Second Quarter, 2010 Overview

The S&P500 lost 11.4% during the 2nd quarter, 2010 and is down 6.6% for the first half of the year – reversing the upward trend experienced over the previous twelve months. The 2nd quarter's negative result was associated with a recurrence in market volatility, as the S&P500 gyrated between 1220 and 1028 over a 90-day period. As this letter is being written, the S&P500 has risen over 50% from the March, 2009 low – still quite a run. However, with the large rebound in the stock market, investors are queasy as they have not yet recovered from the sickly ride experienced during 2008 and early 2009. In fact, in our opinion, some of the recent downfall in the stock market is due to investor fear – many pundits are screaming "sell now, the market is going to revisit the previous lows!" One market technician – a "fortune teller" that reads stock market charts and predicts the market's future movement, is stating that stocks fall 90% from here. We will address these extreme thoughts in our letter. In the end, it remains a wrenching environment for investors as they have not forgotten the sting of a major market fall, and may not forget it for many years to come.

The rational explanation for a setback in the stock market during the 2nd quarter is focused around two points: First, the economy's recovery is slightly lower than anticipated, and investors are now expecting company earnings to rebound gradually. As a side note – we have not changed our view about a projected slow economic recovery from the very beginning. Second, throughout 2009 and the 1st half, 2010, many investors flocked to fixed-income investments in order to obtain moderate returns during an uncertain environment. As a result, fixed-income investments have risen significantly in the past eighteen months. Over the next several years, we believe this trend will be reversed, and many fixed-income investments will underperform other asset classes such as equities on a risk to return basis.

We repeat from our previous letter – *Although the markets have been successful in generating a "significant rally" during the past fifteen months, any rally is "still" suspect due to lingering risks in the financial sector. It is important to note that the equity and fixed-income markets will continue to undergo a long-term "deleveraging" process brought about by financial institutions who borrowed too much money to enhance returns. Therefore, we will most likely continue to see random price movements in both the stock and fixed-income markets during the next few years—along with a high degree of volatility.*

This leads us to our usual statement, which we continue to evolve as market conditions change:

> **With today's uncertain environment of prolonged low interest rates, opaque financial markets, volatile commodity prices, high amounts of consumer and government debt, a bloated trade deficit, large currency imbalances, and ongoing geopolitical issues —investors (including professional) *remain extremely cautious.* At current prices, we believe our *equity holdings* to be slightly undervalued.**

As usual, this is not a general statement on the short-term direction of the stock and fixed-income markets. You should note, however, that we continue to *omit* fixed-income securities from our statement. As we stated previously, most fixed-income securities have risen considerably in the past fifteen months, and the current longer-term yields between 2% and 4% will not offer outsized returns going forward. We think there is now an imbalance between risk and return in the fixed-income field, and this area is somewhat overvalued compared to stocks.

Fixed-Income versus Equity in a nutshell – An investment in a 2-year risk-free U.S Government bond currently offers the purchaser an annual payout rate of 0.6%– not that great would be an understatement. However, an alternative investment in the S&P500 index offers an annual dividend yield of 2%+, and a 2010 earnings yield of around 6.5%. Therefore, we believe that an investment in the stock market today clearly provides a better return than an alternative investment in government bonds.

The Great Imbalance

Many economists are referring to the recent recession as a balance sheet recession. A balance sheet recession occurs when individuals, corporations, and governments incur so much debt that their liabilities closely resemble, or exceed their assets. At this point, everyone begins to minimize debt because of balance sheet problems, making government monetary policy useless. If a balance sheet has negative equity due to liabilities that exceed assets – an entity will cease borrowing more money, and due to increased default risk banks will stop lending money – no matter the interest rate. The only way to deal with an economy that has an overall balance sheet problem is for the government to spend in order to stimulate economic growth. And governments throughout the world are spending, and spending – and will continue to spend until things turn around. (Be prepared for additional stimulus packages in the upcoming months in order to reinvigorate a slowing economy.)

