

AVENIR CORPORATION

INVESTMENT MANAGERS

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When we last wrote you in August of 2011, the stock market was in a free-fall prompted by the U.S. debt ceiling crisis and subsequent downgrade of U.S. Treasury credit by Standard & Poor's. Not quite nine months have passed since the Dow Jones Industrial Average bottomed by falling 635 points on August 8th. Since then, the market has rallied more than 20%. Given the market's strong performance in the face of a highly uncertain economic environment, we think this is a good time for us to share our thoughts and concerns with you.

What has changed?

The post-global financial crisis corporate earnings recovery remains robust. Gross Domestic Product grew sequentially all four quarters of 2011, totaling 3.9% on the year and supporting 15% growth in S&P 500 earnings year over year. Interest rates remain low. Inflation remains tame. Volatility has declined. Bond and stock prices have risen, real estate markets are perking up, and businesses are hiring. In short, the last three quarters have been good, almost beyond imagining a mere nine months after the debt ceiling debacle.

What has not changed is the nagging fundamental problem that came to the fore last August: unsustainable federal government budget deficits and corresponding growth in federal debt. Further, it is not clear how much of our post-crisis economic growth is real and sustainable or merely a "sugar high" resulting from government intervention in the economy. The debt ceiling will be tested again this year, perhaps before the election. No one knows how the next round in this debate will play out, but at some point our nation's debt and the unsustainable level of government spending has to be addressed in a meaningful way. Our concern is that the longer this reckoning is delayed, the greater the ultimate cost of dealing with the economic calamity that emerged in 2007.

Where are we now?

Early indications from first quarter 2012 reports show that the economy is continuing to perform reasonably well, and consumers, somewhat surprisingly, are increasing spending. In general, companies are profitable, but remain focused on strengthening balance sheets and investing cautiously. There are pockets of growth in manufacturing, much of which is export driven, and there is significant activity in the energy sector, reflecting the rapid development of oil and gas shale production, as well as in the technology and communications sectors, mostly related to mobile broadband.

While the outlook has improved in the near term, we are concerned about the potential unintended consequences of the ultra-low interest rate regime engineered by the Federal Reserve. In brief, the Fed is keeping rates low partly by purchasing government securities in the open market, thus increasing demand artificially which leads to higher government bond prices and correspondingly lower interest rates. The Fed's goal is to stimulate borrowing and capital spending by businesses, which, in turn, generates job growth and increases consumer spending. This would all be fine if not for the fact that the money used to make these purchases is being printed, or in the modern era,

created “electronically” with the click of a mouse. The situation can be summarized as follows: artificial demand created with funny money.

We’ve got to give the Fed credit. Something is working, as noted above, but we remain skeptical. Rising consumer spending is often fueled by rising consumer borrowing, and the level of consumer debt is still elevated, though improved over pre-crisis levels. We are not far removed from the most severe economic contraction in generations. Given that we have yet to deal with some of its underlying causes, it would be irresponsible to assume that the crisis is truly over. To this point, it is worth repeating a portion of our September 2009 letter: “Berkshire Hathaway Chairman Warren E. Buffett notes that unpredictable side effects are certain to stem from the unprecedented doses of monetary medicine that have been required to save the financial system and avert a deflationary spiral. These effects, he says, are ‘invisible and could indeed remain latent for a long time. Still, their threat may be as ominous as that posed by the financial crisis itself.’”

The Fed continues to administer “unprecedented doses of monetary medicine” and in January announced that it will do so through 2014, extending its previous plans by more than a year. This extension alone is a tacit acknowledgment by the Fed that it lacks confidence in the recovery’s viability. While massive stimulative measures might have been necessary to stem the global financial crisis, they come at a cost. Frenetic money-printing and record low interest rates cannot coexist forever. The bubble in bond prices that the Fed is supporting will eventually pop and inflation will rise, leaving capital markets vulnerable, although the timing could be far off into the future. Markets that have come to rely on the printing press for security are not healthy.

The Fed itself acknowledges that it cannot keep a lid on interest rates forever without risking unacceptably high inflation, and has stated its belief that it can withdraw its support slowly and gracefully over time before high interest rates and inflation take hold as a healing economy starts breathing fully on its own. We hope this is the case but are convinced this cannot be accomplished without meaningful progress on federal debt reduction and deficit closure measures.

