2010 Annual Investor Meeting Presentation

Cale Smith, Islamorada Investment Management

Saturday, January 30, 2010
Holiday Isle Resort
Islamorada, Florida Keys

Note: I strayed from my original script often during this presentation, but tried to capture those comments and the Q&A session at the end the best I could remember. I also removed the names of some people in the intro for confidentiality reasons. Email me with questions about anything below.

Welcome to the Islamorada Investment Management first annual investor meeting. I'm both thrilled and kind of amazed you all could make it. When I first thought of doing this a year ago, I really thought we'd have some folks over in the backyard and maybe bring a blender out on the porch. We had an amazing year in many respects, though, so here we are.

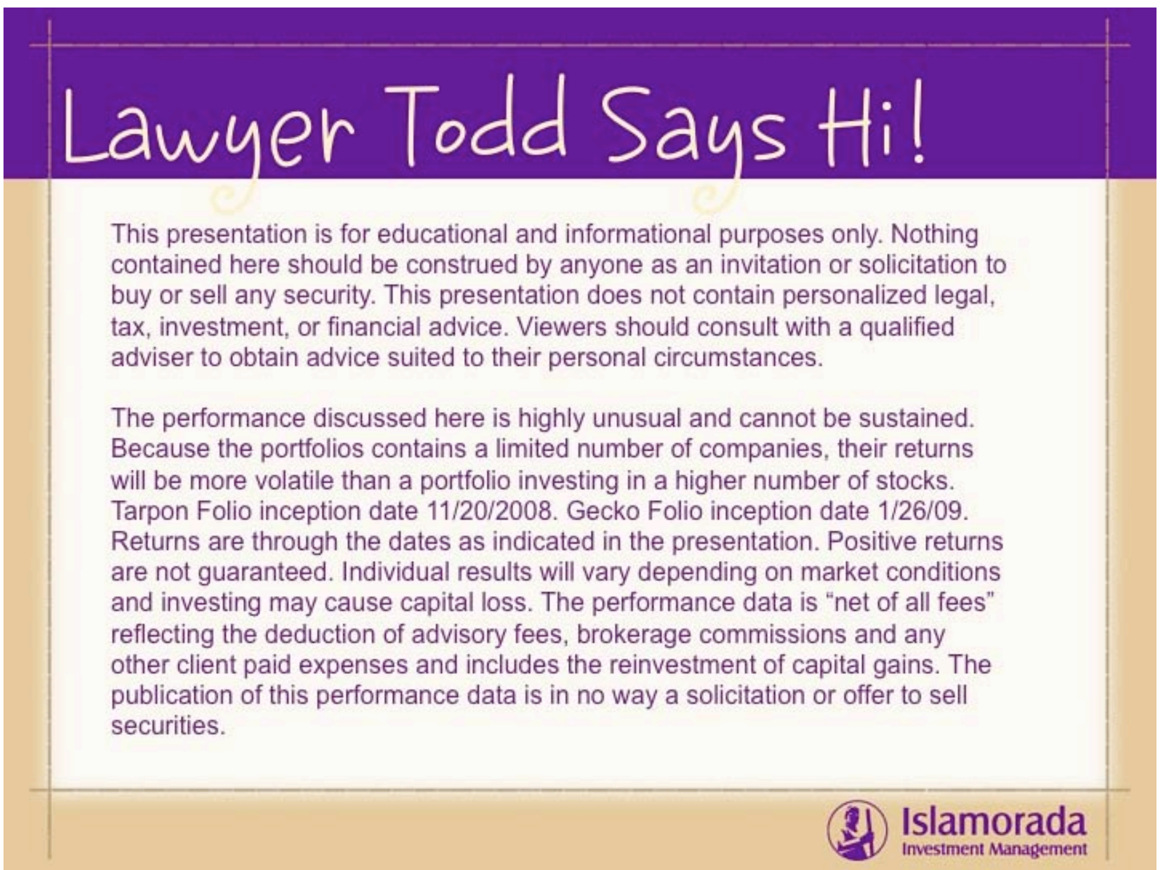
I'm probably not going to have the time to formally thank all the people that I should tonight, but there are a few people here who I think you'll all agree should be recognized before we begin.

The first is Ken Peak, CEO of Contango Oil & Gas, one of the largest positions we have in the Tarpon Folio. Ken will be speaking later, and I want to thank him for down to the Keys this weekend.

There are also a handful of people here who invested with me back in 2008, in the first days after Tarpon was launched. These people were the early of the early, and their support meant and still means a ton. So I wanted to thank Dr. C____ and L____, G___, and the entire T_____ family, too.

We also have a handful of veterans and active duty service members here tonight - everyone from Ken Peak to my Dad to CDR M___ F__, a Coastie down in Key West. Even within that group, though, there's a couple of investors I wanted to single out, and though they're not going to want to stand up, I'm going to ask them to anyways. Both G___M____ and S____ M____ are here tonight, and both are Iraq war veterans. Thank you both for coming and thank you for your service.

Okay, let me tell you what I did with your money in 2009, and why.



Actually, there is one other person who couldn't make it tonight, and that is Lawyer Todd, though he does send his regards.

This is our standard disclaimer that in so many words says that what I'm about to walk through with you should be seen as educational, as opposed to a recommendation. So, hello back, lawyer Todd. Yet another check is in the mail.

Now let's talk performance.

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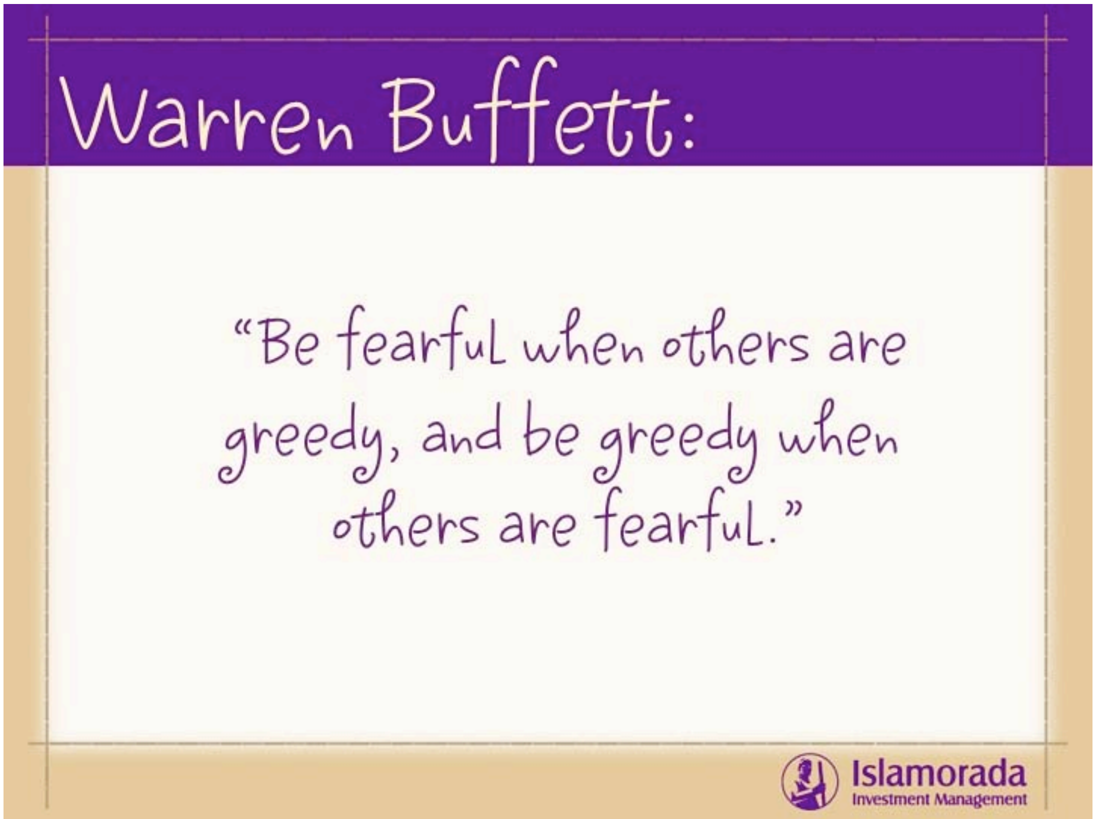
Here are the numbers – the returns of each of the two portfolios you've invested in as measured over their first years. Tarpon was launched on Nov. 20, 2008, and through Nov. 20 of '09 it returned 91%. Gecko was launched on January 26, 2009, and just had its one year anniversary this week, returning 70%. Gecko was yielding 14% when launched and still yields approximately 9% today.

