

July 9, 2007

We live in a culture which has little tolerance for mistakes. Mistakes are a natural part of life and of winning, but if you are going to win consistently, and not just this quarter, you can't, as Yogi Berra said, make too many "wrong mistakes." You also have to be willing to always learn from the mistakes you've made.

An octogenarian friend was three when the great depression of 1929 hit. His father, industrious and hard-working, owned a horse ranch in Montana. He fed his family and his horses through that depression by hitching his wagon to his horse, loading up his four sons and going into town to peer down alleyways and behind businesses to see what others might have discarded that was valuable. "You can tell how well a guy runs his business by going out back and looking at what he throws away," my friend recalls his dad saying. He could tell you which businesses were going to be successful, because they were doing things right, and which wouldn't, because they were doing things wrong.

There's a lot of wisdom to be had, sifting through barrels, scratching through trash bins, learning how to look for things of value. One business stands out to my friend to this very day, a little sheet metal shop. The proprietor, it seems, had fashioned a bin behind the shop and attached it to the brick wall, so that at the end of the day when all the scraps were collected, he could sort them out by size and by thickness, saving those pieces that could be reused or even refashioned into something else of value. "This man is going to be a winner," my friend's dad told him. His dad sized the proprietor up by his habits; he didn't just throw stuff away like a lot of folks did, he evaluated what he threw away. Anyone can go look at a scrap pile, but it takes real genius to know when it contains value. That one's business model could be gauged by examining the discard pile isn't amazing, it's brilliant.

A well calibrated investor armed with good observation skills likewise analyzes financial statements and press releases, studies and compares trends in sales and expenses, profit margins, returns on equity, and costs of capital. He assesses the value of a business, then decides whether that value is already reflected in the price "Mr. Market" has put on that business.

Mr. Market, you may recall, was described by Warren Buffett in the 1987 Berkshire Hathaway annual report:



"Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe to be most conducive to investment success. He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.

Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting

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the business. When in the mood, he names a very high buy – sell price because he fears that you will snap up his interest and rob him of eminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions, he will name a very low price, since he is terrified that you will unload your interest on him.

Mr. Market has another endearing characteristic. He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you.

But like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence.”

The Markets

The U.S. economy continued growing at a moderate pace in the first part of the second quarter, amid generally healthy retail sales. Hiring increased according. While an upturn in housing continues to be delayed, business investment has improved and is boosting the manufacturing sector. Consumer spending is running at a healthy clip given the strength of income growth and the low unemployment rate despite the negative effects of higher fuel prices. With unemployment at 4.5%, the labor market is tight and presents a modest risk to inflation.

With the economy not showing significant signs of weakening, and the housing market slowdown remaining relatively well contained, the Federal Open Market Committee (FOMC), which met at the end of June, remained focused on lowering core inflation. The FOMC kept the Fed Funds rate unchanged at 5.25% for an eighth straight time and made minimal changes to its accompanying statement, suggesting officials are happy with rates as they stand.

Overall, our economy has been very stable and is on pace to grow about 2.2% for 2007. The stock market gains the first half of 2007 outpaced economic growth. With the attractiveness of economies across the globe, private equity money, hedge fund money and institutional money have been chasing performance around the world. Mr. Market has been in a very good mood lately. Consequently, there is a lot of money “sloshing” around in the markets. In our view, prices are neither cheap nor expensive. Risk, we think, is increasing. With the stock market rising in 2003, 2004, 2005, 2006 and the first half in 2007, we would not be surprised if Mr. Market gets in touch with his “inner pessimist,” fearing that you will “unload your interest on him.” That would be normal, though for most folks, not enjoyable.

The fundamentals of the *overall* market aren't bearish; however, they are simply not very bullish. Our thinking leads us to continually assess what we own to see if the prices offered us reflect Mr. Market's greed or his fear. Ultimately the best defense in any market is to own individual companies that represent excellent opportunities. At Jonathan Smith & Co., we're still finding those opportunities today – even in a fairly valued market.

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