



Frequently Asked Questions



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Tom Koehler
Partner

Two of our most frequently asked questions are "How do you determine what stocks to buy" and "How are fees calculated?" As a result, we have decided to dust off a couple of articles from previous newsletters, update them and encourage all to familiarize yourselves with these important topics.

Buy low and sell high. Sounds simple but not always easy to do. Two terms that you will hear on the evening business shows are "momentum investing" and "value investing." Momentum strategies are nothing more than buying into a hot stock when everyone else is. Momentum stocks can go up fast, but they can tank just as quickly.

Value investing, however, is a little more involved. Did you ever wonder why a stock like GE stock could fluctuate in price from \$10-\$20 over a 24 month period? If this company had, say, a billion shares outstanding, it would mean that on one day you could have bought GE for \$10 billion and another day for \$20 billion. How can that

be? Is the company selling twice as many x-ray machines or jet engines one year versus another? Possible, but not very likely. It is extremely unlikely that the long term "fair" market value of a company fluctuates as much as its stock price. What does fluctuate sharply over short periods of time are investor emotions.

An investor who can arrive at a reasonable fair value for a company will be able to use swings in investor sentiment to his advantage.

The key to successful investing is buying when the company's shares are trading below fair value and selling when the shares are above fair value. It may take a long time (remember tech stocks in the late 90's) but stocks invariably gravitate to fair value over the long term. Regression to the mean is one of the most powerful forces in finance (along with compound interest).

Fees

I recently received a telephone call from a client who asked me to look at the portfolio that she had recently opened with one of the major brokerage firms. The portfolio contained one holding, a well known mutual fund that was having a good year.

"Why," she asked, "is my portfolio down but, when I check the performance of the fund, it is up?" "At the time, this particular fund was up about 4%. When she took into consideration the 5% commission she paid, she realized that the fund had to be up a minimum of 5% before she began to make money.

In addition, there is the expense ratio, which reflects the annual operating expense of the fund. This is disclosed by the fund. What may not be disclosed are the trading costs.

Many fund managers turn over stocks in their fund at least once (cont'd page 4)

"The Line" Revisited



Ted Levin
Partner

When we attempt to calculate long term fair value for a company, we employ a widely accepted approach called "discounted cash flow." The approach calculates a company's long term fair value through the use of variables such as expected future earnings and general interest rate levels.

Long term interest rates have been at historically low levels ever since the financial crisis. This has been a real positive for stocks. However, many investors do not believe these low levels are sustainable nor good for the economy. As a result, stock prices tend to reflect a higher level of interest rates.

Over the past seven years Microsoft's stock price has barely budged. Interestingly, over the same period, its earnings have tripled! As a result, Microsoft's P/E ratio has dropped from 30 to 10.

Why the underperformance? In our opinion it has more to do with comparing Microsoft to what the other girls are wearing to school (specifically Apple) than with its own clothes. Microsoft has solid franchises in Windows, Office and servers. Moreover, it has shown that it can withstand challenges to its turf (Linux).

Unfortunately, its push into

more "sexy" businesses has been disappointing, and the management team has been accused of being close minded when it comes to deviating from the Windows platform.

The reader may ask at this point why we are so attracted to this company when its stock price has been stagnant for several years?

Envision a horizontal line on a graph. This line represents a company's fair value. Granted, it will change over time, but for companies like Microsoft, where the earning news has been consistent and widely anticipated, the line's position tends to change slowly over time.

Now think of another line which represents the company's stock price. Some days (or months, maybe years) the second line might be below the first line or above it. If it is below, then the stock is undervalued, and if it is above then it is overvalued. In most cases it will rarely intersect the first line. However, history has shown that over time the lines do converge. The concept of convergence is called "regression to the mean" by some financial theorists. This concept, along with that of "discounted cash flow," form the basis of our equity valuation model.

As for Microsoft, our analysis over the past 12-24 months suggest that the company has a long term fair value in excess of \$35 per share.

