

**Founders Capital Management, LLC**

**2005 Annual Report:  
“Taking a Multidimensional View”**

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## PRINCIPALS' LETTER

*From: Founders Capital Management*

### 2005: Taking a Multidimensional View

The stock market ended the year 2005 with a slight gain of 3% on the S&P 500. (The Dow Jones Industrial Average actually lost .61% in 2005.) This slim return, along with the “minor” market volatility experienced throughout the year, should generate surprise. We emphasize “minor” because, in fact, market volatility during the past 24 months has actually been *lower* than the historical norm: Over the past 100 years, the stock market has demonstrated a 70% chance of moving greater than 10% (up or down) in any given year. [We won't mention the fact that the market has shown a 50% chance of moving greater than 16% (up or down) in any given year.] The so-called tight trading range of the past two years, in which the S&P 500 has moved within an annual 10 percentage-point range since January 2004, is therefore anything but the norm.

George Eliot penned the following in her 1861 novel, *Silas Marner*:

*“The sense of security more frequently springs from habit than from conviction, and for this reason it often subsists after such a change in the conditions as might have been expected to suggest alarm. The lapse of time during which a given event has not happened, is, in this logic of habit, constantly alleged as a reason why the event should never happen, even when the lapse of time is precisely the added condition which makes the event imminent.”*

Given the economic recovery we have experienced over the past three years, and the corresponding gains in the markets, we should not allow ourselves to be lulled into a false sense of security with the belief that the 15% annual returns established during the 1990s are here again. We should stay mindful of the changing conditions characterized throughout our member letters and aware of several circumstances that could lead to short-term financial stress. It is helpful to remember that the lapse of time between financially stressful situations is not a reason to believe financial stress will not happen—in fact, the lapse of time is precisely the added condition that could make a financially stressful condition imminent.

As we have emphasized in the recent past and will continue to repeat until conditions change:

**Given today's uncertain economic environment—characterized by low interest rates, high consumer and government debt, a shifting economy, and ongoing geopolitical issues—we do not expect the stock and fixed-income markets to perform in the future as they have in the past.**

Our performance in 2005 reminded us of Albert Einstein's saying:

*“When a man sits with a pretty girl for an hour, it seems like a minute. But let him sit on a hot stove for a minute—and it’s longer than any hour. That’s relativity.”*

This year’s letter describes our risk conscious investment approach, which is beginning to feel a little like “sitting on a hot stove” as our overall relative performance appears stagnant. We remain unadventurous in our investments and have avoided the “market high-fliers” that have grown in paper value at a much faster pace than the worth of the underlying businesses. As we have stated in the past, we will stay disciplined and ensure that we keep our minds on what is relevant:

**Buying (at a fair value) great companies that create long-term value for shareholders, regardless of what happens to their short-term share price.**

In 2005, the intrinsic value of our collective businesses actually outpaced their growth in paper value—a positive development that should please investors. Although this phenomenon happens from time to time, history has shown that the paper and intrinsic value of businesses trading in the market will converge over time.

Investors wishing to grow their wealth should concentrate on the pace at which their investments grow in intrinsic value. Unfortunately, this is not the norm. Instead, most individuals are ecstatic with high growth in paper wealth, regardless of whether that “wealth” is grounded by a commensurate expansion in *value*. Oscar Wilde sums up our attitude about many current market participants: *“A fool is someone who knows the price of everything and the value of nothing.”* We are delighted to be associated with individuals that truly concentrate on the value of things—there isn’t any foolish behavior among members at Founders Capital Management.

The theme of our 2005 letter is “Taking a Multidimensional View.” We do not claim a cornerstone on intellectual thought, but during times of abnormal market behavior, we feel it is important to take a step back and try to understand the various thought processes and angles that are leading to the apparent conclusion of many that everything is fine, with the economy sailing along at a steady rate.

Our discussion this year focuses on:

- “What to Think” vs. “How to Think” (restated from our 2005 quarterly letters)
- Factors that Influence Investments
- The New Era of Investing
- Consumers’ Use of Debt in the New Era

#### **“What to Think” vs. “How to Think”**

Is the price of oil going to keep rising? Will interest rates continue to climb? What impact would higher inflation have on the economy? How high can government and consumer debt mount? Will commodity prices keep soaring? Which stocks will rise the fastest this year? These are all questions investors are asking today. But in addition to focusing on “what to think,” it is just as important to understand “how to think.”

In the game of chess, after three opening moves, more than nine million positions are possible. Mathematically, chess is an infinite game: The total number of potential moves during a single match is unlimited. Consider this: There are more potential moves during a chess match than there are stars in the universe. And this is in a game involving just two players. Imagine a realm, such as the stock and bond markets, in which thousands of participants react to thousands of variables introduced continually by companies, economists, and business analysts. This thought could paralyze any investor seeking to place money in the market. Rather than think about the many moving parts that impact prices, it is essential to focus instead on eliminating extraneous variables, and to target only those that provide 90% of the information needed to make knowledgeable long-term investment decisions.

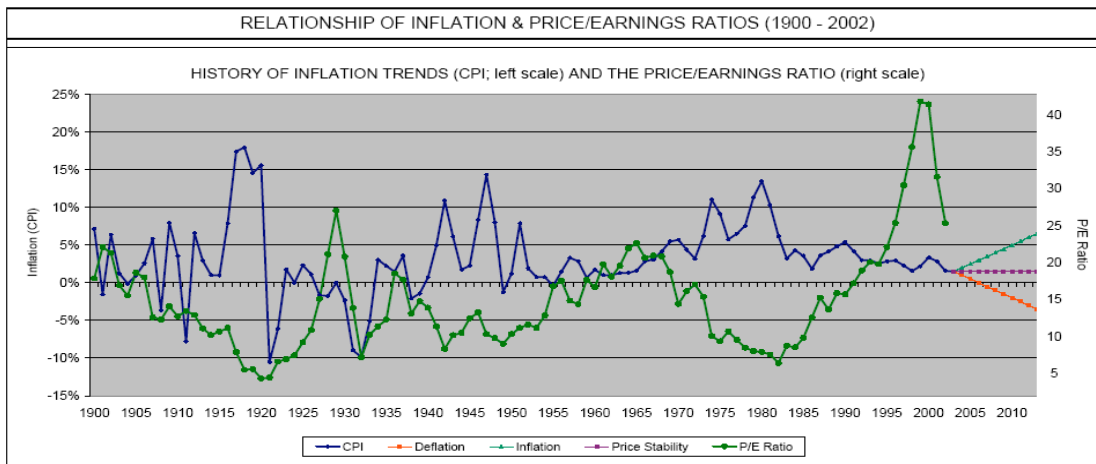
### Thinking Backwards

Investing and the game of chess are similar in many ways. It is important for the chess master (investor) to deliberate at the highest possible level and to envision the board (market) as a living organism that moves, rather than a static picture. This forces him to think logically, recognizing that all moving chess pieces (securities) are interconnected as an evolving entity.

