

Portfolio Commentary Second Quarter 2012

“Man should not consider his material possession his own, but common to all, so as to share them without hesitation when others are in need.”

-Thomas Aquinas

“Tax Revenue as a percentage of GDP is 16.9% today. We haven’t been this low since 1959.”

-Scott Rigil (R) of Virginia

“The biggest misconception is that this is some sort of socialism or federal takeover of the health-care system. The whole idea of the Affordable Care Act is to build on the existing, private health-insurance system.”

-Jonathan Gruber, MIT economist

Our Year-to-Date average return for all portfolios is 6.9% through June 30.

One of the hardest things about investing is waiting for chickens to roost.

Our great first quarter (plus 13.1% on average) stalled by the end of the second (plus 6.9% on average). We expected this, along with the summer doldrums. While we’re still positive for the year, our enthusiasm is waning. The best thing about periods like this is that we don’t have to chase stocks that we’d like to own. Sooner or later, with a market down swoon, they will come to us. It’s like fishing. Cast your rod, wait for the sellers to take your bait and slowly reel in the catch. Then wait and wait some more for the economy and investor enthusiasm to turn positive.

In light of the severity of our 2008 financial debacle, we may be waiting for a long time. Especially when every time there seems to be a glimmer of hope taking hold, something comes along to take the wind out of the sails. Be it the ongoing crisis in Europe, our dysfunctional Congress, a large financial institution losing billions on errant trades, like MF Global and JPMorgan Chase, or a “reputable” firm being exposed for fraud, like Barclays and Glaxo, some weakness in our financial system will send potential investors back into hiding. This will never end. We should be used to it by now. Rather than be discouraged, focus on the good.

The NASDAQ is up 11.77%, the DJIA up 3.30% and the S&P 500 is up 6.57% through June 30. Ginnie Mae’s, using Vanguard’s funds as our proxy, were up 1.9% and the total bond market, using Vanguard’s Institutional Index Fund as our proxy, was up 3.18%. Interest rates are at their lowest in our lifetimes, 30 year mortgages are available for 3.625% and 30-yr US Treasuries yield 2.75%. We are in the midst of a modest economic recovery. Our year-over-year rate of growth in industrial production is 4.7% (historically consistent with a recovery). Capacity utilization at 79.0% stands at only 2% below its long term average of 81%. The NAHB/Wells Fargo Housing Market Index increased in June to 29, **its best reading since 2007!** Building permits increased 7.9% in May. Housing affordability reached an **all-time high** in the first quarter. There remains a high level of skepticism among investment advisors. This is a great contrary indicator that I always read as positive for buying stocks. Only 38.7% of investment advisors are bullish presently. Value line median PE ratio of stocks in the VL index is only 14.1 relative to a market high of 19.7 on July 13, 2007 and a market low of 10.3 on March 9, 2009. Appreciation potential, according to this service, is 80% over the next 3 to 5 years versus only 35% on July 13, 2007 and 185% on March 9, 2009. The S&P 500 PE ratio is only 13.2 times 2012 earnings versus its average of 14.5-15.

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I can rattle off more positives, but I'm trying to keep this note simple. After all, it is summer. I can get caught up in all the negatives too and there are many around, but why send us into a funk? Nothing has changed much since my first quarter letter. I continue to expect economic and stock market weakness over the summer months and better than expected year end results. If I am wrong, about the year end results, then it will only be a matter of time before I am right. I'll use the market weakness to accumulate positions in the companies I like for the long-term. We'll collect our dividends while we wait for more favorable economic growth. We humans will work out our political differences and our economic malaise. It's only a matter of time.

I'm happy to take our average of 6.9% for the past six months, especially when the DJIA is up only 3.3%, the S&P 500 +6.57%, 5-year Treasury Notes yield only .75% and 5 CDs yield only 1.90%. Our clunkers, those that brought down our overall returns include essentially five positions. Enerplus Resources (ERF), Cellcom (CEL), Companhia Siderurgica Nacional (SID), Telefonica, S.A. (TEF) and Pace Oil & Gas (PACEF). Without these, we would have recorded significantly higher overall returns. I've written about each in previous letters, so won't waste more ink on them herein, other than to write that we wait for these to tackle the hurdles before them and to recover in price. At least we collect income for each, except from PACE, while we wait for payday.