In terms of the suggested graphical representation, our quantitative work leads us to conclude that Microsoft is trading below the "line." As a result we continue to be buyers and holders of Microsoft.

The key to successful investing is buying when the company's shares are trading below "the line." As noted earlier, a stock can and does trade below its fair value line for a very long time. It can be difficult for long term investors (versus market timers) to know when the rest of the investing public will come around to our conclusion and bid the stock price up to "the line."

Our experience has been, however, that over time the two lines have a very high probability of convergence. Those investors who have a better understanding of where the line was in the first place are the investors who have the highest probability of long term investment success.

Market Commentary

Our thoughts regarding the outlook for the remainder of 2011 are as follows:

The Bullish Case

The stock market has been extremely strong since August, 2010 for one simple reason, the announcement and subsequent implementation by the Federal Reserve of the second round of quantitative easing (QE2). The bulls believe that the Fed will act as a backstop to any weakness in the economy (and by implication, the stock market). Bottom line, don't fight the Fed, they argue.

Secondarily, there has been some modest improvement in employment trends, corporate profit trends are strong and valuations appear to be reasonable to the bulls.

The Bearish Case

Let's start with the Fed. QE2 is going to end in June. We supported some of the early Fed decisions in late 2008, but we have not been as supportive of the QE2 program. QE2 is a conscious attempt to manipulate asset prices like stocks, houses, etc. via massive monetary stimulus, i.e., printing money. Manipulated asset prices are never a good idea, in

our opinion. The sooner it ends, the better.

As for government deficits, the good news is that there has been a sea change in attitude by many Americans that we have to deal with this issue in a meaningful way. The bad news is that we do not think it will happen until after the 2012 elections. We pray that the economy can last that long.

Inflation trends are increasing across the board. In addition to early indicators like gold, oil and commodity prices, we are starting to hear with increasing regularity from corporate executives that cost pressures are negatively impacting margins.

China has been the world's leading growth engine for the past few years. Their currency policy, however, is causing a significant increase in inflation and imbalances in their economy. Combined with an inefficient public sector, we see increasing evidence of an enormously inefficient capital allocation, primarily in the real estate sector. We are all too familiar with the long term consequences of a real estate bubble.

Finally, there is the Middle East. Like virtually everyone monitoring this situation, we

have absolutely no idea of what will happen next. Our gut feel is that things will get a lot worse before they get a bit better.

Investment Themes

Given this backdrop, three sectors look attractive to us at present.

First, we view the energy sector positively, especially natural gas. The single most important demand driver is the growth of emerging economies like China, India and Brazil. Our concerns with China notwithstanding, we expect this trend to continue for the long term.

Second, we are attracted to the commodity sector. Our expectation of increased inflation, a weak dollar and a global food shortage make this an attractive investment area.

Finally, we continue to see a great deal of value in large cap tech stocks like Microsoft and Intel. While they have been disappointing stocks to own in 2011, they provide very attractive investment opportunities for the long term investor, in our opinion.



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Frequently Asked Questions (cont'd)

per year. An aggressively traded fund may incur an additional 2-3% in trading costs. Add this to the calculation, and the fund may have to increase significantly before the investor makes any money.

At Grant Koehler & Levin, our fees are completely transparent: 1% on the equity portion of the portfolio and 0.5% on bonds annually, plus our cost to make the trades.

What about bonds?

When bonds are purchased, the dealer is allowed to mark up the bond to reflect a "reasonable" profit. This "mark up" does not need to be disclosed on the confirmation that the client receives. The cost shown includes the markup, but it is not specifically identified. Out of sight, out of mind.

Once again, if you consider that a bond could

be marked up as much a 3-4%, depending on several factors.

At Grant Koehler & Levin the bond portion of the portfolio is charged 0.5% annually. There is no mark up. It would have taken 6-8 years to pay the same amount in management fees as the brokerage house's mark up. We believe that our fee structure is as transparent as we can make it and among the lowest in the industry.