Similar to a chess master, the investor must remain focused on a point in time, deciphering between short-term trade-offs that will be of long-term benefit. He must also search beneath opponent's (market participants) moves, looking for the root causes of the challenges posed, as opposed to focusing on "symptoms" that will lead him to think astray. Answering questions posed from moves by an opponent or in the market requires a kind of "thinking backwards" that is illustrated by the following riddle:

*A traveler comes to a fork in the road that leads to two villages. In one village the people always tell lies, and in the other village the people always tell the truth. The traveler needs to conduct business in the village where everyone tells the truth. A man from one of the villages is standing in the middle of the fork, but there is no indication of which village he is from. The traveler approaches the man and asks him one question. From the villager's answer, he knows which road to follow. What did the traveler ask? (Answer is at the end of our letter.)*

An investor seeking insight into the movement of interest rates, the stock market, and other assets has to think backwards. The root cause of movement in interest rates, and changes in associated asset values, is determined by inflation. Inflation (or deflation) is the "true variable" that impacts an investor's long-term returns. Since inflation is essentially man-made, perhaps it can be controlled, and the Federal Reserve under Mr. Greenspan's long tenure has done a very good job of controlling inflation. As summarized in the graph below, over the past 20 years, inflation (the top erratic line) has been relatively stable since 1985. This has created an expectation that inflation will remain controlled in the future as it has in the past. The correlated line, which shows a large spike spanning 1985 to the present, represents the value of the stock market. Note the high correlation between inflation and stock market valuation over time, whereby during periods of growing inflation (and higher interest rates) the stock market loses value. Conversely, in periods of declining inflation (and lower interest rates), the value of the stock market rises. The only exception to this occurred during the early 1920s and 1930s, when deflation negatively impacted the value of the stock market.



As indicated at the right hand of the graph, we are currently at a fork in the road. Investors are asking the question: Will inflation (and interest rates) rise from this point, or will they fall? We feel this may not be the appropriate question, because the ability to provide an accurate answer is low. So, what is the right question to ask at the inflation fork in the road?

Answer: *What is the probability that inflation will remain steady in the future?*

We can see that during periods of inflation or deflation, all asset values experienced volatility. Since we think the probability of inflation remaining constant is low, we should expect with high probability that volatility will occur in the future—in both the stock and fixed-income markets. (We'll get back to inflation again later).

### ***Thinking Rationally***

It is crucial for the chess master to think rationally at all times. When too much emotion enters the game, it becomes difficult for him to maintain a multidimensional view. Emotion can lead to myopic thinking—which, in turn, leads to poor decision-making.

Remaining rational is a critical ingredient to successful investing. Once an individual gets caught up in the emotion of other market participants—buying and selling stock with the hope of buying low and selling high—the opposite usually occurs—he ends up buying high and selling low.

Just as it would seem irrational to sell your house and rent when housing prices spike so you can buy your house back at a future lower price, we think it is irrational to sell a good company now with the hope of buying it back at a lower price in the future. We subscribe to the view that it is far easier to stay an owner of a business vs. renting out the stock. This simple principle is the cornerstone of sound investing: ***Buy good businesses at sensible prices, and hold on for the long term.***

Despite the gyrations of an individual company's stock price, we stress the following key questions for investors to ask:

1. What are the interesting prospects for the business, and how likely are they to materialize?
2. What price are we willing to pay for the inherent business prospects?
3. How is the company building intrinsic value to create long-term wealth for its owners?

The answers to these questions constitute the underlying theme of our ongoing communications. We believe the long-term prospects of all our businesses are strong and fairly predictable. Our equity holdings are currently offered at fair prices—not bargain prices—and continue to make positive movements in underlying value. We are mindful of the volatility in today's markets, brought about by factors that influence all investment returns.

### **Factors that Influence Investments**

The three factors that influence all investment returns should be addressed, particularly in today's uncertain investment environment: **Risk, Opportunity Cost and Inflation.**

#### ***Risk***

People intuitively evaluate risk situations every day, and any potential investment presents various risk considerations: What are the investment's long-term prospects? How well is investment principal protected? How consistent is the income on the investment? How vulnerable is the investment to changes? What is the financial strength of the security associated with the investment? These are just a few of the questions an individual may ask prior to allocating money to an investment.

Our discussion about risk focuses on three key principles to consider prior to allocating capital:

1. **Speculation is the casualty of an investment portfolio.** Take into account only those risks that can properly be evaluated, and once all significant issues associated with an investment have been appraised, including the possibility of loss, then (and only then) look at the expected profit, as well as the time frame of the holding. Do not “follow the crowd,” and don't mind other individuals who tout short-term returns from buying securities at foolish prices, with the hope of selling those same securities to others at even more foolish prices.
2. **The future is *always* uncertain and should be viewed with circumspection.** Weigh each investment first as an income opportunity, and second as a growth opportunity, recognizing a “margin of safety” in each security. When appreciation of principal becomes the overwhelming reason for an investment, reliance on the far future becomes the prevailing force for expected gains.

3. **Constantly investigate any probable connection among ostensibly unconnected risks.** Limit investments to a group of securities that can be understood, and ensure that the investment portfolio is constructed to avoid the aggregation of losses from a particular event or from associated events that will precipitate permanent loss of principal.

### ***Opportunity Cost***

The second factor that influences investment returns is opportunity cost. If an investor with XYZ Company stock, which is yielding a 10% annual return, believes ABC Company will offer an opportunity to earn 12%, he will likely sell XYZ Company to take advantage of the extra opportunity presented by ABC. (Note: We discourage this sleepless, toss-and-turn investment behavior.) Conversely, if there is a high demand for money, and banks can lend equally secured money that earns 10% as opposed to 9% interest, they will naturally take advantage of this opportunity. The point is: All investors are constantly seeking alternative ways to maximize their returns, and investors bear an ultimate "opportunity cost" as they bid for assets and compete for higher returns.

### ***Inflation***

Saving the best for last: The final factor that influences investment returns is inflation. Inflation has the largest impact on the long-term return of all types of capital. Since inflation is essentially too much money chasing too few goods and is a man-made phenomenon, many believe it can be man-mastered. We will pass on that debate for now and focus instead on inflation's high impact, especially on capital-intensive businesses.

To an investor, the important earnings are the "real earnings" a business produces for owners. "Real earnings" are determined by the extra purchasing power an investor achieves having placed his money at risk. For example, let's say you decide to save for your child's college education. Suppose you opt to put aside \$20,000 today for the anticipated first year of college in a decade. Given that you think tuition will increase 5% per year, you decide to put the \$20,000 in a tax-exempt bond earning approximately 5% per year. At the end of 10 years, the \$20,000 will have grown into \$32,000—not bad. But how would you feel if, at the 10-year point, you discovered that the first year's tuition bill had inflated to \$40,000? You certainly would not feel very savvy, having produced no "real earnings" from your initial investment after 10 years. Clearly, if inflation reaches a high enough rate, it can make the purchase of various assets unappealing.

