

AKRE CAPITAL MANAGEMENT

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January 2010
Observations

Fourth Quarter 2009

Least Worst

There is little doubt that the growing middle classes in India and China will have a profound effect on worldwide demand for “things.” Whether it is fuel to heat the home or office, power to run machinery, cell phones to communicate with, or perhaps even motor vehicles for more comfortable and a more certain form of transportation, the demand issues arising from a better quality of life are universal. Those of us in the West are long familiar with this phenomenon.

If fact, the desire in US to acquire things as lifestyles improved was carried to its ultimate extreme in the period just behind us. Most of us believe that U.S. consumers floated the entire first decade of this new millennium on borrowed funds (credit), constantly reinforcing the “Wal-Mart Ideal” – Since it’s here, we should have it. Not limited to the consumers, our financial institutions (primarily our large financial institutions) engaged in a decidedly similar practice. If ten times leverage is a good thing, then certainly twenty, thirty, or even forty times leverage by definition is a Great thing. And, as we have discussed in the past, we evolved this practice into a “too big to fail” mode. When the mighty bankers gambled with the shareholders’ money, rewarding themselves at unheard of levels when they got it right, and falling on their knees before the Treasury and Federal Reserve for forbearance when they got it wrong, the taxpayers ended up with the bill.

The culmination of all this excess, on Wall Street and Main Street, has left the consumer dramatically underemployed, and quite likely, significantly overleveraged. He is worried that he will keep what job he has, or she is worried that she won’t find a job, let alone a suitable one. He is further worried that he won’t be able to pay his rent or his mortgage, or pay his medical bills or insurance premiums. She is worried that if she has a job she won’t be able to retire at a proper age, or even retire at all.

In the past year, one and a half trillion dollars has been removed from credit card lines of credit. Home equity loans are not wildly available, and refinancing is a thing of the past, in both instances because of dramatically lower home prices. The result is that the consumers’ spending resources are greatly reduced. In addition, the Federal Government has piled on unprecedented mounds of debt, and is likely to add further to our long term liabilities by enlarging our “entitlement” programs. The double headed threats of too much debt being added on one side, and too little credit available on the other, has precipitated a dramatic growth in savings, accompanied by a distinct slowdown in spending in nearly every category.

Clearly, the only way to pay for all of this is to have a significant increase in funds flowing into the Federal Government. Over the past fifty years, several of our Presidents have understood well that dependable increased inflows into the Federal coffers could only come from a robust economy. We do not have a robust economy today, and as a society, we face the likelihood that

both individual and business appetites for enterprising acts or risk taking are diminished in light of greater government interference in their activities coupled with the near certainty of higher tax levels on all but the most modest incomes.

So, we have outlined our dilemma. The consumer is constrained, the government is devaluing the currency, and yet life goes on. While these problems are front and center, our job remains to manage your assets in a manner that reduces the likelihood that the portfolio will repeat 2008, while simultaneously increasing the likelihood that the assets will appreciate in an amount that outruns the pace of inflation.

When scanning the globe for investment opportunities, it becomes apparent that several countries face challenges as great or greater than ours. In the past I have referred to the unique power of the American psyche, and flowing from that source there has always been a determination to overcome and to win. Notwithstanding the slow, deliberate swerve into the rather European world of greater social services for our citizenry, I conclude that of all the places in the world to invest, the United States may well be “the least worst.” While no one denies the magnitude of the adversity, we as a people, have a long history of landing on our feet in the face of adversity.

Currently, the arguments are well formatted outlining the bleakness of the prospects facing us over the next decade, as are those which foretell a greater than expected growth in our GDP starting almost immediately. We have no opinion on the merits of all these arguments, as we find ourselves easily swayed by both views at times.

In just a few short months the average investor has gone from being afraid that he would lose everything to being afraid that he is going to miss out. I firmly believe that this fear is misplaced, and that while we did avert Armageddon, we are not yet in the fullness of the sun. Today, we hold more cash reserves than at any time in our history, largely because we believe the road ahead will be bumpy. We are prepared to miss some rallies, rather than to expose our capital to greater losses. We believe there are many great investment opportunities now, but allow that the perception of risk is higher because the consequences of risk taking just came home to roost!

