Arquitos Capital Management

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The Arquitos Value portfolio returned 4.1% after fees in the second quarter. The second quarter was a difficult one for the overall markets. The negotiations in Greece dominated much of the quarter and, ultimately, austerity measures passed. Whether this will save Greece, and the European Union, in the long term is up for debate. It did allow additional assistance from other EU members to flow for the time being.

In the U.S., the debt ceiling debate became more heated at the end of the quarter and is now in full effect. The overall markets expect a resolution. As someone who's spent their last 15 years in the political sphere, and as a natural contrarian, I'm a bit more skeptical. I'm currently examining ways to protect the portfolio if the worst case scenario happens. Do I think the President and Congress will come to an agreement? Yes, but I also know that politicians will be politicians. They respond to political pressure from constituents and interest groups. They do not respond simply because a proposed policy is sound or economically rational.

Let's leave the macro environment aside for now and look at some of our holdings. As you know, three types of stocks make up the portfolio: value stocks, superior leadership stocks, and special situations. It's worthwhile to review how each category has done and take a look at their prospects the second half of the year.

Value

This portion of the portfolio has been a drag on performance. The primary reason has been timing. At the end of Q2 we had about 33% of the portfolio in some sort of a financial stock, whether a bank or insurance company. These stocks in particular are trading at valuation levels that are historically low, which is why I bought into them. What I don't like is the fact that they continue to trade at valuation levels that are historically low. I'm not happy that their underperformance this year has pulled the performance of the rest of the portfolio down, but I'd rather be early than miss the potential for large gains. In most of the financial stocks that we own, if the company were to liquidate, the value would be higher than the current stock price. Obviously a liquidation is not going to happen, but if we look at these stocks from this perspective we can disregard the day-to-day stream of negative news. This is our margin of safety,

The biggest risk is that one or more of these stocks will dilute current shareholders or be forced to set aside more money in reserves. I think that risk is already baked into the stock prices. That means that increased certainty, even if the news is bad, will cause valuations to rise. This mismatch between price and value can't last forever. There is no doubt many of these stocks are unloved by the market. Believe me, I haven't gained any popularity points for owning Bank of America. Once sentiment shifts, though, this portion of the portfolio will lead. Right now, patience is the name of the game.

Superior Leadership

The second portion of our portfolio is made up of companies where I have a tremendous amount of faith in their leadership and culture. If you're an ardent follower, you know I am a Warren Buffett acolyte and long term Berkshire Hathaway holder. Berkshire's size means that it's difficult for the stock to get significantly over or undervalued in a normal environment. Now is not a normal environment. Over this past quarter I increased our Berkshire Hathaway position because shares are currently as cheap as they've been in at least a decade. I peg shares at more than 50% undervalued and I think our increased position in the stock will repay us with outsized returns.

During the quarter Berkshire's stock price decreased nearly 10%. I significantly increased the size of our position on June 8 at a price of $74.96. Over the next month the macroeconomic environment poses an unusually high number of risks. Our large position in Berkshire ensures that we have a safe, cheap, well-capitalized partner as we navigate the next quarter and the rest of the year.

Special Situations

The special situation portion of our portfolio has been the most exciting, and profitable, over the past quarter. We've been holding a position in Barnes & Noble since August 22, 2010. My thesis behind the position was that there would be a buyout and the buyout price would be above $20.

We started accumulating shares at $14.89. Unfortunately, shares slumped all the way down to $8.45. I took the time to re-review my thoughts on Barnes & Noble and came away optimistic. Their CEO, Len Riggio, started the company 46 years ago and adopted the Barnes & Noble name in 1971. Since then he has created or taken control of other family-owned companies that rely on their relationship with Barnes & Noble. The Riggio family owns about 37% of the company. On the other side was activist investor Ron Burkle. Burkle accumulated just under 20% of the outstanding shares before the board of directors implemented measures stopping him from accumulating more shares.

My theory was that either Burkle or Riggio would take the company private and that there was the possibility there would be a bidding war. During my re-review, though, I also began to appreciate the company's digital strategy, specifically with its Nook e-reader. This strategy required significant, early spending and losses, but this digital investment was starting to pay off. I believe it will provide massive revenue gains in the future. That, coupled with the Borders' bankruptcy and the discounts associated with many of Borders' stores closing, meant that the financial results for Barnes & Noble in the first half of this year would be particularly poor. The stock price reflected that. We bought more shares.

The bid came on May 20, but not from Riggio or Burkle and not at an acceptable price. Liberty Media and its well-respected chairman, John Malone, offered $17 per share. The stock went up to $20 after the bid as analysts came out of the woodwork to say the company was severely undervalued. Interestingly enough, Burkle also bought more shares above Malone's offer price, but still staying under the 20% threshold. This sparked rumors of a bidding war. The risk/reward level caused me to sell out of our shares between $19.33 and $19.98.

Shares have since dropped and now trade in the low $17's. The bid has yet to be formerly accepted by the company and there is still a chance for a higher price. Of course, there is also a chance the bid falls through and the stock price drops. I have continued to monitor the stock closely and may trade it again in the future. There's really only one certainty here: If John Malone gets the company at $17 per share it will be a steal, and he knows it. This position heavily contributed to our gains over the past quarter.

At quarter end our four largest positions were in Berkshire Hathaway, Platinum Underwriters Holdings, SuperValu, and Bank of America. Thanks again for following along, and please contact me if you have any questions. I look forward to hearing from you.
Best regards,

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