But, how effective is this global stimulus? Although economically necessary, we are unsure that excessive government spending will be successful in stimulating enough economic growth to bring us back to the good times experienced in the 90's. Why? Because an economic stimulus must be accompanied by an expansion of credit to experience sustainable growth – and no one is borrowing, or lending out additional money.

Our opinion is that we are not experiencing a balance sheet recession, but an "imbalance sheet recession." Too many important economic areas are at extremes, and until these areas are brought into balance, it is likely that any stimulus to jump start economic growth will sputter. We anticipate a long period of time, perhaps ten or so years, to rebalance the following areas that are now at extremes:

Labor – we currently have a labor surplus as unemployment is hovering around 10%, and despite moderate economic growth, we expect chronically high unemployment throughout the rebalancing decade. A recent *Wall Street Journal* article stated that nearly half the jobless – approximately 6.8 million – have been out of work for more than six months. The more relevant statistic is that over 60% of this jobless figure (4.3 million) has been out of work over one year – despite the recent economic rebound. A reason behind the scenario of economic recovery coupled with continued high unemployment is due to increased productivity from retained workers who stay nervous about additional company layoffs – companies are getting more with less labor.

Executive Pay – A chief executive officer of a Standard & Poor's (S&P) 500 index company was paid, on average, $9.25 million in total compensation in 2009. As millions of workers lost their jobs, their homes and their retirement savings in the worst financial crisis since the Great Depression, top executives now earn over 250x the average worker – an historical difference. (Executives are not financially suffering.) For reference, during the 60's top executives earned around 25x the average American worker, and this increased to 35x in the 70's, 70x in the 80's, 145 x in the 90's, and over 200x after the turn of the century. Many CEO's of foreign companies are paid at 20x the average worker. American executive pay is at an extreme when compared to the pay of an average worker.

Housing – We still have a flood of about 2.5 million houses on the market today. Under normal circumstances, with approximately 1.3 million new U.S. households created each year, it would take around two years to absorb this extreme excess of housing inventory. However, we are not in ordinary times. In fact, *The Wall Street Journal* recently cited the number of people that have "strategically defaulted" on their mortgages during the first half of 2009 (a lag period) – 355,000. Basically, these homeowners stopped paying their mortgages even though the payment was affordable. With extreme behavior taking place, such as having it become socially acceptable to renege on your debt obligations, it may take many years to absorb the excess housing inventory.

Commercial real estate – There is $3.1 trillion of outstanding commercial real estate loans, of which $1.7 trillion is held by 3,000 banks and thrifts. This large amount of real estate debt was supplied by banks that supported extreme refinancing which removed largely 100% of the equity from existing properties. Now, this debt is coming home to roost – vacant office space continues to accumulate as businesses pull back on their growth plans. Office buildings lost 1.8 million square feet of occupied space in the last 90 days, pushing the office vacancy rate to 17.4% - the highest level since 1993. As 80% of commercial real estate debt matures over the next 42 months, we can expect additional financial pressure on banks, along with a pull back on commercial real estate development. It may take up to ten years to absorb the excess space that exists in many cities across the U.S.

Government debt (Federal, State, Local & Global) – United States federal, state and local governments, as well as many developed country governments throughout the world are now mired in debt. The eurozone crisis is playing out as we speak, with a €110 billion bailout of Greece and €750 billion of standby credit to support weak countries like Spain, Portugal and Italy. The soaring government debt of the sixteen member currency bloc will force the eurozone countries to cut back on government spending, stifling economic growth throughout the region. Fiscal restraint in Europe will negatively impact America's growth as exports remain tepid. Recent eurozone financial trouble, although known for some time, is creating angst as pundits think we are heading for a double-dip recession. We're not so sure about that – emerging economies such as China, whose gross domestic product (GDP) is growing annually at 10+%, will likely offset the slowdown in the eurozone. With this said, U.S. local governments are beginning to experience tremendous fiscal stress. Local U.S. governments receive one third of their revenue from property taxes. As assessments catch up with declining housing prices and commercial property values, local government revenues will continue to fall in the upcoming quarters, adding to their lost tax revenues. Governments throughout the world are facing a once-in-a-generation shock, and these economic extremes need to become balanced for global growth to resume.