Washington’s role

The resiliency and creativity of the U.S. economy, the largest, freest economy in the world, is unmatched, yet remains seriously threatened by the compounding debt crisis. Our federal government borrows about 35% of what it spends. Much of what it borrows comes from foreign sources, meaning we are both borrowing and exporting dollars every day to pay our government’s bills. It should be disquieting for a president to borrow from China to fill up Air Force One with fuel imported from the Middle East. The rough numbers that follow tell the story. Federal debt totals \$15 trillion, excluding perhaps \$65 trillion of unfunded entitlements such as Social Security, Medicare and Medicaid. Annual U.S. GDP is \$16 trillion, implying a debt to GDP range of over 90% to 400% including entitlements. Meanwhile, elementary math illustrates our spending problem: federal government revenue = \$2.5 trillion; federal government expenditure = \$3.8 trillion; annual federal deficit = \$1.3 trillion. Federal debt, federal spending and federal deficits are all rising. Worse, the power of compounding, which is key to investment success, works against us in the government’s accumulation of financial obligations.

Washington’s failure to forcefully address the looming debt and deficit crises challenges our national character and sends a strongly negative signal to the capital markets, which will eventually exact a price for political inaction. The current path of borrowing and printing dollars is unsustainable, and when the bond market has had enough of this irresponsible dilution of our currency, interest rates

will rise, perhaps significantly. If government spending is left unchecked, more and more of our economic resources will go towards servicing debt, which will reduce economic growth and increase our reliance on borrowed funds. In such a scenario, debt and deficits will keep us in an economic vise, and our financial trajectory leads to Greece. Of course, if Washington suddenly acquires some backbone and addresses our fiscal situation in a meaningful manner, then the tide will turn.

Rising concern in Europe and China

One might ask how have we been able to sustain our borrowing and spending binge thus far? The quick answer is that the rest of the developed world, e. g. Europe and Japan, is in worse shape overall, making the U.S. a relatively safe haven for the time being. The European debt and budget issues are even messier than our own, and it is difficult to see how the conflicting interests of the 27 member nations of the European Union get resolved. This lack of consensus may lead to the dissolution of the Euro as a currency or the possible abandonment of the Euro by some of the healthier countries in favor of their historical currencies. Meanwhile, Japan's economy has been stagnant since the bursting of its property bubble in the 1990s and serves as a constant reminder that governments cannot borrow and spend their way out of recession.

We are also concerned over the true state of the Chinese economy. Chinese government data is unreliable but what little exists suggests a slowing economy. Given China's growing importance in the world economy, this has implications for global growth, and especially for businesses that rely on export to the region.

Lastly, investors must be prepared for an unexpected geopolitical shock. While the concerns of increased Middle East violence are ever present, the possibility that the Arab-Israeli dispute may eventually elevate to a nuclear conflict is a new reality. Not to be ignored are the occasional reminders that large caches of nuclear weapons are also controlled by unstable regimes around the world such as North Korea and Pakistan.

Avenir's response: The importance of a margin of safety

We are always attentive to the risks in our portfolios, but today, we must be especially aware of the "latent and invisible" ones, even if it means accepting lower returns over the short-term. In seeking to preserve and enhance the purchasing power of the capital we manage, we want to own inherently superior businesses run by great managers bought at a big discount to intrinsic value. We focus on what is knowable, starting with the truth that the investment process consists chiefly of purchasing future cash flows at a discount to their estimated value today. In this equation, cash flow received is the numerator and the price paid is the denominator. Because future cash flows are difficult to predict, conservatism in their estimation forms one pillar of the margin of safety. The other pillar, price paid, is completely knowable. There can be no estimation error on price; an investor can only wrongly judge the right price to pay. To rework a Warren Buffett dictum: Price is what you pay. Cash flows are what you get. The ideal is to pay a low price for large, predictable and growing cash flows.

It sounds straightforward, but the challenge inherent in estimating future cash flows is magnified by the increasingly unpredictable economic and geopolitical environment. A few months of rising stock prices can lull investors into complacency. That will not happen here. Our margin of safety requirement has widened.