*At a minimum, to produce "real earnings," a business must achieve a "return on its invested capital" that exceeds its "cost of capital."*

Inflation has a large influence on the cost of capital, because passive returns will most likely keep pace with inflation and be benchmarked against corporate returns. For example, during a period of 10% inflation (this becomes the minimum benchmark for an investor's cost of capital), a corporation that is achieving a 12.5% return on its invested capital and distributing all this money to owners will not produce "real earnings." The problem lies in the fact that the 12.5% return for owners may be taxed at 28% or more, leaving a 9% real return. The 9% return gives the investor only 99% of the purchasing power he originally had at the beginning of the year.

An increasing rate of inflation also creates an environment in which a "double tax" is assessed against a company's capital. Let's assume an automobile company faces tremendous global competition and has constant difficulty raising prices without losing some share of the market. This company inhabits a highly capital-intensive industry, in which the development of a new vehicle or the addition or retooling of plants can cost billions of dollars. During a period of high inflation—let's say 10%—this automobile company may be forced to hold back certain capital expenditures due to high interest rates and the corresponding high cost of capital. Competition makes it difficult for this company to raise prices 10% to keep pace with inflation. If the company decides to wait for better times to make significant capital investments, its current annual earnings and dividends may continue to grow, albeit at a slower pace than 10%. A hidden problem is occurring, however. Capital costs associated with building the same number of units are most likely growing along with inflation at 10%. This so-called inflation tax will be a significant factor in the future, when this automobile company needs to replace or add plant and equipment. All earnings produced during the inflationary period, and maybe more, will be needed to ensure the future survival of this company.

Unfortunately, the world of economics is not so simple, and inflation is more difficult to decipher than it used to be. This is primarily due to the way inflation is currently evaluated. As our economy has grown

more sophisticated, economists have developed various ways to measure inflation. One of these is “core inflation,” a measurement approach that excludes certain items that are affected by volatile price movements. For example, core inflation does not take into account products such as food and energy that can undergo temporary price shocks, because these shocks can diverge from the overall inflation trend and generate a false measure of long-term inflation. Now, we don’t know about you, but we think when the average fuel bill rises more than 20% over the past 12 months, it should be considered inflationary, especially if we don’t believe there is a high probability we’ll see this cost decline in the foreseeable future. The reported number for core inflation, however, would remain low, at around 2%, providing a misleading impression that prices are not rising.

Another factor that influences today’s reported inflation number is “hedonics.” When a person researching the purchase of a 30-inch flat-screen television realizes that the price has remained at \$500 for six months, she might conclude that the price hasn’t changed, but not if she’s a commodity analyst at the Bureau of Labor Statistics specializing in televisions. This government agency, which assembles the Consumer Price Index, may have decided that over the past six months, the newer television offered important improvements, including a better screen. After running the changes through a complex government computer model, the commodity specialist might place the value of the screen improvement at more than \$175. Factoring this in to the current price, the specialist might conclude that the price of the TV has actually fallen more than 25%.

These adjusted measurements display mixed signs of inflation and deflation— leading to something we call “idflation.” Inflation in prices for commodities such as oil, natural gas, and food, is being offset by deflation in prices for consumer products such as computers and electronics. We are concerned that this combination, which leads to a low inflation conclusion, is akin to putting your hands in the freezer and feet in the oven and concluding that you have a perfectly balanced temperature. Unfortunately, you can freeze and get burned at the same time.

An apples-to-apples comparison of inflation today versus 15 years ago shows that the Consumer Price Index is currently growing in excess of 6%, versus the reported 3.5%. (Recently, for example, the state of Connecticut approved a 22.4% rate hike for Connecticut Light & Power customers.) As investors intuitively think inflation is higher than reported, they are seeking outsized returns to compensate for rising costs. This leads many money managers down a path of increasing their exposure to risk, as they attempt to chase returns in a “new era” of investing.

### **The New Era of Investing**

Are we in a new era—or repeating an old error?

Given that today’s investing public has adopted an attitude similar to that of the latter 1990s—if you don’t agree, just take a peek at the current valuation of several Internet companies—perhaps we should address the new theory of investing: “The value of a common stock depends entirely upon what it will earn in the future.”

This line, which describes the euphoric nature of investors during the great 1920s boom, is from the book, *Security Analysis*, written by Benjamin Graham and David Dodd in 1934. This famous work was published after the speculative investment behavior that led to the stock market crash of 1929 and has become the cornerstone of investing.

During this time of recurring speculative behavior, it is useful to recall their teachings, which time has proven valuable. For today’s investors, current earnings and dividends seem to have little bearing on the value of a security, and past earnings are significant only to the extent that they indicate likely changes in future earnings. Essentially, many investment professionals have turned their attention from owner earnings (earnings that may be distributed to business owners today) and earning power on invested capital, to changes in earnings far into the future. This future (and hopefully high) change in earnings dictates the rationale for investing.

Why is this happening? Apparently, potential future rewards have become exceedingly tempting, to the point that professional investors bravely pursue certain investments at any price.

A short story helps to illustrate this thought:

*When Winston Churchill was in school, his instructor passed out a test that consisted of a single question: What is the bravest thing you have ever done? Churchill, being fairly bright, walked up to the instructor at the end of the test and handed him a blank piece of paper, stating, "This is the bravest thing I have ever done."*

Similarly, the bravest thing professional investors can do is to invest clients' money according to a philosophy that follows the "new era" doctrine.

The changes that have taken place in the stock market over the past 10 years have been staggering. At Founders, we believe we are witnessing a seismic shift in how the world communicates and does business. Advances in technology have been so rapid and sweeping that they have likely effected permanent increases in productivity and efficiency. (Note that this statement differs vastly from the idea that we will see permanent increases in productivity.) Due to the constant positive changes in productivity and efficiency over the past 20 years, our ability to objectively define a stable business environment comes into question and could in fact be contributing to a new era theory—of buying investments at any price, because the future looks so bright.

It is not surprising that the agents of change driving the revolutionary developments in how we do business—the technology companies—have experienced inflated valuations. In this type of volatile environment, the normal criteria for valuing these businesses—owner earnings (which may be great in the future), invested capital (of which vast amounts are needed today to cultivate future earnings), and past earnings (not a good barometer, since their history is limited)—are not reliable. Due to the disconnection between earnings, invested capital, and past performance, a company's true intrinsic value has once again become a meaningless measurement by which to invest in a business, leading many investors—who may be more appropriately referred to as speculators—to believe that their only option is to throw up their hands, yell "Yahoo!," – and go Goo-Goo(gle), investing in Internet-based companies by simply guessing at a company's far future outcome.

Several studies over the past century have shown that stock investments tend to outperform alternative investments such as bonds. An investment in stocks versus an investment in bonds will usually provide greater returns because a company's growing earnings yield (earnings per share divided by price per share) has a tendency to exceed the yield obtained on a normal bond over time.

For example, if ABC Company earns \$5.00 per share and its share price is currently at \$50.00, the earnings yield would be 10%. A major portion of these earnings are retained by the company and reinvested (without tax implications to shareholders) to earn a stated return on equity in the future. Clearly, a 10% earnings yield exceeds a normal bond yield of, let's say, 7% (which has tax consequences each time distributions are made). If ABC Company possesses a good franchise and is well managed, it is highly probable that the value of the company will also increase over time as earnings are continually reinvested in the business at a high return on equity.