We will continue to search for great opportunities, in spite of our caution. We will follow the trail we have cut as value investors, weathering the fitful storms created by the risk prone, short sighted few, and their belle-weather followers. In our portfolios we continue to look for businesses which we believe:

- have demonstrable pricing power
- have real prospects for growth
- are not natural targets of regulation
- require only modest amounts of capital to operate efficiently
- are run by people of the highest integrity
- duplicate what happens at the company level at the per share level
- have an opportunity to reinvest all the excess profits at above average returns.

This model of great businesses, great people, and great reinvestment opportunities creates a great “compounding machine” in our minds. When we find these gems, we are disciplined about the prices we will pay. Our goal continues to be to compound your capital at an above average rate with a below average level of risk. The relative low level of risk comes not from the absence of volatility, but rather, from the strength of the businesses themselves. This strength is reflected in their balance sheets, their superior returns on capital, and the outstanding quality of their managements. In the end our rate of return will be determined not only by the quality of the businesses we choose to own, but importantly by the starting valuation (price) as well.

So, here we are, January 2010. The playing field is well described. Our problems at home are enormous, and our commitments outside the U.S. are significant, as well as draining on both resources and attitudes. We think it is impossible to have experienced 2008 and the first quarter of 2009 and not have been affected by it. We have seen up close the unintended consequences of risk taking by others. We have committed modest amounts of capital since the market bottomed in March, and have taken larger amounts of capital off the table. We think it is imprudent to be fearful of missing out on the rally.

Nevertheless, we continue to be excited about individual investment opportunities which we are actively pursuing. At the founding of Akre Capital Management in September of 1989, we said to clients and prospects, that our goal was to compound our clients' capital at above average rates while incurring below average levels of risk. In our opinion, the success of our process is demonstrated in the performance of our funds. From an investment return point of view, we experienced the worst year of our career in 2008. However, the market returns in 2009 remind us that all was not as bad in 2008 as it seemed. Throughout the turmoil, many of our portfolio holdings continued to grow their economic value per share, while also recovering nicely in price. Valuations in portfolios have not yet returned to the highs reached some two years ago, but we have greater clarity in understanding that virtually all financial assets were then experiencing a great bubble.

Never far out of my mind, and preserved in a wall hanging near my desk, are two quotes which are timeless:

“Remember that there is nothing stable in human affairs; therefore avoid undue elation in prosperity or undue depression in adversity.” Socrates, 399 B.C.

“The argument is made that there are just too many investment question marks about the near future; wouldn't it be better to wait until things clear up a bit? You know the prose: Maintain buying reserves until current uncertainties are resolved, etc. Before reaching for that crutch, face up to two unpleasant facts: The future is never clear; you pay a very high price in the stock market for a cheery consensus. Uncertainty actually is the friend of the buyer of long term values.” Warren Buffett, August 1979

Third Quarter 2009

"If you aren't confused, you simply don't understand what's going on." Edward R. Murrow

During the last two years we have experienced the unpleasant outcome of a massive overextension of credit to both businesses and the consumer. Within the business community, primarily the financial sector, we witnessed staggering levels of risk taking in ways that were wholly opaque to investors and most regulators, with all the upside accruing to a handful of the privileged, and all the downside falling on the shoulders of the American people via the Government's backstop. In the consumer sector, the locus of the problem is the housing market, and the fallout is massive levels of default and foreclosures.

It is my view that one major source of the problem was the disconnect between the lender of credit and the ultimate owner of the credit. More simply, when I was younger, and my wife and I wanted to buy our first house, the local banker did two things. First he did some due diligence that enabled him to make a judgment that a) we were able to pay back the loan, and b) we were willing to pay back the loan. The second thing he did was to require sufficient collateral to make him whole in the event we did not pay back the loan. Today we might even refer to this as the belt and suspenders approach to lending. What a quaint idea! The obvious point is that the lender of the credit was also the owner of the credit, and he cared very much about being paid back. History has demonstrated again and again that having a direct relationship between the lender and the borrower vastly improves the outcome.