Consumer debt – A recent Federal Reserve report indicated that consumer credit card debt was reduced by $7.4 billion (10.5%) in the month of May. Nevertheless, total consumer debt (which includes mortgage, credit card, auto, and other loans) is 124% of average household income. This is a change from approximately 65% during the 1980's. Many have quoted the statistic about the average American household holding over $8,000 in credit card debt. This statistic is more telling when dissected. Over 50% of American households have no credit cards, or pay off their credit cards in full at the end of each month – a good number. However, this also means that the average American household that maintains a monthly credit card balance owes over $15,000. According to VIP Forum Analysis, over 35% of households that hold over $10,000 in credit card debt, earn less than $50,000 per year. This extreme liability on a large portion of American households will take many years to payoff – especially if annual interest rate charges on credit card debt remain above 15%.

Trade – Although foreign trade makes up a small portion of the U.S. economy, it is still a source of economic growth. Unfortunately, the U.S. remains a "net importer" of goods as exports are approximately 11% of Gross Domestic Product (GDP) and imports are 13.7% of GDP. In essence, this 2.7% difference ultimately represents a slow sale of the United States to foreigners. Unless this rising trade imbalance is reversed over time, the United States remains akin to a business owner who originally owned all his assets, and then decided to sell off a small portion of his business every year to subsidize ever increasing spending habits. Sooner or later, the business owner loses control of the enterprise, and in a worst case scenario will have nothing left to sell.

Currency – As America imports a larger amount of goods, more U.S. dollars end up in the hands of foreign governments – creating an imbalance of currencies throughout the world. Due to our ongoing appetite for cheap Asian goods, China has now accumulated approximately $900 billion of U.S. dollars – turning around and investing this money in U.S. Treasuries. At this point, the U.S. is becoming more dependent on the kindness of strangers – hoping that foreign governments continue to recycle their accumulated dollars by lending this money back to the United States at less than average interest rates. Unfortunately, the price of righting this currency imbalance could lead to higher interest rates as foreign governments attempt to diversify from the U.S. dollar. One way foreign governments can diversify from the dollar is through a sale of their U.S. Treasuries – further stifling U.S. economic growth.

Global monetary policy – Central Banks throughout the world are slowly socializing private debt to save their economies and the banking system. We have now witnessed the U.S. Government's direct bailout of organizations like General Motors and AIG, as well as purchasing $1.25 trillion in mortgage related securities to save the banking system. The European Central Bank is faced with similar bailout dilemmas with sovereign nations like Portugal, Italy, Greece, and Spain. All central banks realize this vast amount of excess reserves cannot remain in the system indefinitely. However, they have no immediate intention to remove this money from the financial system. If failing economic recoveries ensue, central banks may eventually need to monetize this debt through purchases of government bonds – potentially adding tremendous amounts of money supply and creating a further imbalance in the global monetary system.

Regulation – In past letters, we have described the normal evolution of independent financial markets that went into fast-forward, creating a revolution in the global financial system which officially became interconnected. However, regulation of financial markets remained independent with each nation enforcing their own particular security laws that rapidly lost relevance in the fast-changing interconnected financial universe. Recently, legislation was passed in the U.S. that addresses the imbalance between modern market activity and the financial regulation needed to enforce the "rules of the road." (We will discuss some of this financial regulation in our future letters.) Needless to say, the new financial regulation is a step forward, but does not go quite far enough. Unfortunately, the problem isn't with the rules that we don't understand, it's the rules that we do understand that present a dilemma. As the new legislation makes its way to regulators, bankers are quickly lobbying to "water down" any rules that restrict their ability to use depositor and shareholder capital to maximize returns – for themselves. In addition, the U.S. centric financial regulation being introduced will likely not make its way throughout the global financial system – leading to potential imbalances as global banks find further ways to circumvent the new U.S. financial industry rules.