Both portfolios beat their benchmark, the S&P 500 index, by wide margins. In its first year, Tarpon outperformed by 55.2% and Gecko outperformed by 38.5%.

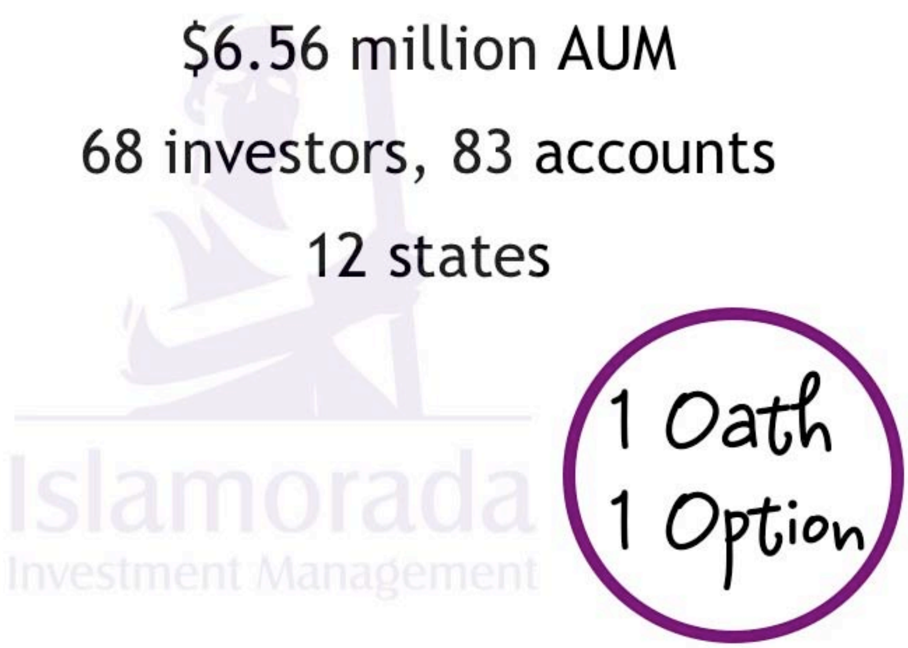
Incidentally, the dates each fund was launched sometimes throws people, because they seem fairly random. The reality is Tarpon was launched on my wife Margie's birthday, November 20th. I'd basically been in a cave for about two months prior to then, doing a ton of research and analysis on various companies, but that list of companies was literally changing every day because the market was so volatile…and I was pretty close to exhausted. Finally I said, enough, let's launch it on the 20th, and that way I could turn my brain off and we could at least go out and have a nice birthday dinner somewhere. As it turned out, though, I fell asleep on the couch at about 7 that night. The intent was there, honey.

Gecko was basically launched as soon as I could finish all my research after getting Tarpon out the door.

There are a handful of different factors that contributed to the great years that both funds have – and just being in the right place at the right time was clearly one of them – but if I had to boil it down to one thing that explained it the clearest, it would be this:



In a nutshell, we were getting some unbelievable prices on amazing companies while most of the world seemed to be running for the hills. More in a minute on this.



2009 was a good year for IIM as a firm as well. After a year of being in business we have $6.6M under management and 68 investors (some of whom have more than one account with us) spread across 12 states. I should point out that our assets under management started with an amount in the low six figures – basically all my own immediate family's money. So, though we are not anywhere near where I think we can ultimately be, given the housing collapse, credit crisis, Bernie Madoff, and everything else we just went through, I'm pretty pleased with that $6.6M figure.

A year later, IIM is also the only firm based in Monroe County that has taken a fiduciary oath. What that means is that I have a legal and moral obligation to put my investors interests above my own. I do not get paid via commissions or referrals and have no conflicts of interest.

Also, I am still focused on IIM being just one option in investors' overall portfolios. I'm a fund manager, not a broker or planner, so I don't need investors to park their entire portfolios with us - and I am not trying to be everything to everyone. My focus is getting as many yards as I can with the ball whether you hand it off to me, or your adviser does. Either way, I'm going to stick with what I love doing – analyzing companies.

As most of you know by now, I'm not a fan of mutual funds. They were once a good idea, but most have far outlived their usefulness. Depending on the stats you look at, 70% to 80% of all actively managed mutual funds fail to beat the performance of an index fund – a passive fund that just owns shares in all of the companies in the market. If mutual funds were automobiles, 7 to 8 out of 10 of them would get rejected before they left the factory.

To be clear, this is a structural problem, and not in any way reflective of the skills of mutual fund managers. There are some very talented mutual fund guys out there. They're just working with one arm tied behind them.

In addition to that quality control issue, though, there are other fundamental flaws with the structure.

Namely, that all investors' money goes into one big pool. When you invest in a mutual fund, you are actually buying shares in a third party entity, not the companies the fund owns shares in. What that means is that when one big institutional investor sells, that can mean higher taxes and worse performance for other investors still in the pool.

I also find it kind of stunning that less that 41% of mutual fund managers own any shares of the funds they manage. I'll say that another way - 59% of mutual fund managers do not own a single share of the funds they manage.

I could go on and on about the flaws, but the more relevant message here is that I built our funds a different way.

My funds are spoke funds. A spoke fund is a group of separate investor accounts linked to a portfolio containing most of the liquid net worth of that fund's manager. In my case, just about 98% of my family's liquid net worth is in Tarpon. I don't own any other bonds, stocks or mutual funds outside of what we've got in Tarpon and Gecko.

