AVENIR CORPORATION

INVESTMENT MANAGERS

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Over the past several weeks long simmering sovereign debt concerns in both the United States and Europe have boiled over, which coupled with signs of a slowing economy, sparked a crisis of confidence that has sent the Dow Jones Industrial Average down approximately 15%, highlighted by a 635 point drop on August 8th. This occurred on the first trading day after the announcement on Friday evening, August 5th, that the debt ratings firm Standard & Poor's had taken the unprecedented, but not wholly unexpected, step of downgrading the credit rating of the United States, following through on earlier concerns aired during the spectacle of the U.S. debt ceiling debate.

The S&P announcement formally acknowledged what we already knew about the extent of federal financial disarray and the inability of the current leadership to come together to address it. Adding to the sense of unease is a lengthy set of economic and political concerns, including evidence of economic weakness in the U.S. despite massive federal stimulus programs and so-called "quantitative easings"; overwhelming levels of state and local debt in the U.S.; a weak jobs market; the spreading sovereign debt crisis in Europe; fears of either inflation or deflation; the value of the dollar; and concern that China's economy may falter. In summary, the pieces for a global slowdown appear to be coming together. And with the financial crisis still a recent memory, a reflexive desire to simply get out of the way is probably playing a role.

Why are the equity markets down?

We have no special ability to explain short-term market swings, but it seems clear that investors are dissatisfied with both American and European political approaches to their respective sovereign debt troubles. It is widely understood that Greece lacks the ability to repay or roll over its maturing debt. Spain, Portugal, Ireland and Italy are on the edge, threatening to send Europe into recession again. An even more dramatic effect could be the disintegration of the Eurozone and an end to their common currency, the euro. In the U.S., economic growth has slowed from over 3% in 2010 to a little over 1% while unemployment remains high and net government borrowing continues to grow. China's economy, now the world's second largest, is built on exports to the west. Should demand from the west shrink, so will China's growth rate. We are among the many who sense a Chinese real estate bubble and question that country's political, social and economic stability. The global economic picture is full of challenges.

When death is imminent, the price of survival is irrelevant. That is the fundamental tradeoff accepted by Europe and the United States in response to the near collapse of our financial systems in 2008. Three years of sovereign borrowing has financed the stimulus programs that shocked these economies back to life. This debt now needs to be repaid, and it will be a long, difficult process that will hobble the world economy for years to come. The fact that the current

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crisis has its roots in the prior one understandably evokes memories of 2007-2009, when a quick exit at the first whiff of trouble would have served investors well.

Is this 2008 all over again?

It is a logical question. The short answer is "no" as important differences exist between the two periods. Foremost is the stronger position most financial institutions find themselves in today. The chain reaction caused by subprime lending nearly destroyed the U.S. financial system a couple of years ago, but record bank profitability, an accommodative Federal Reserve and the passage of time have healed bank balance sheets, allowing them to absorb loan losses more gracefully.

Second, stock valuations in general are not excessive by historic standards. Price-to-earnings ratios are much lower than they were heading into the global financial crisis. The long-term average price-to-earnings ratio for the S&P 500 is 16 but according to current estimates, the S&P 500 is trading today for less than 13 times earnings estimates for the next twelve months. Moreover, after adjusting earnings expectations for a possible recession, valuations are still reasonable by historical standards. In contrast, the ratio was just under 18 heading into 2008. A related measure, the S&P dividend yield, also provides an important and favorable contrast. At 1.77% going into 2007, the S&P dividend yield was almost 3 percentage points lower than the 4.71% ten-year treasury yield. Today, the S&P dividend yield is far more competitive. It stands at 2.32% compared to 2.39% for the ten-year. This narrowing means that stocks start out on roughly equal footing on yield alone, but stocks have growth prospects. Treasuries do not.

Third, high quality businesses are doing very well in the current environment. Many companies with durable franchises have taken advantage of current credit market conditions to improve their balance sheets while simultaneously improving profitability and generating lots of cash, which is often finding its way back to shareholders through dividends and share repurchases. Further, the companies at the core of Avenir portfolios generally have little or no debt and generate cash by the ton, which in many cases, simply piles up on the balance sheet. In times of crisis, abundant cash reserves provide companies with the flexibility to act opportunistically by making acquisitions at distressed prices or buying back stock at low prices. Indeed, in the depths of the last crisis, one of our core holdings took the bold step of temporarily suspending its dividend and applying those funds to buy back stock at a severely discounted price, and the current quote implies a roughly 5 times return in a little over two years in addition to the compounding effect which benefits shareholders permanently. Of our ten largest holdings, which on average constitute nearly one-half of our portfolios, eight have active share repurchase programs in place.

The bear market of 2007-2009 was born of high valuations, excessive leverage and the unseen buildup of toxic mortgage debt in the financial system. No one expected to be mugged by his house, but each of us was, either directly or indirectly. Today's problems – at least the visible ones – may be little easier to grasp: governments simply have unsustainable levels of debt. Servicing that debt will sap economic resources until it is reduced. Western economies need to deleverage and grow, but it is difficult to do both at the same time. And given the levels of debt that must be dealt with, the deleveraging process might take a decade or more. There are no economic tailwinds, and achieving growth will likely be more difficult than in any decade since the 1970's. The winnowing process is likely to be especially unforgiving to the weak and especially rewarding to the strong. This plays directly to one of Avenir's strengths, which is our emphasis on terrific business franchises.

What does S&P's credit downgrade mean?