Market trading – We have previously discussed the hedge fund industry and how the lack of regulation in this area contributed to the market turmoil. A quick refresher: Hedge funds have a stated goal of minimizing investment risk while maximizing gains. A simple hedge fund attempts to evade the risk in a portfolio, for example, by selling certain stocks short (i.e., betting that these securities will decrease in value) while purchasing other stocks long (i.e., betting that the value of these securities will rise). Hedge funds also (ab)use leverage – borrowing up to $20 for every $1 invested in the fund. Largely due to this area of the market's attempt to maximize returns for investors, hedge funds trade in-and out of stocks quickly. In fact, the average stock on the New York Stock Exchange is held slightly more than eight months vs. over eight years in the 1960's. Adding to this trading insanity, most hedge funds use computer software to recognize market inefficiencies, and to automatically trade to take advantage of supposed disparities. As a result, over 30% of the daily trading on the NYSE today is accomplished via program trading – with minimal human intervention. This type of feeding frenzy was a contributor to the now infamous May 6th "flash crash," whereby the Dow Industrial Average lost almost 1000 points in minutes. This imbalance of extreme trading is causing fits and starts in the market, and is divorced from any economic reality underlying the companies these stocks represent.

The ultimate danger – with so many extremes occurring throughout the global economic system individuals, companies, and governments are beginning to *think and react* in extremes:

- Aggressively cutting back expenditures when fearful, and then spending aggressively when confident
- Buying up bonds in fear of deflation and a gyrating stock market, pushing interest rates to multi-decade lows
- Seeking profit by quickly buying-in and selling-out of the stock market – frustrated with low returns

Ultimately, individuals, companies, and countries are reacting in self interested ways, while trying to insulate themselves from global turmoil. This extreme thinking, coupled with extreme reaction is the greatest danger of all, and needs to be brought into rational balance to achieve a sustained economic recovery.

The ongoing question – Where are the markets going in the second half of 2010?

As we constantly state – Founders Capital Management is unable to provide a clear answer to questions regarding any market's near-term direction. The mixed emotional display surrounding the equity and fixed-income markets forces us to remain agnostic to any market's short-term movements, and instead keep our eyes open for opportunities that emerge in a still volatile environment – we will remain rational. In the end, we place continued emphasis on our confidence that we have acquired securities at prices that will provide us a fair return over time (despite gyrating markets). This includes investing in fixed-income instruments that offer a risk/reward relationship that is commensurate with our expected returns, as well as purchasing portions of individual companies through the equity market that we believe offer us a long-term ***margin-of-safety***.
"We will continue to price, rather than time, our purchases. In our view, it is folly to forego buying shares in an outstanding business whose long-term future is predictable, because of short-term worries about an economy or a stock market that we know to be unpredictable. Why scrap an informed decision because of an uninformed guess?- Warren Buffett

At Founders Capital Management our activity remains deep-rooted in seeking investment simplicity – investing in securities we know and understand, and in assets where we can estimate an intrinsic value. We also manage our portfolio to avoid excessive trading. We are engrained to identify developing risks – even in areas that have not yet erupted. We strive to invest for the long-term, and to concentrate on a distinction between what is *knowable and important*, versus knowable and unimportant or important and unknowable. We understand that emotional stability and thinking independently from the crowd eventually leads to success, despite the random behavior of prices in the market.

Our portfolio represents a collection of great businesses, trading at better than fair prices that continue to gain value every day. Berkshire Hathaway, Coca-Cola, PepsiCo, Microsoft, Johnson & Johnson, Comcast and our other holdings, continue to grow their businesses independent of the short-term gyration in their stock quotations. The following are some ***highlights*** in activity for our business groups, along with our expectations for the rest of 2010.

Consumer Group

Our primary consumer holdings—Coca-Cola, PepsiCo, Procter & Gamble and Kraft—had a very good 1st half, and we expect good results for the remainder of 2010.