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"Spoke fund" is short for "hub and spoke" model. The portfolio manager's money is the hub and the spokes lead to each investor's account. Any changes in the hub are simultaneously made in the spoke accounts. Thanks to technology, this can all be done pretty easily.

The name is something we came up with - because Wall Street didn't have a name for this particular way to invest. It's not a hedge fund, nor a mutual fund, nor a separately managed account. I feel like it basically combines the best aspects of all three.

One of the other positive surprises of the last year was the number of calls and emails I got from other portfolio managers about this spoke fund idea. There is easily a whole other business to be built in servicing those guys…but I suppose I like my business just fine the way it is.

I've gotten this question a number of times the past year: Why I am doing this in Islamorada of all places, when we really could be anywhere?

My first answer to that question is, "Take a look around. It's January 30th, people." My family and I love it here, and more than anything, I think all this is more about staying true to the vision I have in my head about raising a family.

I also believe that investing in general is the kind of thing that is best done alone, on an island – at least in the metaphorical sense of the word. I am only trying to make two or three really good decisions a year, and I think being here makes me a better investor because there is simply less noise. I think last year's performance was pretty indicative of that. You may remember some of the headlines popping up at that time – and this is reason one thousand-something I like being here:

It's easier to ignore the crowd down here. Now we had some serious issues during the credit crisis, and I don't want to undersell those, because there were a few moments of panic in there for all of us. But the reality is that is was probably the best buying opportunity of at least the next decade.

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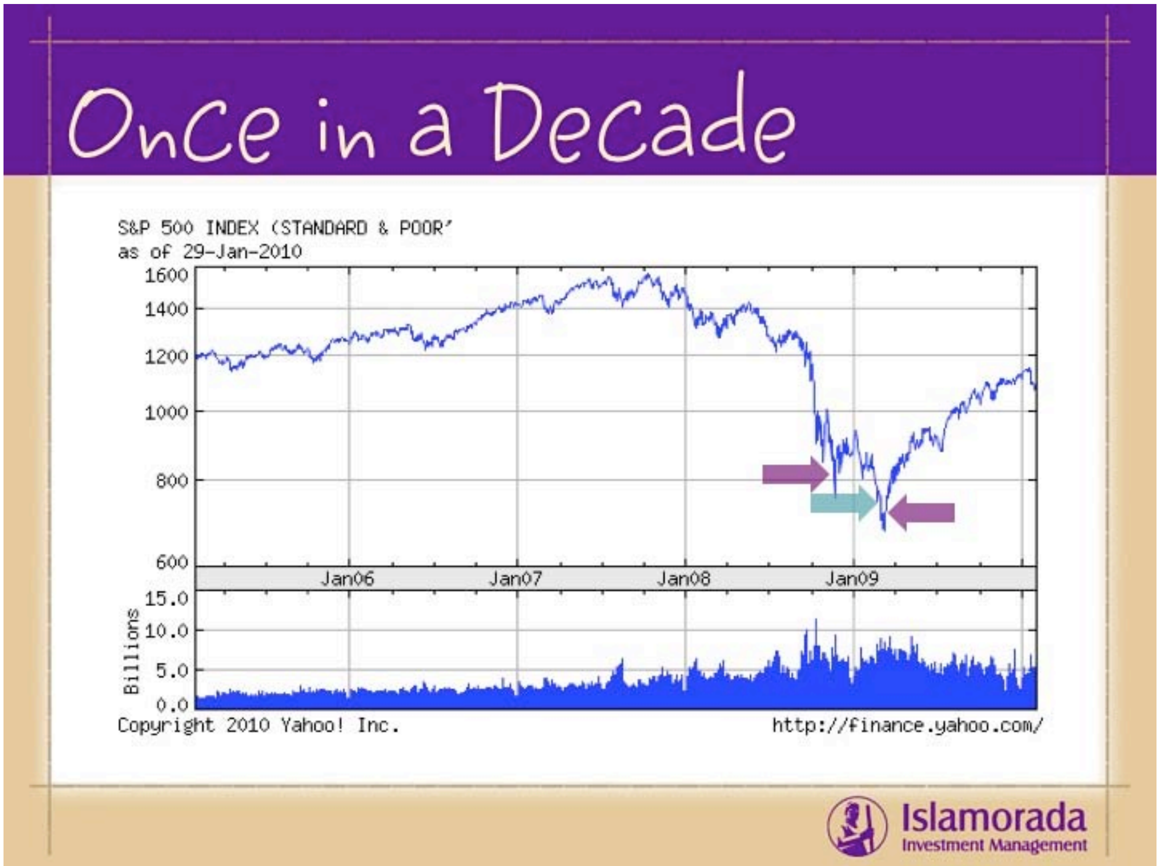


This is a five-year chart of the S&P 500. The first purple arrow is when Tarpon was launched, the green arrow when Gecko was launched, and the second purple arrow when I did a heavy round of additional buying in Tarpon. That's when we first picked up share of Contango, for instance.

So, being able to think clearly is awful important when it comes to investing, and I believe that being in the Keys has a lot to do with that.

I could talk all night about value investing, but I'll boil things down to this:

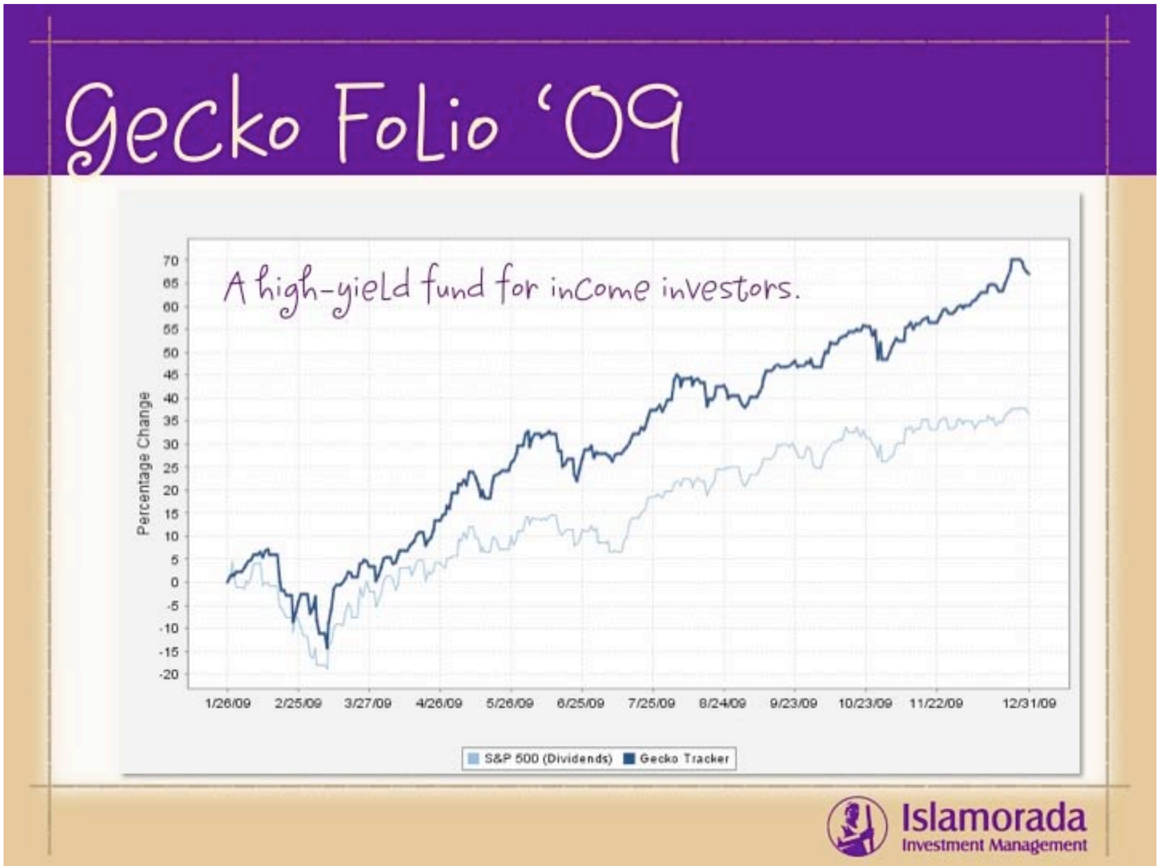
All the analysis I'm doing, all the things I'm reading are basically geared towards answering three questions about companies I may buy shares in:

1 – Does the company have a sustainable competitive advantage, or moat?

2 – Is the company valued cheaply in the market for temporary reasons?

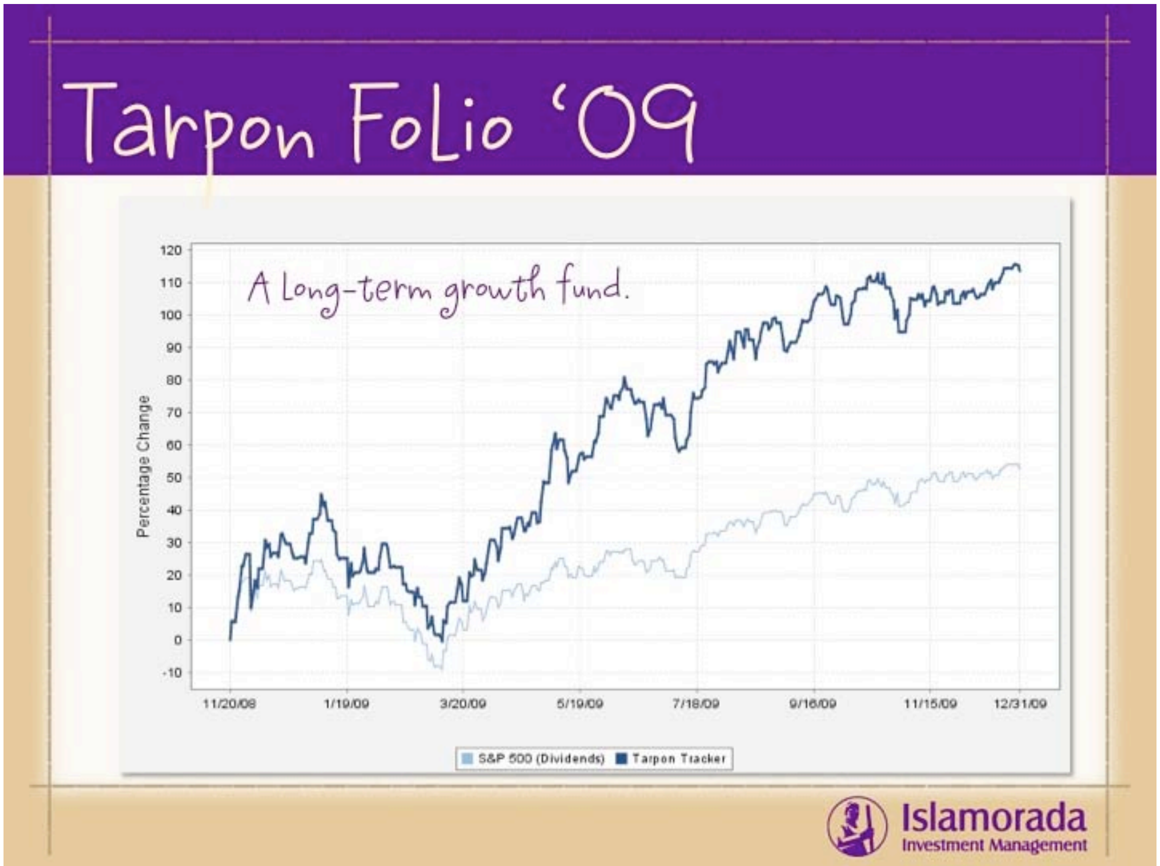
3 – How big is the margin of safety – meaning how big of a cushion do we have if either the market drops, or the company screws up or I miss something in my analysis?

That's the other Buffett – Warren Buffett - the most successful investor of all time, also a value investor.



This is a shot of Gecko's performance versus the S&P 500 from inception until the end of 2009. I have not talked publicly much about Gecko, nor marketed it very much, mostly because a lot of the initial assets we attracted were tax-deferred or retirement accounts, and Gecko is only available for taxable money. But it contains a handful of great oil & gas pipeline companies called "MLPs" or master limited partnerships, which more than met those three value investing criteria I mentioned earlier when Gecko was launched. We also own a closed end bond fund in Gecko that has done very well, not coincidentally because people were petrified of owning high yield corporate bonds at this time last year.

So, Gecko had a very good year as well, and I will be talking more about it in some investor letters this year. Most of you, however, are interested in Tarpon.



This is a shot of Tarpon's performance versus the S&P 500 from inception until the end of 2009.

I try to cover all the highlights every month in my letters to investors, but there are a couple of things I do want to mention here.

The first is that the challenge as an investor is not to outperform in rising markets. Anyone can go out and buy a handful of flashy, hot companies and do well in a rising market. The goal, however, is to outperform compared to the level of risk you take on in the portfolio. I think that mentality of "high risk, high reward" gets more people in trouble in the market than just about anything else. I think the better way to think about it is "low risk, disproportionately higher reward." And that's how I run Tarpon.

As an aside, the person just named the Morningstar Domestic Mutual Fund Manager of the Year (and Decade) was a gentleman named Bruce Berkowitz. Now Bruce runs the Fairholme Fund, which is one of the few mutual funds I would recommend – but he was named Fund Manager of the Year after his fund was up 39% and outperformed the S&P 500 by 12.5%.

So, you know, pound sand, Morningstar.