The downgrade itself is largely symbolic for three reasons. First, S&P had signaled that a downgrade was likely absent a debt ceiling agreement that incorporated a debt reduction program with real teeth. Second, no one questions the ability of the U.S. government to make good on its obligations, which is why, despite the economic and budgetary uncertainty in the U.S., investors have been snapping up U.S. treasury securities, driving yields to multi-decade lows. Third, both Moody's and Fitch reaffirmed their AAA rating last week.

Symbolism aside, the credit downgrade is serious business and may produce a jarring reaction in parts of the market. Many bond, money market and institutional investors have a AAA-only mandate. It is possible that they could be forced to sell holdings of US treasury securities unless a waiver or exemption is obtained. Stickier problems will be faced by entities such as life insurers or investment vehicles financed through the "repurchase" market, where additional reserves or collateral are required if the government bonds that back them are downgraded. To the extent investors genuinely become wary of U.S. treasury debt, interest rates could rise, exacerbating the deficit. The overall dispiriting nature of the downgrade may negatively impact stock prices, at least over the short-term.

Political leaders have a habit of dithering until crisis is on the doorstep. This was evident in the debt ceiling debate, which produced nothing of substance and diminished the public perception of both political parties, Congress and the Administration. It is our hope that the S&P announcement, which comes 16 months before we select a president and new Congress, marks the start of a substantive debt-reduction process, if for no other reason than political self-preservation. Take note of the harshness of S&P's criticism of the political class and policy-makers. The rating agency sees "America's governance and policymaking becoming less stable, less effective, and less predictable than what we previously believed." It goes on to say: "Our opinion is that elected officials remain wary of tackling the structural issues required to effectively address the rising U.S. public debt burden in a manner consistent with a 'AAA' rating..." Unsurprisingly, the announcement contains not a word about how the rating agencies enabled the mortgage crisis in the first place with their lax approach towards subprime mortgage originators.

The reaction by Congress and the Administration to the underlying causes of the S&P action is likely to be the single most important political test of our time. We will learn much about our leadership's political courage between now and the next election.

What you should expect from Avenir in the current environment

The founder of one of our portfolio companies likes to say that people make better historians than prophets. That is why we rely on the intrinsic value standard for our core investments.

When we buy a share in a business, we believe we are paying less than our assessment of what that business is worth today. We try not to rely on a scaffolding of assumptions about what the future might or might not bring. If our analysis is correct, we will be rewarded, even in a flat market environment, as the market closes the gap between quoted and intrinsic value. In fact, putting capital to work patiently in a dull, flat market favors us. We do not wish to compete with a herd during a rapidly rising market.

You should be aware that our portfolio construction process emphasizes those businesses with highly predictable and recurring free cash flows. Two examples are worth noting. Our investment in the packaging sector is one of the world's largest manufacturers of food, beverage and household product containers. It is nearly certain that your pantry, kitchen and bath shelves are lined with products that are contained in its packaging. There is no substitute for packaging and demand displays little economic sensitivity. The majority of the company's business comes from overseas, where emerging markets provide a source of growth. When one buys their first refrigerator, they become a can and bottle user for life and therefore a "customer." Similarly, cellphone usage – particularly bandwidth-slurping "smartphone" usage – is nearly certain to increase worldwide for years to come. Our investment in the wireless infrastructure business enters into long-term leases with the wireless carriers which provide contractual, bond-like and regularly increasing cash flows far into the future. What these two companies have in common are persistent, predictable and measurable free cash flows that are relatively immune to economic fluctuations. They, and several others like them, form the core of our portfolios.

Where do we go from here?

At times like the present, we take comfort in Benjamin Graham's description of Mr. Market. (If you are unfamiliar with this piece, it is posted on Avenir's website) We have no ability to guess Mr. Market's short-term mood swings, but longer-term, today's environment reminds us a little of the 1970's. Stocks went nowhere for the decade, with the S&P 500 index itself compounding at less than 2% per year. Dividends added another 4% for a compounded total return of 5.75%. Yet during that period of time, value investors who made concentrated investments in a handful of terrific businesses, which is precisely Avenir's model, performed quite well. The most notable example is Warren Buffett's Berkshire Hathaway which grew book value per share by 655% versus a 75% S&P total return during this period. We don't profess to be anything approaching Warren Buffet, but we have learned from him and others and do hope to continue to provide our investors with our two-decade long historical net return of about a dollar and a half for every dollar of market return. If we get close to that, we will have earned our keep and most importantly, compounded your capital significantly.

The current environment also serves as a reminder that there is only one approach to equity investing that works over time: invest in durable, well run business franchises, permit them to compound for the long-run, and don't overpay.

In conclusion

There is some good news. The pace of new investment ideas has quickened this year as superior businesses that meet our criteria are now priced as bargains. Among them are two companies that nearly met their demise a few years ago due to excessive debt. Both are intrinsically superior businesses with cleansed balance sheets and new senior managers who embrace our view of capital allocation and shareholder stewardship. Both have the potential to become compounding machines. Their corporate rebirths underscore something that you should understand about businesses in general and American businesses in particular: like the most successful people, they adapt to their environments and are unafraid to embrace change. It is no accident that even after the S&P downgrade, capital from around the globe continues to pour into U.S. treasury securities. When money flees, it flees to the U.S., and it does so because America remains the safest place in the world in which to invest. That remains the case, even after the S&P credit rating action.

The United States represents a quarter of the $60 trillion global economy. How our $15 trillion starting share gets rearranged over the next decade will reflect the drive, initiative, creativity and sheer will-to-win of our still ascendant entrepreneurial culture. We think we have your capital placed with the winners. We are cautious but unafraid, and deeply grateful for the privilege of working with you.

Respectfully,

Charles G. Mackall, Jr.   Peter C. Keefe   James H. Rooney