

*This letter is dated September 2012*

***We've demonstrated a strong track record of being very disciplined with the use of our cash. We don't let it burn a hole in our pocket, we don't allow it to motivate us to do stupid acquisitions. And so I think that we'd like to continue to keep our powder dry, because we do feel that there are one or more strategic opportunities in the future.***

*- Steve Jobs, October 2010*

There is a popular show on the History Channel called *Pawn Stars* about a family-owned pawn shop in Las Vegas. People looking to raise cash bring in items that they hope have value, seeking to either use them as collateral for a loan or to sell them outright. The owners of the pawn shop, Richard "The Old Man" Harrison, and his son, Rick, can pass on making a loan or buying an item if they do not think they can sell it later for a worthwhile profit.

The store owners are in an enviable position-- they have a cash hoard and can afford to be both patient and picky. They have the experience and resources to make reasonable estimates of value (or more precisely, what a customer might be willing to pay for a given item and how long it would likely sit in inventory before selling). They do not need to rush a transaction and can take the time to do their homework on merchandise that is brought in. They can look into whether the item is authentic or counterfeit and whether it is common or rare-- the greater the supply, the lower the value.

The Harrisons have had a great deal of experience buying and selling since they opened for business in 1988. This experience gives them an idea of the value of a wide variety of merchandise. In addition, over the years they have come to know expert appraisers in areas ranging from sports memorabilia to rare automobiles. When they feel they cannot rely solely on their own experience they look to the opinion of experts. They are disciplined (most of the time) about the prices they are willing to pay and make offers significantly below appraised "retail" value in order to allow for a worthwhile profit down the road. If they pay too much they will not be able to make a sufficient return for the risk they are undertaking. Because they are often working with

incomplete information they occasionally make a mistake and buy a fake or pay too much for an item. However, their experience, network of experts and cash hoard put them in a good position to make profitable purchases on average. They can be patient and picky, limiting risk and taking advantage of bargains when they come along.

At the Madison Group, we work to invest our clients' money when our due diligence suggests to us the potential reward is significant enough to justify taking on the associated risk. Like the Harrisons we must work to understand the value of assets for sale. We also need to maintain a position of financial strength and liquidity so that we are able to take advantage of bargains that may come along. To achieve attractive returns we must be providers of liquidity to those who are financially or emotionally stretched and therefore we cannot afford to be overextended ourselves. As investors in stocks and bonds, rather than rare books, antique firearms, and memorabilia, we enjoy a key advantage versus the Harrisons-- the assets we buy generate cash flow. Owners of assets that provide cash flow have time on their side in that they get paid while waiting for a premium price buyer to come along. Importantly, owners of cash generating assets do not have to sell to earn an attractive return on their holdings.

I share the analogy of the Harrisons' Las Vegas pawn shop at this time to help clients better understand our investment philosophy and the thinking behind our sizable cash allocation. The current cash and short-term fixed income allocation in our managed accounts is high by historical standards and far above the allocation we held during the financial crisis of 2008 and 2009. During the crisis we provided liquidity to other investors (we traded our cash for their shares of stock) who presumably needed the money (or at least felt like they needed it). We were able to buy businesses that were trading below 60 cents on the dollar of what we thought they were worth. Since that time, stock prices-- as measured by the S&P 500<sup>1</sup>-- are up more than 100% and our analysis today suggests that stocks on average are priced at about 100 cents on the dollar. Our cash position has grown as we have sold shares of some businesses at prices above our estimate of intrinsic value and, in a few cases, sold stock in companies that no longer meet our investment criteria.

Cash and short-term fixed income securities today pay very little interest, but that is secondary to our discipline of investing only when we think the upside potential is enough to warrant the downside risk. Otherwise we are willing to hold cash and wait for future opportunities. The fact that cash is paying next

to nothing is not, for us, sufficient justification to take on risk. Market corrections, economic crises and political turmoil come around often enough that it seems reasonable to expect new bargains to present themselves eventually. We understand that cash serves as an anchor on performance in rising markets but we view our focus on protecting client capital to be paramount. The Harrisons know from experience that having cash on hand today is necessary to take advantage of tomorrow's bargains. There are times, at least in our way of thinking, when the same holds true for managing an investment portfolio.

Phil McCauley III  
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<sup>1</sup> Thomson Reuters

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