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Client Letter – September 30, 2010

We witnessed a historic month end to the third quarter. The S&P 500 closed at \$1141.20, representing an 8.9% return for the month of September and an 11.3% return for the quarter. The month of September has historically been a lack luster month for the S&P 500 but this year it “bucked the trend” and turned out to be the best September monthly performance since 1939. Comparatively, the average performance across our strategies returned 6.1% net of fees and 8.7% for the quarter net of fees. This lagging the market can mainly be attributed to our higher cash balances, a concept known as “cash drag,” as well as our overweight positions in large cap multi-national corporations which tend to grow at a steady pace. Should the market continue to advance, we realize it may feel uncomfortable if your neighbor is making seemingly higher returns while we have some cash “sitting on the sidelines.” However, if investor speculation continues, we believe this would only be a short term discomfort because we believe we would see these price levels again. The market is currently priced in a manner that would require no bumps in the road ahead, which we find highly unlikely. We want to be sure that when we put cash to work, it is in sound investments with expected returns high enough to warrant an investment given the level of risk, as opposed to attempting to make returns by riding the speculation wave. While not fully invested at the moment, we feel comfortable and confident your portfolios are positioned in such sound investments and feel optimistic for what the future holds.

Are We Experiencing a “Bond Bubble?”

Academia focuses much on modern portfolio theory. One of the major assumptions upon which this theory is built is comparing things to the so-called “risk-free rate,” which in practice Treasuries are used as proxy. But are Treasuries really risk-free? Just because something is labeled as a “bond,” does not mean that it is somehow less risky than a stock. Labels aside, whether it is called a bond, stock, or real estate, when discussing expected rates of returns and risk levels of any asset, how much cash you are receiving and what you are paying for that cash is what matters most. In modern portfolio theory, risk is measured by volatility. We, however, view risk as a permanent loss of capital or a loss of purchasing power. Without even delving into the debt loads this country is facing, let us assume that Treasuries will not default. True, you will receive your principal back plus some interest along the way. However, if there was inflation far greater than interest received over that time frame, you have experienced a loss of purchasing power, and thereby a permanent loss of capital. And if you were forced to sell before maturity, the risk for loss could be even greater.

On May 22, 2010, Barron’s Editorial Commentary written by Thomas G. Donlan said the following: “In that hypertensive time at the end of the Carter administration, bond investors were skeptical of everything, because they had been burned so much, so often. It took a coupon yield of 10% to make the market open its eyes. At first glance in the spring of 1980, the 10% Treasuries looked attractive...Even the risk imposed by the high inflation of the time seemed worth taking in return for a seductive 10% yield. The “perfect 10” issue marked only the third time that the U.S. had paid a coupon yield in double digits. Wall Street quickly took a cold shower. In the first day of trading, the 10% bonds fell 3½ points, earning them a new nickname that reinforced bond traders’ reputation for mordant humor. “Buyer enthusiasm for the 10% Treasury issue had been so poor that dealers had labeled the issue the DC-10s, because they crashed on takeoff,” said the Wall Street Journal’s bond column on May 12, 1980.

(An American Airlines DC-10 had crashed in Chicago the year before.) That was only the beginning. A year later the price of DC-10 bonds was **down 40%**. The Treasury was selling new 30-year bonds paying 15% interest..."

Could we be in a similar situation today? There has been lots of talk lately about a "bond bubble." In 2009, Warren Buffet wrote in his annual letter to shareholders, "When the financial history of this decade is written, it will surely speak of the Internet bubble of the late 1990s and the housing bubble of the early 2000s. But the U.S. Treasury bond bubble of late 2008 may be regarded as almost equally extraordinary." On the other hand, others argue this is no bubble caused by irrational exuberance, but rather our own government and foreign investors buying up Treasury debt. Some say it is simply rational investors moving money out of lousy yielding money market funds and into Treasuries for higher yields.

Whether or not Treasuries are in a bubble still remains to be determined, but from our standpoint they appear to be way overvalued and certainly not risk-free. In our opinion, Treasuries are actually *riskier* than many of the equities you own. It is difficult to understand why someone would prefer a Treasury yielding 2.5% over a wide selection of recession-resistant, high quality, multi-national corporations that are trading at low valuations from historical standards. These companies are growing their assets and have the ability to adapt to changes in prices. Not only are their free cash flow yields significantly higher than Treasury yields, but even their dividend yields are currently higher. For decades Treasuries have performed well due in part to a declining interest rate environment, whereas equities have suffered because they were grossly overvalued. This is not a time to look at past performance and assume the same outcomes will come to fruition and neatly allocate your portfolio in these so called "risk free" assets believing your money is protected. We believe this is an excellent time to be invested in above average businesses at below average prices.