Our combined consumer group represents a global powerhouse business that will generate over $25 billion of cash for shareholders in 2010 – continuing to do well in a challenging economic environment. We believe that each of these four holdings will grow their annual sales and operating profits in 2010 between 3% and 12%. In addition, the average annual dividends being distributed to shareholders for these combined businesses currently equals 3.3% – better than the 1.76% one can earn through an investment in 5-year U.S. Treasuries.

We remain committed to a long-term investment in this group due to a consistent purchase pattern among their product categories that creates an efficient revenue and profit stream. The worldwide consumption of Coca-Cola, PepsiCo, Procter & Gamble and Kraft products, coupled with consistent purchase patterns and high product turnover allows these companies to effectively utilize assets, and to produce increasing profits and dividends for shareholders – whether in robust or difficult times. The art of making Tide®, Crest®, Oreo's® or concentration syrup for Coca-Cola and Pepsi products has not changed in decades which means associated property, plant, and equipment last for years. During difficult economic times, these companies can defer large capital expenditures. This is very important, as these businesses can increase their penetration in growing parts of the world with minimal reinvestment, as consumers in more mature economies are forced to curtail purchases in challenging times. An economic downturn creates long-term strength for our consumer product companies – and these businesses are getting stronger every day.

Industrial Group

Our primary industrial holdings—United Technologies Corporation and Lockheed Martin are performing well in 2010 as the economy rebounds from the recession.

During the 1st half of 2010 we purchased Lockheed Martin, replacing Burlington Northern which was purchased by Berkshire Hathaway. In total, we slightly raised our industrial holdings through Berkshire's full ownership of Burlington Northern and our addition of Lockheed Martin, a $45 billion global security and information technology company. As we emphasized in our 1st quarter letter, the majority of Lockheed Martin's business is with the U.S. Department of Defense and U.S. federal government agencies. Lockheed Martin is the largest provider of IT services, systems integration, and training to the U.S. Government. Lockheed Martin's business is also comprised of international government and some commercial sales of their products and services.

Infrastructure businesses such as UTC and Lockheed Martin perform well during tough economic times as each possesses a cemented infrastructure that is difficult to remove and/or duplicate. For example, it has taken more than a century to build the U.S. rail and defense infrastructure, and it would take a substantial amount of time and capital to create alternative organizations with expertise to compete with UTC and Lockheed Martin. Although infrastructure businesses are somewhat capital-intensive compared with most consumer-product businesses, certain attributes make this type of investment attractive in the current environment. Any increase in long-term spending (and revenue) over an established infrastructure that is difficult to duplicate spells higher profits for companies such as UTC and Lockheed Martin.

When facing a challenging global environment under stressful times, companies strive to become more efficient through their use of rail transportation versus more expensive trucking, and countries continue to invest in defense projects to protect their citizens and economic infrastructure. For example, Lockheed Martin will receive a long-term benefit from the $380B F-35 Joint Strike Fighter program – this order for over 3,000 fighter jets will replace retiring military aircraft and will be a vehicle of growth for Lockheed over the next 5 years.

With improving economic conditions, United Technologies and Lockheed Martin are expected to be very profitable during 2010. We will remain committed to these industrial businesses as the average annual dividends being distributed to shareholders of our defense businesses currently equals 2.9% – again, better than the 1.8% one can earn through an investment in 5-year U.S. Treasuries.

In addition, we believe these businesses have gained competitive advantage during the recession, and are poised to grow significantly in the future.

Healthcare Group

Our primary healthcare holdings, Johnson & Johnson and Medtronic achieved profitable growth in the 1st half, and we expect these medical businesses to grow their operating earnings throughout 2010. .

J&J and Medtronic will grow their combined sales and earnings per share at approximately 4%, and 10% respectively in 2010. This result provides both firms cumulative sales and profit growth through the recession. J&J and Medtronic continue to concentrate on markets outside the U.S., and we expect growth in overseas markets to propel these companies forward during the next decade. The most significant growth opportunity in the upcoming years will be from the so-called BRIC countries—Brazil, Russia, India, and China.