[Note: I didn't get into this during the presentation - the screen was too small for folks to see the numbers and dates around the chart - but in the Tarpon chart in this slide and the Gecko chart in the last slide, you may note the chart shows returns that were higher than the ones I publish. As I mentioned in the [Ask the Geek section of this letter](), that's because these graphs were pulled

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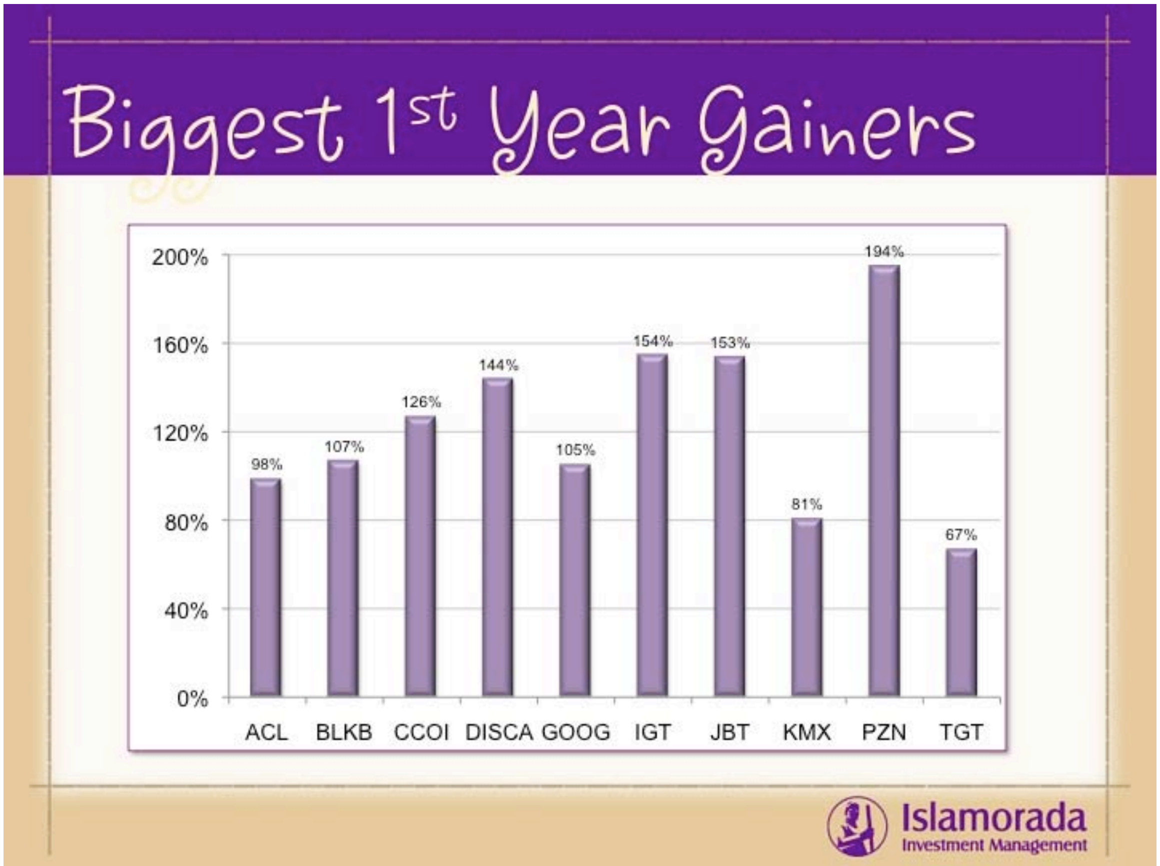
straight from our custodian FOLIOfn, which uses a method of computing performance called the modified Dietz calculation. I calculate our performance using real dollars in several tracking accounts established just to measure performance, and my numbers are lower. The modified Dietz method is also what mutual funds use to calculate their returns. Read into that whatever you may.]



Here are the ten biggest contributors to Tarpon's performance last year - as measured from launch of the fund either until the one-year anniversary or the date I sold it if prior to then. These are unweighted results, so they don't necessarily reflect our exact returns, but I thought they were instructive nonetheless.

We had three stocks that doubled in under a year (ACL, BLKB, GOOG);

One that went up 1.25 times (CCOI);

Three that increased 1 and a half times (DISCA, IGT, JBT);

And one more that basically tripled (PZN).

Today we still own ACL, GOOG, JBT, KMX. I recently sold CCOI and DISCA, actually.

I think this goes without saying, but I'll say it anyways –this kind of performance in a single year is extremely rare. I'm very optimistic about Tarpon in 2010, but our numbers at next year's meeting will look nothing like these.

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As of today, here are our top five holdings in Tarpon – ranging from 10% to 7% of the portfolio.

1 – Contango Oil & Gas – Ken Peak will talk more at length about his company. Contango's future is important to ours, too…so, quit buying Ken drinks.

2 – Paychex – Otherwise know as the boring but beautiful payroll outsourcing business that on a dollar for dollar basis is more profitable than Google.

3 – Berkshire Hathaway – Berkshire is Warren Buffett's holding company, and it is a new position for us. New as in "this week." I am also eating some crow right now because of it. Last fall I told you, as well as a reporter from SmartMoney magazine, that we wouldn't own shares of Berkshire in Tarpon – basically because there were too many other opportunities out there. But Berkshire right now is pretty close to the cheapest I've seen it, and it is one of the best businesses in the world.

There was also an opportunistic reason behind buying Berkshire now, too, that I'll try to sum up:

