

River Capital Advisors, L.C.

Investment Management, Consulting & Wealth Management

The Margin of Safety Quarterly
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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

- We've enjoyed strong returns this year after a difficult 2008 due to investment discipline, successful tactical allocations and strong returns from individual managers.
- Our goal is to wait patiently and then act when we see investment opportunities, which we believe can materially raise portfolio returns over our five-year investment horizon.
- We prefer our portfolio managers to focus on bottoms up fundamental company analysis.
- Of course, the "macro" issues will always be important as they affect individual companies and the determination of future owner earnings used to determine the intrinsic value thereof.

When the dust settled on one of the most eventful and upended years in memory, investors had generous gains in stocks and certain segments of the bond market to salve the wounds of a disastrous 2008 and first quarter of 2009. Stocks finished the year strongly, continuing their powerful run that began in early March. Large-cap stocks, based on the S&P 500 Index gained about 6% in the final quarter and finished 2009 with a 26.5% gain. In both the quarter and the full year, growth sharply outpaced value, but between larger-caps and smaller-caps, returns were pretty similar. On the domestic fixed-income side, returns varied widely in 2009. Barclays Aggregate Bond Index gained 5.9% for the year, but the Barclays US Treasury 1-3 years gained only 0.8% and the long term treasury was down 6.4%. High-yield bonds, crushed both, with the Merrill Lynch U.S. High-Yield Cash Pay Index gaining 56% for the year.

Heading overseas, the story was emerging markets. Both equity and debt of emerging-markets countries left their developed-market counterparts in their dust. Vanguard's Emerging Market Stock Index Fund had a full year gain of 76%, versus a gain of 37% for the predominately developed market Vanguard Total International Stock Index. For bonds the pattern was tighter but the same: Emerging-markets bonds (JPMorgan GBI-EM Global Diversified Index) gained 22% for the year, while developed-nation sovereign bonds (Citigroup World Government Bond Index) gained only 2.6% for the year.

Our feelings at this time regarding "Mr. Market's" historic rise in 2009 and decline in 2008 can be summed up as follows: "We try not to get too depressed when the markets decline, and we don't get too excited when the markets go up."

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Our Client Portfolios

In general, our portfolios had a very good year! The patience and discipline that you (our clients) exhibited through out the last two years have paid off greatly. Strong gains in our tactical positions in high-yield bonds and both emerging-markets equities and debt (we recently unwound the equity position) combined with strong overall showings from both our active fixed-income and equity managers have benefited portfolios. Generally, we adequately stress tested the near term liquidity needs that allowed most of you to maintain your portfolio allocations. This allowed the portfolios to participate in the sharp rise that occurred from the March lows.

We are optimistic that periodic dysfunction in the markets will allow our managers to continue to find opportunities as well as allow us to take advantage of additional tactical opportunities. The incremental value of these opportunities may be much lower than it was this past year, where absolute returns were unusually high, but in a low-return environment they can make a material difference.

Macro View vs. Fundamental Company Analysis

Years 2008 and 2009 provided many lessons for us as well as our clients and managers. After 2008's global banking system's near collapse, almost everyone began to engage in macro-economic prognosticating, as well as short-term thinking. The lessons of 2009 illustrate that while "macro" is important, we don't feel that the macro is "knowable" and even if it is, you don't know how the macro view will affect the stock market in the short term. The key question may be "what is in the stock price and is this overly pessimistic or too optimistic?"

Let's take the debate of "inflation" vs. "deflation" over the next 3 years. We could make a good case for either scenario (at the present time). We spend a considerable amount of time internally debating the effects on our client portfolios of both scenarios. We said a year ago that we felt sure of "flation." We were just not sure if it would be inflation, deflation or reflation. We now hope for anything other than deflation.

The governments around the world are trying to inflate our economy as we experience significant deflation in many asset classes over the last 2 years. This situation is very important to asset allocation as well as specific company valuation. However, the outcome of ranges are so wide in the short term that they are not knowable with a high probability. Also, we have learned that once everyone feels one way, it generally doesn't come true. That being said, our general view is long-term, both inflation and high interest rates will be the result of the massive global stimulus and our federal deficit.

However, we don't think the macro view is "knowable" with any degree of accuracy. We prefer our portfolio managers to focus on bottoms up fundamental company analysis and lessons from Graham and Buffett. Of course, the "macro" issues will always be important as they affect individual companies and the determination of future owner earnings used to determine the intrinsic value thereof.

Let us quote from one of our great manager letters discussing the many macro driven “general-fighting-the-last-war” of 2008.