What happens if ABC Company's stock price increases significantly? If the stock price doubles to \$100.00 per share in a few months, ABC Company (currently earning \$5.00 per share) will now have a 5% earnings yield. All of a sudden, the normal tendency for a stock to outperform a bond is less certain. Let's take this one step further and say that ABC Company's stock price then quadruples over the next nine months, to \$400 per share. An earnings yield of 1.25% is clearly much lower than a conservative 7% bond yield, and even a fast, predictable growth in ABC Company's profits shows that it could take years for its earnings yield to reach a conservative bond yield. In essence, the investor is purchasing the current earnings of ABC Company and obtaining a much lower initial return than an equivalent investment in a conservative bond, without the extra protection provided by the normal bond investment. Thus, an investor becomes highly reliant on ABC Company's growth in earnings.

The new era thus starts out with a sound premise that devolves into an unsound result, owing to a disconnection between the alternative use of investor funds and a fair assessment of calculated risk.

We are reminded of one Internet company that has a price-to-earnings ratio of approximately 75. The earnings yield is currently at 1.3% (1/75). Although the expectation is that this company will grow its earnings at a rate of 50% per year over the next few years, even at this accelerated growth rate it would take four years for investors to achieve a 7% earnings yield. This may well happen, but the probability should be closely evaluated, given the technology industry's highly competitive environment. An investor

may be better positioned in an alternative investment with a current earnings yield of 7% and a high probability of growing at 10% per year over the next four years.

Why do we encounter an occasional disconnection between investment risk and reward? This is a question that many economists have attempted to answer over the decades. One of Aesop's fables—"The Astronomer"—will illustrate the answer:

*An astronomer used to go walking at night to gaze up at the stars. On one of his walks, he absentmindedly fell into a well. As he struggled to get out, his cries of help attracted a passerby who, upon hearing what had happened, laughed and said, "My good sir, your efforts to peer into heaven have made you forget to look at what is under your feet."*

That the valuations of many securities are out of sight may be an obvious fact to investment observers. Many investors, however, seem to choose to be out of mind to avoid missing the chance to participate in heavenly gains. Unfortunately, the ground on which investors stand may feel shaky because of their weak foundation of logic.

There is an economic model that states that the events leading up to financial stress begin with a "displacement"—a shock to the macroeconomic system. The origin of the displacement can vary, but in the past it has been attributed to war, a great (or not so great) crop harvest, or an invention that has a revolutionary societal impact—the steam engine, the railroad, the automobile, electric power, the computer, the Internet, and so on. In addition, political events such as the spread of democracy and capitalism can lead to financial success or failure for many countries. Whatever the nature of the displacement, its widespread impact on the economy ushers in significant investment opportunities in new ventures. As investor optimism takes hold, economic expansion is usually followed by an extension of bank credit that enlarges the supply of money.

Suppose that investors have an urge to speculate, causing a surge in demand for goods and financial assets (stocks, housing, etc.). The increased demand puts pressure on companies to produce more goods, and the supply of financial assets increases. In turn, sales and profitability at many companies grow, and the cycle continues until "overtrading" occurs, with valuations reaching euphoric levels. Investors begin to believe that this level of activity will continue forever, and everyone involved becomes a fair-weather optimist. (Imagine if inflation is reported as benign during this period.) Nobody thinks to carry an umbrella, and sooner or later, it's inevitable: The storm comes! At Founders Capital Management, we will remain grounded in our outlook, and we always carry an umbrella in case of rain.

### **Consumers' Use of Debt in the New Era**

*A banker is a fellow who lends you his umbrella when the sun is shining but wants it back the minute it begins to rain.*

—Mark Twain

These days, credit can be obtained in a variety of ways, including use of credit cards, borrowing against a retirement account, or refinancing a house (maybe several times)—all of which can exacerbate an already volatile investment climate. In this type of environment, consumer debt quality is more important than quantity.

There are three main types of consumer debt:

1. **Cash-Flow Financing:** This type of consumer financing is the most common (and most conservative). A consumer borrows money (and the lender provides money) based on a relatively certain cash flow that will ensure payment of principal and interest. A perfect example of cash-flow financing is a home mortgage. A bank lends money to a consumer knowing that the borrower's earning power is sufficient to meet the monthly obligation on the loan. (We're not sure how this would play out today, with many individuals opting for adjustable rate mortgages—payments could rise significantly if interest rates increase, and loan defaults could increase.)
2. **Speculative Financing:** This type of debt provides financing without a defined stream of cash to pay back a loan. Consumers often use new speculative financing debt to cover old debt—for example, by using a credit card. There is usually not a bona fide asset backing this debt, and a defined cash stream has not been fully secured for the debt obligation. Many consumers evolve to

the point that they use the opportunity of a new credit card with special offers (and a higher line of credit) to remit their obligation on an older credit card.

3. **Ponzi Financing:** There really was a Charles Ponzi. Ponzi promised to pay investors 50% interest for the use of their money for 45 days. His plan was to arbitrage foreign exchange between actual depreciated exchange rates at which foreign currencies and international postal coupons could be purchased overseas and the higher fixed rates at which these coupons could be redeemed for stamps in the U.S.

Essentially, the Ponzi scheme became a chain letter, with the 50% profit guaranteed to earlier purchasers of Ponzi's notes paid by later investors. Many of the early investors even put their money back into the pot to earn another 50%. As buyers suspected that their money was at risk, they stopped investing, and the house of cards collapsed. When he was arrested, Charles Ponzi had raked in \$7.9 million and possessed \$61 worth of stamps and postal coupons.

The term "Ponzi Financing" is associated with extreme speculation, perhaps to the point of a swindle. Why mention the Ponzi scheme? While maybe not as extreme as Ponzi's system, instances of aggressive speculation are not hard to find today. Many individuals are borrowing (several times) against the rising equity value of their home, taking out speculative low-interest adjustable rate mortgages, racking up credit card bills, siphoning their retirement savings, and consuming beyond their means. Leveraging their assets, individuals are then buying additional real estate (with the hope of further rising prices) and/or purchasing Internet companies and hedge funds with the hope of increasing their wealth—all to further borrow against their growing assets and continue consuming in the present day. This activity is leading to a self-induced swindle as individuals establish a chain letter effect on their own assets. Sooner or later, there could be a day of reckoning that has large repercussions on our economy.

Fortunately, we do not see our members engaged in this type of irrational behavior. At Founders, we will continue to honor our members' conservative nature. Our investments in fixed-income securities will remain short-term, whereby we achieve fair returns for the minimal risk we take. In addition, we will stick with our current businesses, which are measurable and have promising worldwide prospects. We want to assure you, our partners, that we will remain mindful of the risks in today's markets and will allocate capital in a way that minimizes any long-term effect on the *value* of our holdings (with the knowledge that we cannot control the short-term *prices* of our holdings).