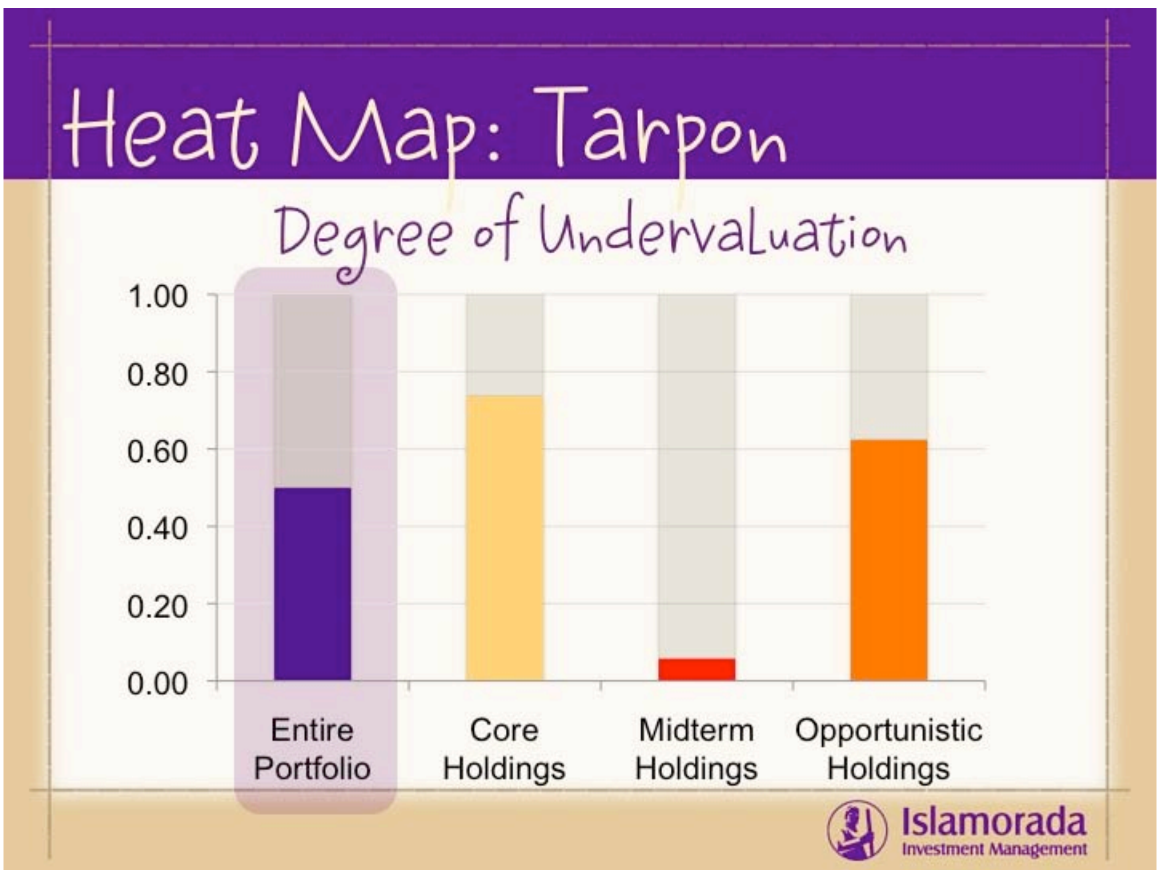
Berkshire is buying a publicly traded railroad company, Burlington Northern, that is a member of the S&P 500 Index. When Burlington disappears from the index, S&P will need to find another company to replace it. It seemed pretty apparent that the most probable candidate to put in the index would be Berkshire Hathaway – which is not in the index currently for a handful of reasons. If Berkshire were to be added to the index, though, a lot of index funds will have to buy shares in Berkshire so they continue to accurately mirror the index, and all that buying would obviously will drive the price higher.

As it turned out – and some times it just pays to be lucky - about four hours after I finished buying Berkshire shares for us, the announcement came out that, in fact, Berkshire was going to be added to the index, and Berkshire shares have risen 12% from when we bought them this Tuesday.

So, I am eating some crow on buying Berkshire shares, but it also tastes pretty good right now.

4 - Lowe's Companies, as in Lowe's hardware stores, is another new position for us that I'll talk about more in my next investor letter. The bottom line is that I think its worth around $35 a share and it's trading at $22.

5 - Atwood Oceanics - a very well run offshore contract driller - is also a relatively large position for us that I think will do about $4 in earnings per share this year, so it's also very cheap. I will have more to say about Atwood before long as well.



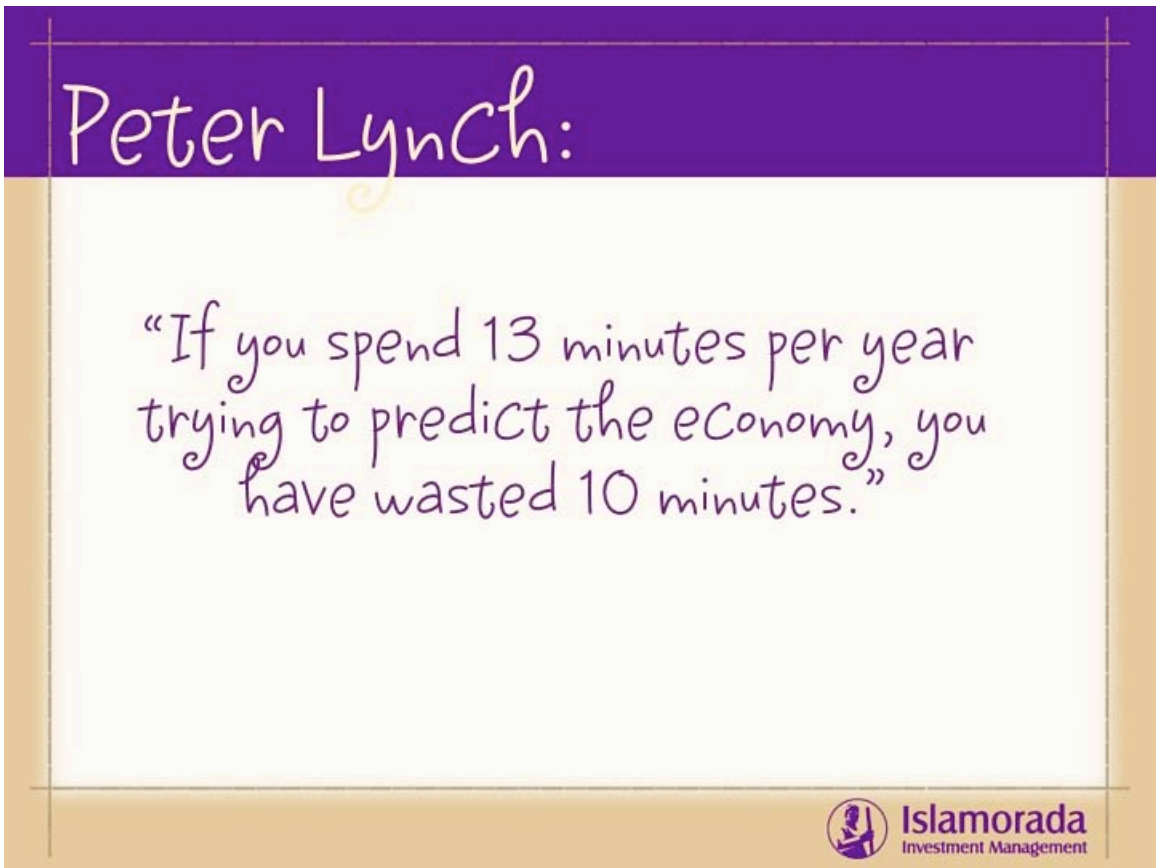
This is what I call the portfolio's Heat Map. It's something that I created just to keep track of how much value there is in the portfolio at any time. So it's sort of a homegrown metric. I call it a Heat Map for no real reason other than "Heat Map" sounds pretty cool.

What it shows, though, is the degree of undervaluation in Tarpon.

I classify holdings in Tarpon three different ways, which you can see at the bottom there, and I create this map by calculating the differences between our companies' real values, and their current market prices, weighted to reflect our actual holdings. The main point is that if I'm right in my valuations, then someone investing in Tarpon today is buying an asset that is trading at 50% of it's full value.

A year ago, by the way, this looked like a staircase, starting at .80 for core holdings and the Entire Portfolio bar was just under 1.00. We may never see that again in the next decade…but one can always dream.

So, while the market as a whole may be pretty fairly valued, I think there is still a lot of value left in Tarpon.



I want to share a couple of quick thoughts on the economy, because it's one of the most common questions I get. In general, though I tend to agree with Peter Lynch.