“A macro oriented investor could have logically decided on January 1, 2009 (or in March when stocks were meaningfully lower) that with the horrible global economy, the teetering banking systems across multiple countries, and the extremely weak stock markets, it was a good time to sit on the sidelines until some economic clarity emerged. By contrast, an intrinsic value investor who focused on the free cash flow that certain well-run, competitively advantaged companies generated – even in a severe recession – would have purchased those cash flow streams at incredibly low multiples, i.e., high cash flow yields. Those who chose the macro route and parked in cash missed what was the best purchase point for equities in our lifetime and earned virtually nothing on their liquidity. This leads to the second lesson of 2009: comfort comes at a very high cost. Buffet made this point in an August 6, 1979 Forbes article entitled, “You Pay A Very High Price In the Stock Market For A Cheery Consensus.” Selling stocks in 2007 would have been uncomfortable; in retrospect we all should have done more of that. Buying or even holding stocks in early 2009 was very uncomfortable; investors should have done that. Many investors feel most comfortable when the consensus confirms their view. Making the same investment choices as a large number of other intelligent people mathematically almost insures doing the wrong thing at the wrong time because security prices reflect the collective action of the consensus group. So where are we now? We believe that we are between the valuation extremes of the mid-2007 highs and the early 2009 lows. With global markets having

risen rapidly since March, bargains are less plentiful, and free cash flow yields are less attractive. However, valuations are still compelling when compared to the past. Our price-to-value ratios remain at or below the long-term average. Also, the “comfort gauge” still appears favorable given the excessive quantity of cash people are holding in lieu of equities. This cash on the sidelines constitutes significant future buying power that will someday make its way back to attractive, growing corporate free cash flow yields that almost always find their long-term recognition either in the stock market when overall psychology shifts or from corporate M&A. Today, many macro mavens are comfortable owning the taxable, fixed coupons of 10-year Treasuries at yields of 3.7%. We much prefer the after-tax growing free cash flow coupons of dominant businesses at yields of 9-10%.”

Conclusion

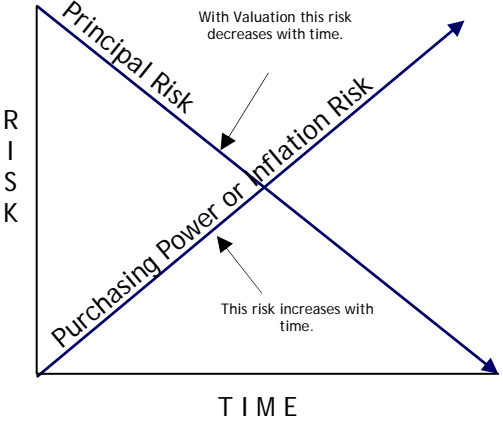
Our team has spent the last several weeks traveling to meet and holding conference calls with some of our existing managers and managers that we are considering adding to our approved list. We also continue to keep a watchful eye on global macro scenarios and how they might affect our clients asset allocation. But again, we don't think future macro events are “knowable.” The important point is what is built in to “Mr. Market” and current bond yields. In the short term, fear, greed, psychology, technicals (momentum) and liquidity drive the market. We focus on our client's long-term goals and asset allocation and use a diversified group of managers who we believe do bottom-up fundamental analysis to protect the portfolio from a permanent loss of capital for our long-term investors.

Summary

We are happy to report good news this quarter and year-to-date. We know that it will take more quarters like this to make up for “Mr. Market’s 2008,” but, we are confident our portfolios have the foundation to perform favorably over the long term. In fact, we think that the next few years could produce some superior returns with our asset allocation, tactical positions and managers that can differentiate themselves. Again, we stress client individual goals and objectives and appropriate asset allocation with both a long term and short term plan as the cornerstone to achieve success.

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 addition, we want to take this time to thank all of our clients and friends who have recently provided us with referrals. Our best marketing tool is delivering great value to our current clients. Give us a call if you have any questions or we can be of further service!



<p>Why Allocation with a Disciplined Valuation Approach is Important for the Long Term</p>  <p>KEY POINTS TO NEVER FORGET!</p> <ul style="list-style-type: none"> *Prudent Diversification with Concentration *Time Horizons *Goals & Objectives *Margin of Safety *Valuation 	<p style="text-align: center;"><u>CONTACT US:</u></p> <p><u>RCA Wealth Management</u> Asset Management Investment Consulting Estate Planning Family Office Services Retirement Strategy Tax Planning & Consulting</p> <p>Main Office: 5011 Gate Parkway Building 100, Suite 300 Jacksonville, FL 32256 (904) 398-2075</p> <p>Affiliated Offices: 314 Gordon Avenue Thomasville, GA 31792 Toll Free: 1-877-225-8320 (229) 226-8839</p> <p>2630 Centennial Place Tallahassee, FL 32308 (850) 893-8418</p> <p>3433 Peachtree Road, NE Suite 660 Atlanta, GA 30326 (404) 442-2727</p> <p>RCA is a Registered Investment Advisor and consultant with over \$100 million under advisement (over \$1 billion including our affiliate), for clients primarily in the Southeast. We are independent fee-based advisors and consultants with no affiliation to any outside companies or commissioned products. Certain material in this work is proprietary to and copyrighted by Litman/Gregory Analytics and is used by RCA with permission. Reproduction or distribution of this material is prohibited and all rights are reserved.</p>
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