Through an evolutionary process, the originators of loans in more recent years (really since the introduction of the mortgage backed security following the savings and loan crisis in the 1980s), have had no real economic relationship to the owner of the credit, and the coup de gras was that the mortgage originator was paid on volume, rather than on credit considerations. It has been no help as well that the U.S. Congress got into the act and literally forced lenders to make riskier loans to help that element of the population which was otherwise unable to buy a home. A report by the National Association of Realtors (2006) found that the median home buyer in 2005 put down less than a 2% down payment on the purchase of their home. Given that the median price of both new and existing homes have declined from their respective peaks, the subsequent buyers of 4.9 million homes since the peak have negative equity in their real estate investment. This was written in 2006!!! We are still experiencing the fallout of this lending folly, and will likely continue this difficult experience for many years to come.

Just as the notion that everyone should have a college education is folly, so too is the notion that homeownership is for everyone. Democratic capitalism doesn't work that way, and to my knowledge, no other system of government in the world has demonstrated that every member of the population can own their own home.

Back to the bankers. Because these bright folks figured out years ago that we have an implied "too big to fail" system in place for large (meaningful) financial –and now other commercial enterprises like car manufacturers- institutions, they levered up their balance sheets to unprecedented levels with highly risky assets, making a bet that was essentially "heads I win, and tails you lose." Not unlike the mortgage origination business, the bankers figured out that they got paid simply by originating the risky assets. They further discovered that they would be paid a second way if their "bets" should win, and they would be rewarded at unheard of levels. If they

lost, the institution paid, and therefore the American people paid, because of the unwritten but very much a reality “too big to fail” (TBTF) doctrine. Incidentally, many of these risky assets were directly related to the folly in the home mortgage market.

Just as the mortgage security became popular following the S&L crisis, modern day academics continued to invent exotic financial instruments, which became even more popular for the bright bankers to use to “hedge” risks. Apart from the fact that the owners of these derivatives often had no “insurable interest” in the risk they were taking or avoiding, their use spread like wildfire across the globe as the world became very small through the wonders of the internet. (“Insurable interest” refers to one’s ability to buy risk coverage such as a life insurance policy. It is illegal in the U.S. to buy a life policy on someone with whom you have no direct relationship, for obvious reasons).

Once the value of the underlying collateral began to decline –we cited above that a rapidly growing group of new homeowners were “underwater” by 2006 – all hell broke loose because there was insufficient collateral to pay back loan obligations, whether home mortgages, or overnight loans between bankers and commercial corporations.

Observation One: Leverage does not make any investment better or worse, it simply magnifies the outcome. To paraphrase an old Wall Street observation; “Leverage is a coward; at the first sign of fear, it disappears.”

Observation Two: If one put down just 2% on a home and borrowed the rest, a mere 2% decline in the home value wipes out the equity!

Observation Three: If a bank is levered to 40 times, a mere 2.5% decline in their assets wipes out their equity.

Everybody was playing the same game! The bankers however stacked the deck in their favor, in a way the homeowners could not.

At the end, we experienced a liquidity crisis. It caused the failure of many financial institutions. It caused a very significant drop in the value of common stocks and residential real estate. It caused the closing down of many businesses, both public and private. It has caused the U.S. to have 17% underemployment. It has caused the consumer’s access to credit to be either completely withdrawn or dramatically curtailed. It had caused a dramatic slowdown in retail sales of almost every variety. It has caused the U.S. government to add massive amounts of debt. It is just now causing massive declines in the value of commercial real estate. To be blunt, it has caused the U.S. and many foreign countries to experience an economic crisis unseen since the 1930s. And, we are unlikely to have a recovery that resembles that last ten years in any fashion.