So here are my three minutes on the economy. And to be clear, these are not my estimations, but the estimates of the few people on Wall Street that I believe have any credibility when it come to making economic forecasts:

- 3.5% to 4.0% growth in GDP in '10 – meaning the economy is getting healthier;

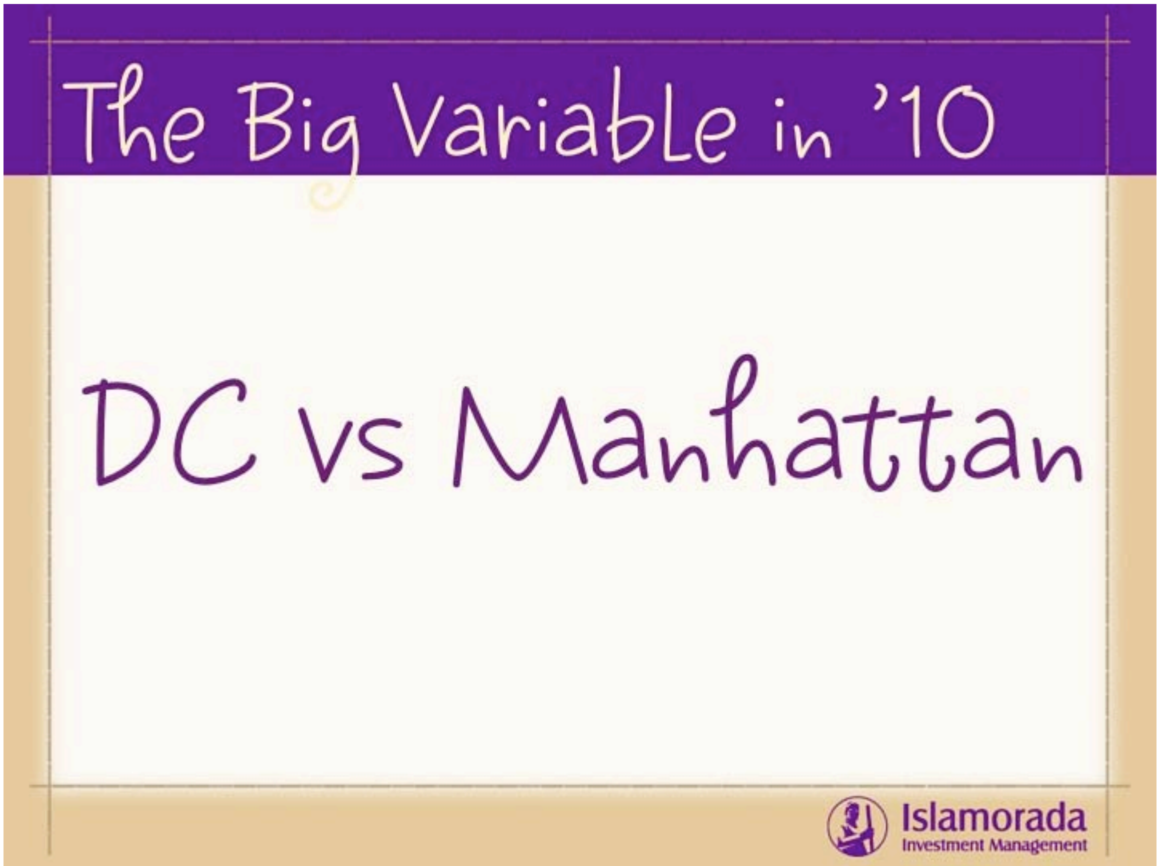
- 3.0% inflation – meaning prices will start to rise at an average level;

- Unemployment will peak in Q1 – so there could be a bit more bad news to come on the unemployment front;

- Jobful (vs jobless) recovery – the data seems to show this recovery will be more like 1983, when we created jobs, as opposed to '91 or 2001, when the economy bounced back but jobs never did.

- S&P near 1,400 in four years*?* - please note the asterisks there. That is by no means an economic nor market prediction as much as it is simple math. If you presume the companies in the S&P 500 will grow earnings at their long-term average rate, and that they deserve a valuation that reflects what they've had on average over the last ten years, then you get to 1,400 in about four years. It closed yesterday at 1074…so figure that means about an 8% rise in the market each year for next four years - in theory - and keeping in mind that it won't go straight up - and, this is a big if, assuming our legislators and elected officials don't screw things up.

Which brings me to:



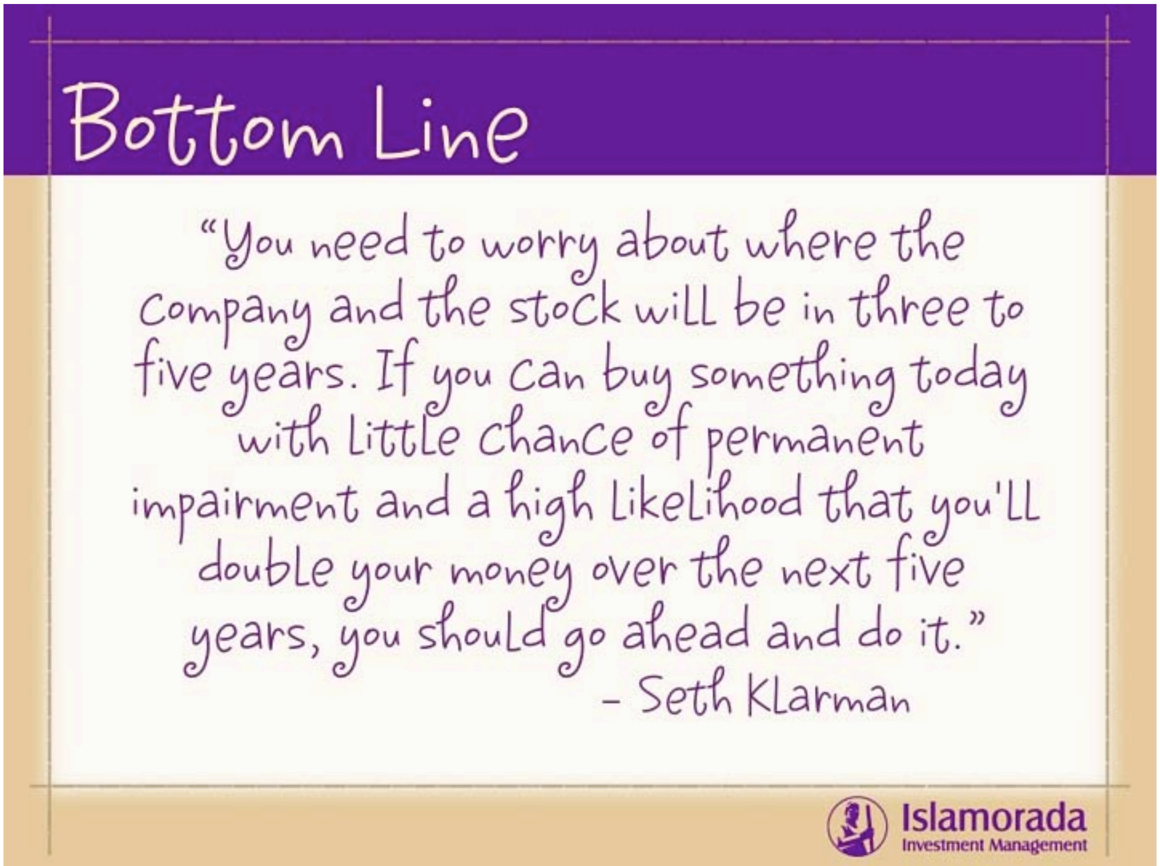
The big variable in the market this year will probably be the coming battle between the administration and Wall Street. And it is early, but it appears to be shaping up as a no-holds barred, Texas steel cage match. The question of what will change about financial regulation in the next few years is an important one, and it's creating a lot of uncertainty in the markets right now.

