest rates.
 - Key is when and how much?
- “New normal” in consumer spending or temporary reset
- Potential over regulation / protectionism
- Greece / European Debt Crisis Contagion

Macro Positives

- Unprecedented Global Stimulus
- Fed continues low rates
- Coiled spring from inventory rebuild
- Housing bottoming
- Credit markets back to pre-Lehman levels
- Systemic risk over
- Operating leverage from “cost cutting”
- Upward Earnings revisions for 2010
- Household net worth finally rising
- Some signs of increasing spending / confidence
- Inflation remains tame / low interest rates for now
- Cash on sidelines earning nothing
- Large Corp B/S net liquidity approx \$1 trillion
- M & A activity anticipated / Stock Buybacks
- Pent up demand building
- Highly confident value managers still say price/value normal (approx 65%)