## MANAGEMENT'S DISCUSSION & BUSINESS UNIT REVIEW

*We continue to focus on the long-term prospects of our business operations and evaluate how our businesses are increasing value for shareholders over time. Our concentration on business activity is what ultimately drives a company's stock price—not the psychological feelings of individuals seeking to make money on a "paper trade."*

Following are highlights of our portfolio companies during 2005:

### Equity Investments

Our **Food and Beverage Division**, PepsiCo and Coca-Cola, had a very good year. PepsiCo experienced stellar growth, while Coke's business began a turnaround. In 2005, PepsiCo will report earnings of \$2.65 per share—a projected 14.7% increase in earnings over 2004. In 2006, PepsiCo expects to grow earnings at approximately 10.5%, to \$2.93 per share. Driving this tremendous growth is a powerful engine: A dominant snack food business and a strong beverage business, especially in the noncarbonated market. PepsiCo continues to grow its snack food division. During the 4<sup>th</sup> quarter, the company announced an agreement to purchase two businesses that will expand its presence in the snack food category: Stacy's Pita Chip Co., an all-natural snack company based in Randolph, Massachusetts. This move builds on PepsiCo's better-for-you business segment, which now represents about one-third of PepsiCo's North American sales. In addition, PepsiCo has acquired Sara Lee Corp.'s European nuts and snacks business, which positions PepsiCo to expand its international snack division by adding the Duyvis brand in the Netherlands and Belgium, and the Benenuts brand in France. PepsiCo's snack food business now generates 62% of company revenue and 65% of operating profits.

Volumes at Frito-Lay North America are expected to grow 2.5%, with sales and operating profits up 6%. Similarly, PepsiCo's international snack division has delivered solid results this year, with volumes growing 4%. It is our belief that in 2006, volume growth at Frito-Lay North America will be approximately 3%, and international snacks will grow at 6%.

At Pepsi Beverages North America, 2005 results were better than expected, with sales and profits increases of 9% and 10%, respectively. The strength of noncarbonated soft drinks Gatorade, Aquafina, and Tropicana have been a clear driver of growth at Pepsi's beverage business. Pepsi has also done an exceptional job of creating and introducing trendy new products such as coffee drinks (Starbucks' Frappuccino and Double Shot) and energy drinks (under the SoBe and Mountain Dew trademarks). In addition, PepsiCo has ably catered to the growing demand for healthy beverage alternatives with low- and no-calorie drinks, which now represent about 31% of Pepsi's North America beverage portfolio.

The international beverage business is posting even more impressive results, with sales of both carbonated and noncarbonated beverages growing at a double-digit rate. During 2005, beverage volumes grew 11% with the strength of Pepsi, Mirinda, 7Up, Mountain Dew, Gatorade, and Tropicana. We are excited about PepsiCo's future prospects and look forward to another good year in 2006.

On the other side of the beverage mirror, Coca-Cola continues to recover after a difficult 2004–2005. We have noted Coca-Cola's rough patch during the past 18 months. The company's management team has outlined a strategy to improve the company's performance that includes a focus on:

1. Increasing the marketing of its brands by \$400 million annually, and
2. Aggressively exploiting the fast-growing noncarbonated beverage segment.

Throughout 2005, Coca-Cola posted solid gains in its share of the carbonated soft-drink market, driven by the increase in promotional spending as well as new-product introductions. As part of the increased marketing focus, Coke will be introducing new advertising in 2006. The "Live on the Coke Side of Life" multicultural and multimedia global ad campaign will launch in spring 2006 in several countries with commercials designed to transcend global boundaries.

Coca-Cola introduced 21 new trademarked products in 2005 that target consumer desires. In 2006, Coke will concentrate on expanding its energy drinks in the U.S. ADVANCE by Powerade, TaB Energy, and Full Throttle Fury will double the company's North America portfolio in the fast-growing energy drink segment.

We also expect Coca-Cola to focus on advancing growth in emerging markets such as China. It is estimated that China will contribute an astounding 18% of Coke's estimated volume growth between now and 2010. China is now Coke's fifth-largest market worldwide, accounting for 4% of global volume. Volume has grown at an impressive compounded annual rate of 19% over the past 10 years. Based on China's pace of economic development and Coke's potential for market share gains in noncarbonated beverages, it is estimated that Coke can grow volumes by 15% per year for the next five years. China will likely grow in importance over the next five years, potentially contributing 6% of worldwide volume by 2010 and an eye-popping 18% of global volume growth.

We are excited to watch Coke grow its global business franchise. For 2006, we are expecting Coke to grow its worldwide volume between 3% and 4%, with revenue increasing 5% and earnings growing 8%, to \$2.30 per share. We remain confident in Coca-Cola and believe the company has a very big future and tremendous opportunity in the global beverage business.

In 2005, we added an **Industrial Holding**—Tyco International. Tyco is a diversified manufacturing and service company involved in fire protection systems, electronic components, medical devices and supplies, engineered products (including industrial valves and controls), and environmental and other industrial consulting services. The company also designs and manufactures plastic products, adhesives, and films.

A few years ago, Tyco ran into problems resulting from previous management's dishonest behavior. Since new management took over, Tyco has divested several non-core businesses, replaced all its board members and most of the company's senior management team, reduced its net debt by close to \$15 billion, and delivered improving fundamentals in most of its businesses. The process of regaining credibility and enhancing the business is continuing under Tyco's new CEO, Ed Breen. In the 4<sup>th</sup> quarter, Tyco announced that it would sell its Plastics, Adhesives and Ludlow Coated Products for \$975 million in cash. Although this transaction is not meaningful from a financial perspective, it represents an example of management's intent to create value for shareholders by shedding lower-quality businesses and concentrating on high-quality core concerns.

We believe Tyco's core franchises are healthy and poised for longer-term growth. The company is positioned to generate more than \$4 billion of owner earnings in 2006. This conservatively translates into \$1.90 per share in cash next year. We are excited to be investors in Tyco under Ed Breen and his new management team and will keep members apprised of the company's progress over this next year.

Our **Technology Division**, primarily Microsoft, produced positive results in 2005, but the price of Microsoft's stock remained dormant despite the company's growing franchise. A key question is: When will Microsoft's stock price reflect the increase in the company's intrinsic value? We do not know the answer to this question, except that history has shown it will happen. Our aim is to maintain investments in companies able to grow the value of their businesses at 10+%—a very difficult feat in business—and Microsoft continues to achieve that goal.

So why the stagnant stock price?

The latest reasons concern Google's recently announced alliances with Sun Microsystems and Time Warner Inc.'s America Online unit. Google and Sun Microsystems have forged a partnership to distribute and promote each other's products. The companies have also declared future plans to "leverage" their respective networks to distribute each other's software. For example, customers downloading Sun's Java software will have the option to download Google's toolbar. Google also announced a deal with America Online (AOL) in which Google will pay \$1 billion for a 5% stake in AOL. Terms of the deal would allow AOL to sell advertising among the search results provided by Google on AOL World Wide Web properties.

Analysts' concerns about Microsoft include the following:

1. Google will potentially broaden distribution of OpenOffice/StarOffice with Sun Microsystems, threatening Microsoft's Office franchise.
2. Google will permanently supplant Microsoft in search and software, creating an environment for distributing competitive software products for free (supported by advertising) through the Google search site.