We would like to take the opportunity now to discuss two recent purchases we made during the quarter.

H&R Block

The share price of H&R Block (HRB) has been under considerable pressure as of late. It appears that investors fear the worst about HRB's ability to deal with its mortgage loan repurchase obligations and mortgage loan portfolio, regulatory changes that would affect its refund anticipation loans, and also changes in the tax preparation industry in general. A careful study of HRB's potential for future earnings convinces us that HRB is a "diamond in the rough."

HRB's mortgage obligations are not quite as bad as they initially appear. When you hear terms like "repurchase obligations" and "\$33 billion mortgage portfolio," it can incite fears. This is not, however, like all the credit-default swaps that brought down AIG. These are loans that are put back to HRB as a result of deceptive loan practices. When the mortgage operations were sold off in April 2008, they established a loan repurchase reserve of \$243 million. Since that time, they have received \$686 million in claims which so far has resulted in \$55 million in losses out of the \$557 million claims they have finished reviewing, leaving the current repurchase reserve at \$188 million. According to HRB's new CEO, Alan Bennett, about two-thirds of those losses occurred in the first half of that period in 2008. The cases where poor lending practices occurred have largely been exposed, which means fewer claims will be filed over the next few years. In other words, time is on the side of HRB. Of course, if the housing market worsens, more claims could surface. But considering that the duration of the average home mortgage is 10 years, they have a very conservative cushion built-in. With about 320 million shares outstanding, even if losses exceed estimates, the impact to the valuation of the share price would be pennies.

From a worst-case scenario, HRB's potential loss exposure with their mortgage loan investment is minor. The principal balance of mortgage loans stands at \$563 million. Imagine a scenario worse than the worst-case scenario where every loan defaulted. If you assume the recapture rate is 50%, in this preposterous example

losses would amount to \$0.88/share. So, despite some small level of risk, HRB has mostly sold off their exposure to mortgage loans and reverted back to their more profitable business core of tax preparation.

Most important to an investor should be the future of HRB's profitable core as a tax preparations business. In the current market conditions, DIY (do-it-yourself) firms such as Intuit Inc. have seen increases in their market share while HRB's market share has been sliding. But is tax preparation going the way of newspaper companies, eroding slowly until only self-serve online tax preparation software is all that is left? It is certainly unlikely! First, taxes are inevitable, and in our current environment it isn't likely that the U.S. tax code is going to get any simpler. In fact, the pages of tax code have grown at an exponential rate. Second, we believe that while there is some movement from HRB customers towards self-service products, it is more likely that the decline in their tax preparations is largely for an entirely different reason. According to the company itself, it projects that somewhere between 15-30% of its potential clients are unemployed in the current market (compared to the current 9.5% unemployment rate). If that is true, there definitely would be fewer people in need of HRB's services – whether that is because they do not need to file or simply cannot afford to pay taxes.

To us, the major concern is what will become of their lucrative refund anticipation loans. The government has viewed the practice of issuing rapid refunds as predatory lending. In an attempt to curb the practice, the IRS decided to eliminate its "debt indicator" – data that shows outstanding taxes owed or judgments which would reduce tax refunds. As a result, underwriting becomes more difficult. However, there is still a great demand for these types of loans. So, instead of reducing their underwriting participation, HRB will need to raise prices by refunding less, thus making them look even more predatory than before. Here we have yet another example of the government meddling in the economy and creating an unintended consequence. The battle is still raging, and thus our concern is that the government's actions may reduce HRB's revenues in one of their most profitable operations.

A note about management – HRB is infamously known as making some dumb strategic decisions such as getting into the mortgage business at the peak. We are pleased to see them making choices that will change this poor reputation. For one, they have been focusing on running a more efficient, lean business by shedding underperforming offices and shrinking unnecessary staff. Another positive strategic move is they are continuing to convert more and more company owned offices into franchises, a much more profitable business model. We also applaud management for repurchasing a significant amount of shares when their stock was under pressure. In the first quarter of their fiscal year, they spent nearly as much on stock repurchases as they did during all of last year – \$235.7 million last quarter versus \$250 million last year.