About all we do know for sure right now is this:

- Some things must change. We simply cannot have 27 year olds selling billion dollar credit default swaps to each other via instant messenger. But smart reform is different than punitive action against Wall Street, and the recent weeks have surfaced the latter as a real potential issue.

- As a result I think we can also expect that this anti-Wall Street, anti-Federal Reserve brand of financial populism will probably continue until the elections this fall, and as a result, regulatory risk - or the odds that a company you own could be surprised negatively by a new regulation - is high.

So for your investments outside of Tarpon or Gecko, keep this slide in mind. If you own shares in any of the big banks and/or ratings agencies, for instance, it may be time to really think that through again.



Whatever happens in 2010, though, I want to be clear it will not change anything I do. I'm very happy about the companies we own, particularly when I look out a few years. Again, I think Tarpon as an asset is 50% undervalued, today. It may take a few months to close that gap, or it could take a few years. In either case, we should do pretty well. I'm always looking for opportunities, still thinking all the time about risks. I thought that final quote from another well-known value investor named Seth Klarman summed my own opinion up pretty nicely.

Does anyone have any questions or comments?

[The first question was more of a statement from a distinguished older gentleman who looked a lot like me. Okay, it was my father, who wanted to reiterate he was both happy and proud to be an investor. Thanks, Dad. Now, no more softball questions, please.]

Q. How do you know when to sell something?

A. There are a handful of reasons I will sell, but the most common reason I sold anything the past year was because shares reached my estimate of intrinsic value for the company. When I do my initial valuations, I come up with a per share number, or a range of numbers, that I think the company is really worth, and assuming nothing has changed too much during the time we've owned it, I'll sell when the price gets to be within a reasonable range of that value.

It's important to stay as unemotional as possible about selling, and I confess it's easy for me to fall in love with some of these companies. It was hard to say goodbye to Discovery, for instance, but there is little support for the valuation right now. And, as I mentioned in one of my investor letters, you guys don't pay me to be a sentimentalist.

There is also an opportunity-cost case to be made for selling. For instance, if something is trading at a 20% discount to its real value, and I find something else that is trading at a 40% discount and it's a better business, I'll sell that 20%-gap company regardless of what its shares have done while we owned it.

There are a handful of other cases, too….for instance, if the business really starts to unexpectedly deteriorate, or if management starts selling a lot of stock. I may not necessarily sell based on just that, but I'll take a closer look at that sort of thing.

Q. What sort of industries do you prefer to invest in, and would you invest in foreign companies?

A. All of our companies are domestically listed, and that's primarily a function of a few things, one of which is the size of our portfolio. It's just easier to find opportunities to do well when you're managing a small portfolio. Should we ever get to be a billion dollar fund, well, first, that's a problem I'd love to have, but then we might need to look outside the U.S. to find good values that can have an impact on performance.

As far as the industries we're in, I have a slight telecom bias in the portfolio right now, because I spent a few years in the industry and things there still look relatively cheap. I'm not an expert, but I do feel pretty comfortable with understanding those businesses. I'd say rather than stick to certain industries, though, I try to stick to certain kinds of businesses – basically, simple ones. My standard is that if I can't explain to my five year old how a business makes money, I probably shouldn't be investing in it.

That will keep us out of certain industries. I looked hard at JP Morgan last year around this time, because they would come out stronger after the crisis was resolved, but they had about $77 billion of derivatives on their books. They don't really know what all that is, and I certainly couldn't tell, so I passed.

So, I'd say I'm attracted more to simpler businesses than certain industries.

Q. How do you value the companies you buy?

A. The value of any company is the present value of all its future cash flows – and I focus on cash flows as opposed to profit, which can be more opinion than fact. So, essentially, I'm figuring out what the normal cash flows are based on conservative measures, and comparing the value I determine with the value the market is putting on the shares. Most of the time, those values are on average pretty close. Last year when we launched Tarpon and Gecko, however, they were not. But discounting cash flows is the primary way to value a business.

That's not the only way to do it, however, and sometimes a valuation should be more balance sheet driven, or focused on hidden assets. Sometimes retailers, for instance, own their real estate, the value of which is not on the balance sheet but might be bigger than the entire market cap of the company. There are also special situations, kind of like the Berkshire Hathaway scenario I mentioned earlier, as well as Alcon.

I could spend all night talking about it, but there is not one standard way to do it. Those three things I mentioned earlier in that value investing slide basically summarize what I'm doing every day.

Q. Are there any industries you don't invest in?

A. Yes – and I've made no bones about this in the past – I don't invest in healthcare companies (Note: Alcon is a special situation as I talked about in this letter). I don't understand the healthcare industry. It is so inefficient that it just baffles me. So, we won't own any pharma or insurer company stocks. Warren Buffett had a great quote: "If you're sitting around the poker table for ten minutes and don't know who the patsy is, then you're the patsy." I feel that way about healthcare companies. I would be the patsy.

Otherwise, there are plenty of industries that I don't consider myself an expert in, but after you've looked at things long enough you can see similar competitive advantages across industries. Take Contango, for instance. I am not an expert in natural gas, but I know Ken Peak is, and I trust him. I also know the power of being the low cost producer in a commodity industry, and when combined with a big enough margin of safety, it was enough for me to buy shares there. A lot of the advantages in healthcare are regulatory based, though, and I can't tell if those regs will be the same in five years.

Q. How do you find the companies you invest in?

A. I just read pretty voraciously. It's not very efficient, but it's the best way I know of to find good companies to invest in. I do have a couple of stock screens I use every morning, and the 52 week lows list can be a good one, but I just get more ideas out of actively looking. We also spent about $10,000 on subscriptions to independent research firms last year, so if you've heard of a particular service, I probably get it. To a certain extent I try to outsource the identification stage of recognizing potential investments when I can, though all the analysis I do myself. But basically, I'm reading a ton.

At this point, I introduced Ken Peak, CEO of Contango Oil & Gas, who walked through his slides with our investors. You can see Peak's presentation here.

Please contact me at csmith@islainvest.com if you're interested in learning more about investing with us. Thank you.

- Cale Smith
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January 2010