These arrangements present real business challenges for Microsoft. Still, we have confidence in Microsoft's business capabilities. Microsoft plans market introduction of Vista, the next edition of its

operating system, in 2006. Vista has been in development for about five years and represents the longest period to date between new operating system releases for Microsoft. A major reinstallation of desktops and laptops is expected to begin in 2006, with about 40% of responding corporations planning to replace their hardware (and software). Given a stated average reinstallation cycle of four years for desktops and three years for laptops, the introduction of Vista should assist in generating 10% annual sales growth for Microsoft over the next four to five years.

While expanding its business, Microsoft continues to produce more than \$1 billion in cash per month. Microsoft maintains more than \$40 billion in cash and investments on its balance sheet. We expect the company to keep growing and to earn approximately \$1.40 per share during calendar 2006. In our view, Microsoft is still a great organization, and the company will remain a core holding in our portfolio.

Our other technology holding, First Data, had several positive business developments in 2005. J.P. Morgan Chase & Co. and First Data agreed to integrate their jointly owned merchant businesses under a new joint venture. The new business, Chase Paymentech Solutions LLC, will be 51% owned by Chase and 49% owned by First Data. The joint venture has also entered into a five-year deal with First Data Merchant Services, under which it will process about 13.1 billion transactions a year with more than \$500 billion in annual card volume in the United States and Canada—a very positive development for First Data.

First Data also announced a management change, bringing in Mr. Ric Duques as CEO to refocus the company. Mr. Duques recently stated: “My three primary objectives are (1) shareholder value, (2) shareholder value, and (3) shareholder value.” This is music to our ears. We believe the new management team will evaluate First Data’s business portfolio and concentrate on growing those segments that have the greatest future potential. It is also likely that the company will sell business segments that do not have good growth potential.

The crown jewel of First Data is Western Union. Western Union’s business growth continued to accelerate in 2005 as consumer-to-consumer transactions rose more than 15%. It is our opinion that Western Union is well positioned to capitalize on surging migration from non-industrialized to industrialized countries. Migration between industrialized and non-industrialized countries is big business, with \$92 billion in official remittances, according to the Organization for Economic Cooperation and Development, and will continue to flow. Moreover, many countries are increasingly looking to formalize what has often been an underground business. These two trends indicate an attractive opportunity for established and respected brands like Western Union.

First Data produces a lot of cash from fees on each transaction processed through its system. We expect First Data to earn \$2.55 per share in 2006 and to return most of the \$2.0 billion of owner earnings to stockholders through share repurchases. We remain excited about First Data’s prospects and consider it a long-term growth opportunity, as transfer payments increase worldwide and cash transactions lose ground to debit and credit card transactions.

Our **Financial Service Division** had a mixed year in 2005 as our major holding, Berkshire Hathaway, contended with an unexpected large loss from Hurricane Katrina. Berkshire reported that its share of losses associated with Hurricane Katrina would be in range of 3% to 5% of insurance industry losses. Although the full extent of losses are still not known at the time of this writing, a \$60 billion industry loss would translate into a \$1.8 billion to \$3.0 billion impact on Berkshire Hathaway’s 2005 results.

Berkshire Hathaway has more than \$45 billion in cash and cash equivalents on its balance sheet and can easily absorb the unusual toll of Katrina. In fact, Berkshire is far better positioned to absorb this loss than other insurance companies, and this unusual situation could actually end up strengthening Berkshire’s industry position. Insurance companies must raise prices to recover losses, and Berkshire is in the best position to benefit from rising premiums.

As we have stated in the past, we have not lost any confidence in Mr. Buffett’s abilities and refrain from judging performance over a 12-month period (365 days is not an investment horizon). Warren Buffett continues to load his investment gun, and we will adhere to his patient stance. We will also continue to allocate capital to Berkshire Hathaway in this somewhat frenzied market environment. Founders Capital Management considers Berkshire as ballast for our investment ship, and we are secure in Mr. Buffett’s ability to put this cash to good use and generate strong returns for shareholders over the long term.

(We are often asked what will happen to Berkshire Hathaway’s stock price once Warren Buffett is no longer able to carry out his duties as CEO—a good question. Although we believe that Mr. Buffett has

prepared for an eventual transition at Berkshire Hathaway, he seems to be in good health and we expect him to be around for a long time. Our first-hand observations indicate that he is very energetic and focused on the business.)

Our major **Retail Division**, Home Depot, grew approximately 10% in 2005. Although this is a slightly slower growth rate than last year, we remain pleased with the performance of Bob Nardelli and his team. So why are many investors “hammering” Home Depot’s stock price if the company’s intrinsic value keeps growing at a 10% to 12% clip? Looming macroeconomic issues present legitimate concerns for Home Depot’s short-term profitability, such as a slowdown in housing starts and rising interest rates. Home Depot’s technology investments are beginning to pay dividends by driving improvements in every facet of the business, however, and the company continues to benefit from centralizing operations. This improving technology is leading to better labor productivity, improved distribution, and more dynamic merchandising, which all leads to higher profitability and improving returns, in turn offsetting any economic impact slower growth may have on profitability.

As Home Depot continues to build its internal infrastructure, the company is cementing the next building block by taking advantage of opportunities in the services, professional, and maintenance and repair markets. Home Depot refers to this collection of business segments as “Home Depot Supply.” This is a potentially very large business that merits discussion. HD Supply revenues are growing at around 25% and are projected to reach an estimated 5% of Home Depot total sales in 2005 (up from 3% in 2004). These markets are attractive due to their high fragmentation and lower capital investment requirement, and the ability to leverage Home Depot’s existing infrastructure and gain cost synergies. The current components of HD Supply encompass:

- **Apex:** Wholesale supplier of plumbing, HVAC, appliances, and other products, with 26 locations.
- **Your “other” Warehouse:** Distributor of plumbing, lighting, and hardware supplies, with five distribution centers.
- **HD Builder Solutions Group:** Service provider that supplies products and arranges installations for builders through 27 locations. Services include flooring and countertops, with current expansion into lighting and cabinets and plans to offer window treatments.
- **White Cap:** Distributor of specialty hardware, tools, and materials to construction contractors through 80 locations. White Cap commands the number-one market share in a highly fragmented industry, with more than 20,000 companies.
- **HD Supply’s Maintenance Solutions:** Provider of maintenance, repair, and operating products to the multifamily, lodging, and hospitality industries through 20 distribution centers. HD Supply is expected to expand its share in the \$15 billion maintenance and repair market.

Clearly, Home Depot is evolving quickly and is also looking at international opportunities. The company estimates the “do-it-yourself” market outside the U.S. at \$250 billion (the U.S. market is \$200 billion), with China representing \$50 billion and growing five to six times faster than the U.S. market. Home Depot is currently exploring opening stores in China through both acquisitions and normal operations. We believe the global Home Depot story is just beginning to build, and we’re excited to hear about future developments.

Our **Media Division** continued to grow in 2005 as we added a few more companies to our portfolio. We believe the key to a successful media company lies in providing “great content” to consumers. For example, each time Disney produces a blockbuster movie, it places the content into the company’s so-called vault. Every so often, Disney removes one of these great movies from the vault and reissues it to consumers all over the world (on DVD today, or On Demand in the future). Question: Do you think your grandchildren and great grandchildren will watch *The Lion King*—and will you pay for the content? The answer is most likely a resounding “yes.” The Disney movie library represents an ongoing annuity that is very valuable—no matter the medium in which it is shown. In fact, it is so valuable, it is challenging to put a price tag on it.

