

January 22, 2012

The stock market is filled with individuals who know the price of everything, but the value of nothing.

Phil Fisher

The Arquitos Value portfolio returned (6.3)% after fees in 2011 compared to the S&P 500's 2.1%. After a down 3rd quarter, the portfolio returned 14.8% for the 4th quarter in 2011.

As I mentioned in last quarter's letter, we continued to see a lot of volatility in the markets. We recovered much of what we had lost in the 3rd quarter but not enough to get us back to the break even mark for the year. Investing styles go in and out of favor. Over the last couple of years value strategies have lagged the market. As a bottom-up stock picker, that's not an excuse though. If I would have better chosen individual stocks, our results would have been better. I bet too big on a few financials in 2011, not just banks but insurers as well, and it ended up hurting our results. While I thought our financial holdings were cheap at the beginning of 2011, they are even cheaper now. I expect to see these stocks rebound this year.

A good example of how better bottom-up stock picking makes a difference is our profitable investment in Citizens Republic Bancorp (CRBC). We first bought Citizens Republic on November 1, 2010 for about \$0.63 per share. They did a 1-10 reverse stock split in the first half of 2011 and ended the year at \$11.40. It was our best position in 2011, up nearly 84%.

We also had some holdings that I bought into over the last four months of the year that performed very well. Valeant Pharmaceuticals (VRX) is an international specialty pharmaceutical company that has branded pharmaceuticals, branded generics and over-the-counter products. They also have a dynamic CEO and an undervalued stock. We bought it on October 14, 2011 at \$35.99. Shares appreciated just under 30% by the end of the year.

Clearwire (CLWR) is another stock we bought into in October. Our average purchase price was \$1.53. It ended the year at \$1.94 for a 27% gain. Clearwire's stock was cheap in the beginning of the 4th quarter on funding concerns. Those concerns went away by the end of the quarter, but there is still substantial room for the stock to grow.

Contrast CRBC with the nightmare that was Bank of America in 2011. I've written about Bank of America before so I won't elaborate again, but the stock was our worst performer in 2011, down 57%. Bank of America chopped off about 4% from our returns just by itself. I thought it was cheap in the beginning of the year at \$13.34 but lawsuits, regulatory concerns, the crisis in Europe and, most importantly, daily negative headlines about the bank (some valid, some not) have significantly hurt shares. I think the

negativity is way overblown and I wouldn't be surprised if Bank of America turns out to be our best performer in 2012. In fact, it's already returned more than 27% so far in 2012.

Another big loser for us was Tongxin International (TXIC). This Chinese truck part maker dropped about 47% before we sold it on October 12. Small Chinese companies trading in the U.S. did not fare well in 2011. Tongxin has American leadership, but concerns that are typical to the Chinese market materialized during the year. The company appeared to continue to be profitable, but it's unclear whether their numbers can still be trusted. I should have sold out sooner. I've learned a valuable lesson with Tongxin that hopefully will help to prevent future losses in other situations.

Finally, another bank stock hurt us this year: Synovus Financial (SNV), a Georgia-based bank. I sold about half our position in Synovus in February and March in order to decrease our exposure to the sector. Those sales were between \$2.50 and \$2.85, actually giving us gains on those holdings. Unfortunately we still had about 3.5% of the portfolio in the bank when I completely sold out at \$1.33 on October 24 for a 48% loss on the year with that remnant position.

Going forward I continue to be optimistic with our holdings. During the volatile 3rd and 4th quarters I did some repositioning into some stocks that I feel have less downside risk than the ones they replaced, but also tremendous upside potential. Our current bank and insurance holdings are undeniably cheap based on long term historical measures. Their valuation metrics will revert to something close to the mean at some point, but I can't say if it will be in the next three months or three years.

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

Best regards,

Steven L. Kiel
Arquitos Capital Management

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