So, you ask, “What do we do now?” Or perhaps, “How should we be thinking about our investments?”

The individual investor has a great advantage, in that he is able to think “long term.” In fact, it is imperative for him to both think and act long term, if he is invested in any asset class that can fluctuate in value, and is not guaranteed by the Government. (And this guarantee may itself become suspect.) We also believe that the only thing to focus on is the fundamentals of the individual assets (stocks, bonds etc.)

As an investment manager, we find ourselves in a position similar to the S&Ls in the 1980s. The dilemma that we find ourselves in is that we borrow short –our investors have the right to withdraw their capital on fairly short notice – while we invest long term. The ideal solution for us would be that our clients’ capital was committed for a long period of time, and that the terminal years were staggered among clients, hence creating no real end point from the absolute long term investor perspective.

Of course the world does not operate this way, and so we consciously construct portfolios with an eye on liquidity, all the while trying to make true long term investments. In fact our definition of an “investment” is a place (asset) where one contributes some capital, where one has a list of expectations about the asset, and where one allows for the passage of time to let the expectations develop. So, by definition, long term. Anything short of that becomes a gamble on the price movement of the asset, and this we try to avoid.

Our notion is that today’s stock market has a long list of here-to-for outstanding businesses which are selling at attractive valuations. Because our experience has demonstrated that businesses are usually getting better or worse, and since we have a view that the next decade will be more difficult than the last decade, our job is to determine if historical measures of value are suitable for the coming decade. This is the task we are intensely focused on today.

Our experience in the last twelve months has been a real challenge! In the fourth quarter of 2008, and the first quarter of 2009, our investments took a pounding. I was known to say at times I just wanted to throw up. Further, I was unable to make any assurances to any of you who asked that the system would stay together. Several participants in the crisis who were in the highest levels of government, have since said that the worldwide economic system was within days of collapse!

So, what has happened to these portfolios which we manage? In 2008, our performance was worse than the market. In 2009, our performance is better than the market. I believe that the reasons we were worse in 2008 was neither fully predictable, nor relevant in the liquidity crisis, as quoted valuations bore little resemblance to real economic values. In 2009, we are experiencing a more realistic recognition of true underlying values. Recall, that over a period of five, ten, or twenty year period, the cumulative return we have generated in your portfolios has been measurably better than the market. We have said for years that we will invest in businesses which are exceptional in many ways, and that using the valuation discipline we employ, a portfolio constructed of these businesses is likely to result in an investment experience which is indeed better than average.

An investment undertaking has to be focused first on risk management. How one manages risk is critical to both long term survival, as well as the rate of return achieved. Rate of return is the bottom line in all investing, whether one never met a CD that they didn’t like, or in fact preferred private equity. Our goal is to invest your (and our side by side) assets in such a way that we are likely to have a better than average outcome while incurring a below average level of risk. Risk to our way of thinking does not mean issues of price fluctuation (volatility), rather it means exposure to permanent loss of capital. We manage this risk in your portfolio by focusing on the fundamentals, and by thinking long term.

The crisis which we have recently endured has highlighted several important issues in a client/manager relationship in which we are engaged. The first is that both parties must be fully

aware of limitations that the other has. From our perspective, we clearly need to better understand exactly where the “hot button” is for every client, as discovering it deep into a decline proves unrewarding for both parties. If we have failed in this important fact finding, we truly apologize, and will absolutely try to better understand your particular concerns and needs. The understanding of this has, and may again, alter the desired outcome of our investment plan on your behalf.

Not unrelated to the first point, we need to emphasize the observation that absolute risk aversion and growth of capital are inconsistent. So in addition to understanding better each client’s financial, psychological and emotional requirements, we need to adjust expectations to better fit these requirements. In the last couple of weeks, I heard a speaker define “prudent” as meaning simply that it is which everyone else is doing, whatever it is. Our own experience in the forty or so years we have been investing is remarkably different. You can be certain that we will strive to identify value in common stocks and debt instruments, without any concern about what everyone else is doing. I believe that our record on your behalf makes clear that what we do is more rewarding, less risky, and indeed more enjoyable. We have said in the past that what we do is “conservative but not conventional.”