In contrast, the “new” media companies like Yahoo! and Google have little or no content. Yet the price tags for these companies (if you purchased all outstanding shares) would total \$185 billion. That same \$185 billion would buy *all* of Disney, Viacom, Liberty Media, and Gannett—with around \$50 billion left over to buy 60% of Time Warner. We believe our concentrated investments in great content providers will pay off handsomely in the future. Disney, Liberty, Comcast, Viacom, and Gannett are all media companies that supply the daily news, stories, movies, and shows that we read or watch each day. Many individuals

believe newspaper and broadcasting companies will “permanently” give up all advertising revenues to Internet sites such as Google and Yahoo!. We do not subscribe to this extreme view. “Content”—news, programs, movies, etc.—is what will drive advertising in the long-term media business. As our media holdings continue to build upon their great content, we feel our holdings will reap rewards over the long-term.

Our **Commodity Holdings**, led by Barrick Gold, Central Funds of Canada, and Chevron, ended with a good year. The rationale underlying our commodity purchases are addressed in the preceding discussion—high trade deficit, budget deficit, consumer debt, etc.—which could lead to a long-term devaluation of the U.S. dollar. A natural adjustment to the U.S. dollar relative to other world currencies will eventually bring our trade deficit in balance as U.S. goods become less expensive to foreign nations. But until the U.S. government executes a plan to lower the budget deficit, and U.S. citizens begin to pay down debt and raise their savings rate, the dollar will most likely weaken over time against other currencies. This devaluation is due to the fact that foreign investors, as the primary purchasers of our debt, have assumed the role of banks. If Americans owed each other, the dollar devaluation would be less likely because the investment interest earned on borrowed money would stay within the U.S.—that is, one American’s loss would be another American’s gain. This is clearly not the case today, with foreign investors of the recipients of our interest income. We do not see a quick fix to these various issues and believe it is highly probable that the U.S. dollar will lose value in the long term as our nation continues to overconsume. As the U.S. dollar weakens, it costs more dollars to purchase an ounce of gold, silver, or oil. Thus, in real dollar terms, these commodities rise as the U.S. dollar weakens.

With this said, the close inverse relationship between the price of gold and the U.S. dollar has weakened this past year, with the gold price largely remaining above \$450/oz. during a period in which the U.S. dollar strengthened substantially against the Euro and other currencies. While in our view changes in the U.S. dollar will continue to be an important factor in determining the direction of the gold price, it is increasingly not the only issue driving the price of gold. For example, concerns regarding the worldwide economic implications stemming from a \$60+ per barrel oil price and \$11.00+ per mcf natural gas price are other factors that support an argument for higher long-term gold prices. And finally, the danger of inflation has risen and will also impact the price of gold as investors use this metal as a psychological “hedge” against inflation.

Barrick, our major gold holding, continues to build a new generation of mines around the globe and has the lowest total cash costs among the major gold producers. In 2005, Barrick announced that the new Veladero mine poured its first gold. Veladero is one of two Barrick mines commencing operations in early 2006. Cowal is also scheduled to start production in the 1<sup>st</sup> quarter, 2006. The second half of 2006 should be strong due to the contribution from the Lagunas Norte, Veladero, and Tulawaka mines, which all commenced production in 2005. Barrick is poised to grow gold output from between 5.4 million and 5.5 million ounces in 2005 to nearly 7 million ounces by 2007. This represents a compound annual growth rate of 12 percent.

During the 4<sup>th</sup> quarter, Barrick initiated a transaction for Placer Dome, a large gold company with 17 mines in seven countries. Collectively, Placer’s operations yield more than 3.5 million ounces of gold annually. Two copper mines that produced more than 400 million pounds of copper in 2005 complement Placer Dome’s gold business. Under the terms of the offer, Placer Dome shareholders may elect to receive \$22.50 in cash, or 0.8269 of a Barrick common share, plus \$0.05 in cash, for each Placer Dome common share, subject to pro ration based on the maximum amount of cash and Barrick common shares offered. In any acquisition, we evaluate the intrinsic value of what we are giving versus what we are getting. It is our opinion that the Barrick offer for Placer Dome represents a fair exchange. We will keep you up-to-date on this transaction as it is finalized in 2006.

Our investment in Chevron, a leading international integrated oil and gas company with operations worldwide in a variety of energy segments, has fared well due to rising energy prices. (We should be careful of what we wish for here.) In light of the quick spike in Chevron’s stock price, we should reiterate our long-term view: First, Chevron’s acquisition of Unocal precipitated a significant decline in stock price, reflecting market sentiment that the price paid for Unocal was too high. Our calculation was that the Unocal acquisition price was fair and that the value of Chevron should not have declined, especially considering the valuable reserves Unocal holds in Asia. Since our initial investment, the market has adjusted to reflect our view, and Chevron’s value has recovered. Second, it is our opinion that the price of

oil will plateau at a higher level in the future than it has in the past, as the growth of economies such as China's and India's leads to increased energy demand. The current valuation of Chevron does not reflect higher long-term energy prices. We plan to hold Chevron in our portfolio until higher oil prices are reflected in the company's valuation.

### **Fixed-Income Investments**

Over the past two years, we have emphasized several points of concern about fixed-income instruments that remain unchanged: Lower-than-normal interest rates, high consumer and government debt, a shifting economy, and ongoing geopolitical issues. We have also discussed a risk associated with this "secure investment vehicle" that has not changed—the possibility of default.

At the end of 2004, we reported that we had not seen a significant rise in interest rates, and it initially looked as if our sale of longer-term bonds in 2003 had been premature. Things changed in 2005, however, as short-term interest rates rose from 2.25% to 4.25%, causing the average bond investor to experience a slight 1.7% gain in 2005. Although in the end there was a small gain in the bond market, throughout most of 2005 the average investor experienced a loss in the fixed-income market. We have chosen to avoid this exciting roller-coaster ride by investing our fixed-income proceeds in higher-yielding short-term bonds. As we've stated before, we remain comfortable giving up volatility in favor of maximizing our fixed-income yield, while at the same time avoiding the risk of losing principal due to rising interest rates.

In 2006, we plan to stick with our strategy of avoiding longer-term fixed-income investments, which are more sensitive to rising interest rates. We will remain committed to placing our proceeds from maturing bonds in shorter-duration fixed-income securities. As shorter-term corporate and government bonds come due, we continue to reallocate this money to the highest-yielding, safe, short-term bonds we can find. This "let's be safe rather than sorry" attitude reflects our motto when investing in fixed-income instruments: *First, protect principal*. Given that principal on fixed-income securities moves in the opposite direction to interest rates, we are extremely concerned that a continued rise in interest rates could significantly impact the value of long-term bonds. It still does not make sense to us to accept the paltry 4.4% yields offered on 10-year government securities, and we are unwilling to risk losing significant sums of money to "guarantee" a similar yield to short-term bonds in trade for more than nine years of investment. We will patiently persist on our disciplined path until we find longer-term opportunities for our money to achieve higher returns, in exchange for a fair risk. In the meantime, we are happy to earn more than 4% on our short-term fixed-income securities, as this is equivalent to returns available on longer-term issues.