Most importantly, HRB is trading at less than 7 times cash flow – the lowest it has ever been. In our minds, there will always be a large group of individuals who would rather not do their own taxes by themselves and prefer the peace of mind and human connection that HRB offers. Their recognized brand name and low valuation make HRB extremely attractive.

The For-Profit Education Industry

In the last few months, for-profit education stocks have flunked, in many cases dropping 50% or more from their highs. The negative headlines have been focusing on increased scrutiny over two main issues: recruitment procedures and gainful employment.

The Government Accountability Office (GAO) released a very disturbing report detailing several deceptive recruiting practices. For example, undercover applicants were encouraged to falsify information on their financial government aid applications and were told inaccurate salary expectations coming out of school. In 2004, safe harbors were created that loosened the government's incentive-compensation rules. The Department of

Education (DoE) wants to remove all the safe harbors which would open up these schools to all sorts of litigation and place more restrictions on recruiting procedures. Senator Tom Harkin, Chairman of the U.S. Senate Committee overseeing education, is conducting more high-profile hearings regarding these deceptive marketing practices, and so we expect more negative news to plague the industry in the ensuing months.

The second issue is related to the “scam” stigma that some of these institutions are garnering, i.e. taking tuition and handing out a worthless certificate, leaving students saddled in debt and unable to secure employment or receive enough pay increase to service their debt load. During the recession, enrollment skyrocketed as people hoped to get a leg up in a struggling economy. While this created a tailwind for the industry in the face of a declining stock market, it also put them under the microscope when graduating students entered a deteriorating workforce and defaults on loans increased.

In order for an institution to qualify to receive federal financial aid, the DoE is proposing a school prove they are adequately preparing or “gainfully employing” their students by demonstrating a 45% repayment rate or students do not spend more than 12% of their income in repaying their loans. Since government aided loans can make up the bulk of these schools revenues (up to 90%), it would be devastating if a school is found not eligible to receive funding. Last Monday, the DoE released loan data that was much worse than anticipated, with nearly all for-profit schools failing the repayment test. If these new rules pass, many schools will likely need to cut tuition in order to meet the threshold requirements that would regain access to federal funding.

When considering these companies, one thing that needs to be taken into consideration is any internal lending. States have faced revenue shortfalls, and so schools have stepped in to provide the shortfall in lending. If the certificate or degrees being issued turn out to be less valuable than thought, or if the economy is struggling and graduates cannot get employed, some of these schools will be on the hook for the secondary loans they made. In other words, the revenue they would have been recognizing all this time was in actuality losses coming down the pipeline. In most cases, their loan loss reserves seem quite ample, but the gravity of this problem would not really be exposed unless a severe recession hits.

We researched 14 stocks in the for-profit education space, and we find several extremely attractively priced. A Credit Suisse report was released where an analyst ignored her estimate of \$1.2 billion cash that she estimated would be on ITT Educational Services balance sheet in a few years by assigning zero value for that cash, and discounting cash flows at a 30% WACC (weighted average cost of capital) simply to achieve what would justify the current stock price. When analysts are making such extreme assumptions, surely we are at or very close to the bottom. On a risk-adjusted basis, our favorite in the industry is Apollo Group (APOL) which operates the University of Phoenix. They had an estimated repayment rate of 44%. One downside here is that they are such a large company, growth is more difficult. But amongst the higher quality programs, they are the cheapest stock in the group.

The industry is currently involved in a so-called “negotiated rule making” process, so there probably will not be much clarity until after the elections, the deadline for any new rules to take effect. Clearly, the new rules can significantly impact the companies’ revenues and margins, but the “bell curve distribution” is very favorable for some of these stocks. While the range of outcomes is wide (with the government being the wildcard), we believe the odds are stacked in our favor. Even in worst-case scenarios, the quality programs will survive and continue to make profits. When you are paying 5 times cash earnings (or even less in some instances), there is plenty of room for things to go wrong, but still come out ahead in the end.

Concluding Remarks

We recognize that there is great uncertainty in the markets and in the world. Emphasis on the declining dollar, the Fed printing money to curb deflation, the mid-term elections this November, all seems to be in the forefront of media attention. Such events are important when looking at a backdrop or the macro economy, but at the end of the day, what is really important, as it relates to your investment account, is the individual companies that you own. We continue to believe that this is a market where above average companies can be bought at below average prices and in the long-run you will come out on top.

Sincerely,

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