We will remain committed to a long-term investment in this group as these companies share similar attributes to consumer companies such as Coke and Procter & Gamble. Healthcare companies make goods that experience a consistent purchase pattern among their product categories. As with the consumer group, this creates an efficient revenue and profit stream under all economic circumstances. As a side note – we expect our healthcare companies to perform well throughout the healthcare reform implementation. In addition, the combined dividend yield on our healthcare group is approximately 2.7%, exceeding the yield opportunity given on an investment in 5-year U.S. Treasuries.

Technology Group

Our technology holding, Microsoft, is emerging from the recession storm better than most companies as consumer demand for smartphones, tablets, PC's, notebook and netbook computers exceed expectations. The market for personal computers is rising, even as demand for new devices such as smartphones and the Apple iPad takes place. Technology market researcher Gartner Inc. projects a 20.3% jump in global PC unit shipments this year, aided by a nearly 29% increase in the home computer market. Microsoft is a big winner as a primary provider of software to technology devices, and we expect the company's growth in 2010 to reflect increasing consumer demand for software across all platforms.

We have emphasized previously that software is not a capital-intensive business, and Microsoft is positioned for consistent growth as long-term world demand for computing continues to increase. Additionally, Microsoft is at the beginning of the new product cycle that will significantly add to its sales and profit growth over the next 48 months. The company is rolling out their next-generation operating system – Windows 7 – for consumers and businesses, and Office 2010 is being offered to both groups in the 2nd half of the year. As a result of this new product offering, we are anticipating consumers and businesses to continue refreshing their technology with Microsoft's new products.

Microsoft remains a perfect example of a company that we believe displays a disparity between its market price and intrinsic business value. We estimate that Microsoft's intrinsic business value per share has doubled over the past five years. During this same time frame, the company's stock price has not moved—and we believed that Microsoft was selling at a fair price five years ago! How does this incongruity between market price and intrinsic value develop? In Microsoft's case, extreme investor pessimism remains about the company's future – some of it is justified. Many pundits question the importance of Microsoft's basic operating system in the future Internet-based computing world, and as consumers move to "alternative"

devices like smartphones and computing tablets. We do expect competition in the operating system and device areas – Google has a new operating system (Chrome), along with their Android phone operating system. Apple continues to grow their market share of the smartphone market through the iPhone, and has just launched the iPad tablet to consumers. Apple recently stated it sold more than 1.7 million iPhone 4s in its first five days on the market, making it the most successful product launch in the company's history. Apple also said it sold more than three million iPads in its first three months on the market. We expected these products to be very popular, and think they will create additional consumer demand for various technology goods. For example, Microsoft announced new tablet-style devices running the Windows 7 operating system from about 20 manufacturers at a conference in mid July – competing with the Apple iPad. In our opinion, we don't think Microsoft will be left in the so-called "dust."

It has taken Microsoft over 25 years to place its tentacles throughout the computing world, and it would cost companies billions of dollars to change from their current IT structure. We feel Microsoft has tremendous intellectual talent, and will most likely have time to continue adapting and developing new products in a changing technology environment. In summary – competition is good for everyone, and Microsoft, Google, Apple, and consumers will all benefit.

In the meantime, Microsoft retains almost $40 billion of cash on its balance sheet, and is expect to produce approximately $20 billion in additional cash during 2010. The company pays shareholders a dividend of fifty-two cents per share, and will repurchase around ten billion dollars of stock this year. All-in-all, this represents a 6.5% return to shareholders at Microsoft's current share price – we are very pleased with this result and will stay invested in Microsoft.

Financial Services Group

Our largest financial services holding, Berkshire Hathaway, is displaying continued growth as the entity will increase net worth by approximately $10 billion during the 1st half, 2010 (from $135.7b to $146.0b), increasing per-share book value by 4.25%. Even though Berkshire's per-share book value has now grown around 17% from the end of 2007, Berkshire's stock price is down over 15%. This represents another instance where we believe that a disparity exists between company price and intrinsic value. We believe Berkshire is worth more than its current stock price, despite its current gains, and the company should produce a satisfactory growth in net worth during 2010.