## WHAT'S NEW AT FOUNDERS?

We have had an interesting year at Founders Capital Management. During 2005, we became involved in several exciting projects. We are privileged to be working with DIC Entertainment and Warren Buffett on a TV/video series focused on teaching children how to budget, save, and invest. DIC Entertainment provides quality entertainment to children around the globe and has brought such characters to the screen as Inspector Gadget, Sonic, and Strawberry Shortcake. DIC also collaborates with Berkshire Hathaway in producing a segment of the film shown at the annual Berkshire Hathaway shareholders meeting (we will be there again this year).

Founders is also working with the University of Connecticut's Family Business Program in helping family businesses manage their organizations through challenging and competitive times. We admit to an ulterior motive: As Founders Capital Management grows, we are interested in promising investment opportunities in private enterprise. Our criterion for private investments is similar to any public investment: We are attracted to businesses run by talented managers that exhibit excellent long-term economics, in which we can become a minority owner at a reasonable price. (We have attached a letter to this report that we recently sent to a private business owner who is building an excellent franchise.) Of course, finding "excellent businesses" run by talented owner/managers, whether public or private, is like finding a needle in a haystack. So when we identify one of these rare needles, Founders will pursue an investment opportunity. Although we may be extremely picky in our choices and our pursuits will many times temporarily fall on deaf ears, we will not allocate money to any concern that does not meet our strict investment criteria.

Finally: Our new website is up and running. Check it out at [www.foundcapital.com](http://www.foundcapital.com). Our goal is to provide you, our partners, with a user-friendly communications forum and account management tool. Through the website, you may access your account, read our quarterly and annual investment letters, and access other valuable information. We are always striving to serve you better—so please don't hesitate to send us your suggestions.

Thank you for the opportunity to serve you and for your continued trust. We look forward to working on your behalf during 2006.

**Answer to riddle on page 3: "*Which road goes to your village?*"**

Dear \_\_\_\_\_,

The following are some thoughts regarding my visits to \_\_\_\_\_ over the years.

Many owners spend a lifetime; passionately creating a business that builds a unique relationship with each individual customer. Behind the scenes, an exclusive customer connection is associated with a relentless pursuit of offering the highest quality products, while providing an atmosphere for a different and unmatched experience. It is my observation that \_\_\_\_\_ possesses passionate owners and associates who are focused on providing the highest quality products, along with a unique customer experience that is difficult to duplicate.

Owners of successful businesses such as \_\_\_\_\_ spend an inordinate amount of time managing the many challenges associated with continuing to build their company to even higher levels. They may receive advice from various professionals, and are often faced with pressure to “trade-off” philosophies that may conflict with the original long-term view to build their business. During the past decade, investment professionals have been enticing owners to look through what I call the “hopeful eye.” The hopeful eye is a disguised sales pitch that provides owners with a glimpse of working with private investment firms that will eventually bring the company public, and allow all owners to participate in the “New Future.”

Practically, most private investment companies will fall into one or two categories:

- (1) An investment company that will “pool” the assets from many individual customers and invest the money in a large basket of private companies – usually several dozen – in order to diversify risk. The portfolio of investments, and the partnering owners who are basically money managers, change frequently.
- (2) A financial concern that caters to investing in private companies that invariably operates with large amounts of borrowed money, which leverages accumulated assets in order to maximize returns. These so-called private investment funds command a significant portion of the appreciation of the business, and make claims of managing risk through the careful use of exotic financial arrangements.

Founders Capital Management is a different kind of investment company. We consider ourselves unique because we are agnostic regarding the market for businesses and its direction. We personally make all capital allocation decisions, and do not rely on investment banks or other advisory firms to evaluate our investment opportunities. We fundamentally seek to become a minority part owner, at a fair price, in a company with excellent products, and a promising future. Most importantly, we have a desire to partner with honest and able majority owners, who possess exceptional management capabilities. Deferring business judgment to current owners is significant, because we do not have any newly minted MBA’s or managers set in the wings to run businesses. Our expectation is the business would be run in the future using the same principles as in the past.

Lastly, in contrast to “buy em now-sell higher later,” or momentum investing styles, we also apply a very long-term outlook and acquire portions of companies that we intend to hold for many years. We are extremely picky in our choice of investments, and while our opportunities are limited in scope, we are patient and ready to make a commitment when the right opportunities present themselves.

\_\_\_\_\_ has an extraordinarily bright future (you probably realize this). If you decide to seek additional capital to continue the growth of your business, we would like to be considered as a possible minority partner. Our interest is a \$2 to \$3 million commitment. We do not believe in exotic agreements that give us a preferred distribution of funds with warrants attached, etc. We actually prefer a straight equity investment without any strings attached, and leave you to manage the company. We will not pester you regarding an investment opportunity, as we understand the focus needed to continue building a successful business.

In the meantime, if you have any questions regarding Founders Capital Management, please do not hesitate to contact me at the following phone number – 860-731-0801.

## FOUNDING PRINCIPLES

***We regard Founders as a collection of members with a unique attitude toward investing.*** Although we are not a partnership, we consider ourselves partners with our members, and we invest our own wealth alongside that of our clients. (In other words, we “set ourselves around the same table.”) This unique approach ensures that we treat our members’ wealth the way we would like to have our own wealth treated and provides our members confidence that we are using the most effective methods to achieve our goals as we mutually build long-term wealth.

***Founders takes active and direct control of managing wealth*** and makes all investment decisions. Founders offers a fee-based investment service and purchases securities directly for our members. There is no conflict within our firm—the client comes first. There are no “hidden” commissions or fees within a portfolio. We seek to minimize trading and to identify the best execution strategy when purchasing a security.

***Founders focuses on risk management when managing wealth.*** Risk management serves as a foundation for successful investment. We believe it is extremely important that investors understand the risks they are taking when investing in securities. It is important to directly match an investment portfolio to risk tolerance, as a mismatch can lead to volatility that is uncomfortable for our members. We invest in quality securities at the right price that will be held for a period of years. This enables Founders to monitor investments more closely than if they were in various mutual funds with constantly changing positions, and to maintain lower investment management fees.

***Founders has a distinctive viewpoint—one that is rooted in seeking long-term value.*** Founders’ investment practices are value-based. We are disciplined and make investment decisions only after we have thoroughly measured the long-term value of a stock and/or bond. We are agnostic about the market and its direction, and we apply a rational thought process when we acquire any security. Our goal is to purchase quality securities that will obtain the highest compounding yield over the greatest length of time, ensuring that we have a “margin of safety” on each individual investment.

***Founders fully communicates with members and assists them in achieving their investment objectives.*** It is our opinion that members benefit from a fiduciary and due diligence standpoint if they receive a high level of communication and commitment from the managers they have chosen to invest their funds. We are committed to keeping members informed of our investment choices, and we are open about reporting the pros and cons of each investment.