The importance of the business franchise

A margin of safety is often found in businesses that possess a true economic “franchise.” We use the term to mean a “right”, a “license” or a “privilege” that confers an economic advantage to a business permitting above-average returns on invested capital. Such a business should also have some shielding from unpredictable macroeconomic factors. Even better, it should grow in good times and bad. Companies with these characteristics are simply winners, and tend to stay winners. Our investment in the wireless tower industry is a superb illustration of a business franchise. Most people don’t want to have a cell tower in their view shed, making it difficult to obtain the permits needed to construct one. This creates scarcity value as demand for space on cell towers is high and growing. The price is set accordingly. The cell phone business isn’t going away and, in fact, demand for wireless services remains insatiable. Wireless carriers need to know they have capacity reserved for years to come so tower leases tend to be 5-10 years in length, plus renewals. Our investment is essentially a tollgate on a highway carrying a traffic load that will increase for years to come, good economy or bad. As a result, we know approximately what the company’s cash flows will be far out into the future, and thus it is relatively simple to estimate the company’s value.

Only a tiny percentage of businesses possess this tollgate characteristic. We own a number of them and are constantly searching for such opportunities. In contrast, in varying degrees the cash flows of most businesses are heavily influenced by the general direction of the economy and capital markets, rendering their valuation far more difficult. To the extent their balance sheets contain financial leverage, their results, good or bad, are magnified. Few businesses have franchises that can be characterized as toll gates, but we can avoid businesses whose destinies completely depend on economic stability and predictability.

Opportunity in times of uncertainty

Amid all the uncertainty, the list of positives is long and it should not be overlooked. Businesses that survive hard times often emerge stronger. In general, businesses post-crisis have never been healthier. Many sit on mountains of cash and operate at historic levels of productivity. To the extent the market undervalues these businesses, their cash hordes provide flexibility to make acquisitions at distressed prices or to repurchase shares. Properly executed, share buybacks can increase shareholder value immensely. Speaking of excess cash, many of our financial institutions are now considered overcapitalized, less than three years after some of them experienced near death.

At thirteen times forward S&P earnings, which equates to an earnings yield of 7.8%, stock prices are historically on the low side and may be priced to withstand a fair amount of bad news. And consider this striking fact: bonds have outperformed the S&P for the last 30 years. Treasuries are supposed to return *less* because they are considered the “risk-free” asset. Over time, stocks are supposed to return *more* to compensate for their greater risk. It is one thing for the less risky asset to outperform for a period of a few years, or maybe even a decade during periods of great economic tumult, but for 30 years? For more than a generation, the risk/reward equation has been turned on its head. Given our views on interest rates and inflation, we are willing to predict that the outperformance of the bond market will soon be a thing of the past, meaning equities should outperform bonds and cash.

Our investment philosophy emphasizes preservation of capital. In these uncertain times, that remains our first priority. In general, we are concentrating investments in our less-economically sensitive portfolio holdings. While the value of our portfolios will surely vary with the market (maybe even more than the market occasionally), their intrinsic value should grow faster than the economy and

thus outperform the market over time. We will try to use market volatility to our advantage. If a terrific business run by terrific managers becomes available at a big discount to intrinsic value, we will be prepared to pounce.

In summary, we worry that the cure for the global financial crisis may be as bad as the disease itself. The ongoing need for “monetary medicine” has created an unhealthy dependence on the printing presses of central banks around the world and is likely to result in higher interest rates and inflation down the road. That said, equity investors should not be discouraged. Markets are on the cheap side. In times of high inflation, businesses that generate high returns on capital tend to do well relative to other asset classes. Great businesses are flexible and adapt. New ones are being formed that will transform and improve the way we live. Winners find a way, and we already own many of them. Volatile markets may offer us the chance to own even more at bargain prices.

Long-term, we are especially optimistic over the prospects for U.S. equities. The concerns we mention are real and serious but are more than matched by the overwhelming momentum of what we’ve already described as the largest, freest, and most resilient economy in the world. In addition to being the freest, it is also the most transparent. That means dollar for dollar, you are safer here than anywhere in the world. Despite our economic problems, the U.S. is the preferred destination for both capital and people seeking safety and opportunity.

As always, please get in touch with any thoughts or concerns. Your views are valuable to us. Thanks for the privilege of serving you.

Respectfully,

Charles G. Mackall, Jr.

Peter C. Keefe

James H. Rooney

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