Rather than just asking through this missive as we have in the past, that you keep us abreast of your requirements, you can be certain that we will plan to be in direct contact with you about this issue.

Second Quarter Letter

The market has settled down recently after a more raucous start to the year. Investors are digesting the shape of the economy and the new Presidency while the issues of business growth, access to capital, future tax rates, and health care reform remain unclear and unsettling.

Over the past eighteen months nearly every adult suffered a significant diminishment in the value of his assets. Whether it is an investment portfolio, a retirement account, or a residence, our conclusion is that the declines value in aggregate is about 35%. Practically no one has escaped.

Those that chose to liquidate near the November or March lows have suffered even more, as they haven't participated in the rebound which has been significant. While personal financial circumstances may have intervened, they, just like us at ACM, could not rely on assurances that the decline would not continue.

For years we have been aware of the market sages' wisdom suggesting that periodically the equity markets may decline by as much as 50%. And while aware of this wisdom, it was not built into our portfolio structure in a way that provided protection of capital in a manner which we would have expected. The Nation's entire financial system was severely stressed, last fall and was within days of complete collapse, according to many sophisticated observers.

The situation created a true conundrum for many, including us. The question raised was simply: "Do we go to cash-preserving capital; do we take advantage of falling prices – perhaps ridiculous prices-by buying more; or do we simply hold on with the belief that prices will surly rebound? During the worst of the market's disarray, we experienced a true liquidity trap, as diversification added no value, and there were no bids for nearly all assets.

It is both our experience as well as our continuing belief that owning a non-diversified portfolio of better than average businesses will increase the odds of our experiencing a desirable investment outcome. While most of our portfolio companies have altered their growth plans because of the uncertainties referred to in the opening paragraph, they will continue to move forward. Our surmise is that the U.S. economy will be more restrained in the next decade than is has been in the last two. We also believe that the odds are better than even that the solution to the enormous - and still growing - government debt burden will be aided by a devalued currency. We will pay back our fixed dollar debts with a currency less valuable than when the dollars were borrowed. The likely by product of this "solution" is higher levels of inflation and perhaps higher interest rates as well.

We regularly remind you of our need to be fully aware of your financial picture and what role these assets play. The experience of the last eighteen months reinforces this view. Please help us understand your thoughts and plans for the future.

Sincerely,

Akre Capital Management

First Quarter 2009

April 15th finds us with a positive return for the first time in a long time. Believe me; we are grateful for the experience! Also at mid month most of you will find yourselves with a substantial cash balance, as we used the six week market rally as an opportunity to trim some extra large positions, and to reduce in size one or two others. Our eventual goal is to add a few new positions, to make several smaller positions larger, and generally to hold a little more cash than normal. You recall that we began the year-end letter with the questions “Is your portfolio properly positioned today for an uncertain economic environment and an unstable world?”, and further “what are we ... doing to position your portfolio for a more favorable result going forward?” The changes we have made in the last 100 or so day are done with these questions squarely in mind.

Our sense of the world is that the “crisis” has passed, the economy is still declining, although we believe more slowly, and that the market is generally in a “fair value” range. Our investment opportunities are not likely to be as attractive as they were two months ago because the “panic” has abated, for now. Absent from your portfolio is any form of large financial institution. This is unusual for us as we have held positions in one or more banks for many, many years. The experience of 2008 has caused us to be more cautious, as we do not have a high level of confidence that all of the issues of concern have been properly recognized on the respective balance sheets of the various institutions.

For many of you 2008 was a very stressful year! We have tried to be responsive to your concerns, and hope that you feel as we do now, that the worst is likely behind us. Accordingly, we continue to work to position your portfolio for the opportunity to have above average investment results, while continuing to be mindful of the most recent market experience.

Please continue to keep us informed as your concerns or your financial requirements change.

Akre Capital Management, LLC