Mr. Buffett has scaled back the company's coverage of catastrophic events such as hurricanes, leading to underwriting results that are not equal to the past few years. Subsequently, Berkshire's insurance float, funds that are used for new investment in businesses, has remained static. We remain unconcerned with Berkshire's decision to temporarily pull back their catastrophic insurance coverage throttle. Insurance is a business where discipline is not only a requirement for profitability, but a necessity for long-term survival. As competitive insurance companies have supplied catastrophic insurance coverage and aggressively invested premium money in esoteric securities, Berkshire has come out on top. Berkshire's relative success is important to note, but weakened competitors is more relevant. Due to a weakened insurance industry, we expect insurance prices to begin to harden in the latter part of 2010. This means Berkshire should begin to open up the underwriting throttle a bit in the future – providing catastrophic insurance coverage to various industries at increased prices, and reenergizing growth in investable float.

Even though Berkshire's investable float has not significantly grown the past few years, Mr. Buffett has cut a slew of large deals during this market downturn – representing over $50 billion of new investment. The following is a completed deal summary for Mr. Buffett, consummated during the financial turmoil:

1) Berkshire invested $6.5 billion with the Mars family to purchase The Wrigley Company. In exchange for this investment, Berkshire received $2.1 billion of preferred stock and $4.4 billion of "subordinated notes," due 2018. The notes will be held to maturity and are currently receiving annual interest at 11.45%.
2) Goldman Sachs Group, Inc. agreed to sell $5 billion of perpetual preferred stock to Berkshire Hathaway in a private offering. The preferred stock has a dividend of 10% and is callable at any time at a 10% premium. In conjunction with this offering, Berkshire Hathaway also received warrants to purchase $5 billion of common stock with a strike price of $115 per share, which are exercisable at any time for a five

year term. As a side note, these warrants are now very profitable as Goldman Sachs recent share price was above $155.

3) General Electric sold $3 billion of perpetual preferred stock to Berkshire Hathaway. The preferred stock has a perpetual dividend of 10% and is callable after three years at a 10% premium. Berkshire Hathaway also received warrants to purchase $3 billion of GE common stock with a strike price of $22.25 per share, exercisable at any time for five years.
4) Berkshire acquired a 12% convertible perpetual capital instrument issued by Swiss Re at a cost of three billion Swiss Francs
5) Berkshire acquired three million shares of Series A Cumulative Convertible Perpetual Preferred Stock of The Dow Chemical Company ("Dow Preferred") for a cost of $3 billion. The Dow Preferred was issued in connection with Dow's acquisition of Rohm and Haas.
6) The big one—During the 1st half, 2010 Berkshire closed the Burlington Northern acquisition, for $26 billion, of the remaining 77% of BNSF Railroad that it did not already own—valuing the entity at $44 billion, including the assumption of $10 billion in debt. Mr. Buffett's investment is a big bet that railroads will increase their relative share of the transportation market as fuel prices increase, and that the U.S. economy will grow in the future (increasing the amount of goods being transported).

At the end of the 2nd quarter, 2010, we expect Berkshire to have roughly $25 billion of cash on its balance sheet; a level we believe is slightly on the lower end of Mr. Buffett's targeted "buffer." This likely indicates little potential for large deals during the remainder of 2010. A closing note – during this past six months, as a result of the BNSF acquisition, Berkshire Hathaway split its stock and joined the S&P500 index. We believe Berkshires participation in the index will be slightly positive as institutional ownership becomes a large part of Berkshires shareholder community.