Our significant winners for the year thus far include EZChip (EZCH) up 41.3%, Vertex Pharm (VRTX) up 68.4%, Wyndham (WYN) up 39.4%, Banco Americano (BLX) up 33.5%, MIPS Tech (MIPS) up 49.6%, Cedar Fair (FUN) up 39.4%, Mueller Water (MWA) up 41.8%, Manitowoc (MTW) up 27.3%, Getty Realty (GTY) up 37.3%, Huaweng Power (HNP) up 41.8% and DRT CRT Pfd (DCAQP) up 135.7% among others. Provident Energy (PVX) was taken over by Pembia Pipeline (PBA) giving our clients a gain averaging over 36%. Additionally two pharmaceutical/ biotech positions popped for us during the quarter. Vertex (VRTX) a holding we'd owned since 2002, jumped up to \$66 from the mid 30's on news that their trials for cystic fibrosis treatment were favorable and drugs for treatment won FDA approval. Our clients hold a 147% average gain in this investment today. Gilead Sciences' (GILD) combo drug treatment for hepatitis C performed better than expected. While we hold fewer shares in GILD than we do in VRTX and this is a more recent addition to our accounts, we enjoyed a pop in the stock price giving our clients a 22% average gain in GILD.

While everyone reading this letter does not own all of these positions, many, who have been with us for many years, do. This speaks to the value of long-term investing and of **adding to your accounts systematically**. Doing so gives us fresh powder to put to work and to spread out your investments across a wide net of possibilities. I have found that the broad net approach has worked best for me over the years. I never know with certitude which holdings will catch fire within a particular period. Placing our bets across many possibilities increases our chances of finding a winner.

Our experience with CGM Focus fund highlights our broad based approach against a more focused one. A recent article in Bloomberg Businessweek featured a comparison of the investment styles between the CGM Focus Fund, a concentrated approach, and others with a broader based approach, similar to ours. Ken Heebner's performance at CGM Focus topped all diversified U.S. stock funds in the decade through 2007. We moved a significant amount of our smaller accounts into the CGM Focus fund during those years and participated in his success. However, ever since 2007 CGM Focus fund has lagged. In fact the performance has been so poor, losing an average of 6.3% annually since June 2007 that we moved most of our investments out. During this same period of time our portfolios, with a wide cast approach, have produced average returns of 1.8% annually. This may not seem impressive, but remember that June 2007 was close to the peak of our markets before the financial calamity. To be up 1.8% annually since then rather than down 6.3% annually is enough to make me want to come to work tomorrow and to continue with our investment style.

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In summary, **please consider adding cash periodically to your account** especially during periods when our stock markets are falling and everyone else is panicking out of the markets. This past May was another great time to buy stocks. May 2012 was the worst performing May since 2010, when we had the Flash Crash, and the fourth worst May since 1950. On May 31st, the DJIA closed at 12,119. Today, July 11, even with the most recent weakness it closed at 12,605, 4% higher. More dramatically, March 9, 2009 represented the low point of the most recent rout and an even better time to buy. Remember? Then, no one wanted to invest. The markets are up over 100% since. It was, in hindsight, a great time to commit money into the stock market. **These weak summer months present us with the opportunity pick up some great values.**

As you review your performance report, note the interest and dividends you've earned since the beginning of the year. We've focused on investments providing yield during the past ten years. These have helped us weather the downside periods of our markets. We expect slow moderate growth overall during the next several years or at least until our economies are able to generate jobs for the advanced information age and our people are able to develop applicable skills to be productive within it.

We apologize to those clients who came on board within the past fifteen months and who are still holding negative returns. Please continue to be patient with us. These investments we have made for you will turn positive one of these days. I know this may be difficult advice to follow, but do consider adding to your portfolio. The stocks you hold are on sale and we should be adding to your portfolio while they are.

In closing, I thank you again for your continued business and confidence. Please call should you wish to discuss any aspect of your portfolio or overall financial plan with us.