Retail Group

Our major retail holdings, Home Depot and Walgreens, faced a challenging operating environment in the past few years as consumers curtailed their retail purchases. While we are experiencing an economic recovery in 2010, we don't expect consumer buying power to bounce back to prerecession levels. With this said, we remain very interested in the retailers who can actually gain long-term value during a tough economic environment – and Home Depot and Walgreens are doing what we expect. Although companies in the retail industry face intense competition, the retail areas in which we are invested involve a couple of two-horse races—between Lowe's and Home Depot in the home improvement market, and between Walgreens and CVS in the retail pharmacy market. In our view, it is nearly impossible for new competitors to gain a foothold in these specialized retail segments that require substantial infrastructure and real estate. A new competitor would find it very difficult to challenge Home Depot, which owns about 87% of its stores and has listed property and equipment valued at about $27 billion. (Walgreens owns 19% of its stores.)

Home Depot and Walgreens are expected to grow their combined sales and earnings at 4% and 17% in 2010. In addition, our combined dividend yield for these two retailers is approximately 3%, exceeding the yield opportunity given on an investment in 5-year U.S. Treasuries.

Media Group

Our primary media holdings— Disney and Comcast —had a challenging time given the backdrop of a weak economy, however, both companies are turning the corner in 2010 as their growth resumed in concert with the economic rebound. During the recession both of these media companies continued to gain franchise strength, with Comcast completing a joint venture deal with General Electric, resulting in their ownership of 51% of NBC Universal. Disney also added to their franchise during the recession through the purchase of Marvel Entertainment, the global entertainment licensing company with a library of more than 5,000 characters, including Wolverine, the X-Men, Spider-Man, Captain America, the Fantastic Four, Iron Man, and the Incredible Hulk. Both of these deals will add value to Comcast and Disney in the upcoming year.

Our combined media group represents a collection of diverse and powerful businesses. We remain committed to the media business, and strongly believe that a concentrated investment in content providers will pay handsomely in the future. The media business is cyclical in nature due to its heavy reliance on advertising as a source of revenue. The cutback on advertising expenditures that occurred during the recession is reversing in 2010, increasing sales and profitability for both Comcast and Disney. We feel our media businesses will

continue to gain competitive strength and attract further advertisers over the next decade due to their solid foundation in family entertainment, cable and Internet services. Disney and Comcast also possess annuity-like attributes, selling products that are in demand every day—very few consumers will deny their children a Disney animated film or cancel their cable service during difficult times.

Commodities Groups (Metals and Oil)

Our commodity holdings primarily include Barrick Gold, Central Funds of Canada, and Chevron. Although Chevron remains our largest integrated oil investment, during the recent downturn we added significantly to our oil holdings through purchases of ConocoPhillips. There are several reasons as to why we have a long-term belief that commodity prices will rise in the future, perhaps significantly. First, it was our belief that the value of the U.S. dollar would deteriorate over the long term, and unfortunately this assumption is proving correct. Although there has been some renewed dollar strength due to the European sovereign debt crisis, we have not changed our negative view about the dollar and believe that our country's current loose monetary policies will result in a continuing deterioration of the U.S. currency. Over a long-term period in which the dollar has continued to lose relative strength against world currencies, gold has risen to more than $1200/oz. In fact, it is quite possible that we could experience another bout of deterioration in the dollar as many states and municipalities may begin defaulting on their debt, ultimately facing bankruptcy. Basically, the federal government may need to be a lender of last resort to defaulting states and municipalities, sooner or later printing more money. If monetary policy remains loose, and printed money cannot be removed from the system in the future, the consequences could possibly be higher-than-normal inflation.

U.S. monetary policy and changes in the dollar's value will continue to be important factors in determining the price of certain commodities in the future; however, they are not the only driving issues. We also have ongoing concerns regarding the geopolitical and global financial landscape, as the "world money supply" increases rapidly. The U.S. is not the only country printing money to bail out its financial system – the European Union is coming apart at the seams as countries like Portugal, Italy, Greece, and Spain face mounting debt problems. The European Central Bank has no choice but to lend and eventually print money to bail out these sovereign nations. This fact supports a further argument for higher long-term commodity prices, as a growing world money supply can ultimately lead to global inflation.

Second, there is a long-term growing imbalance between commodity supply and demand. Just prior to the recession, daily worldwide oil consumption reached approximately 87 million barrels of oil per day, while production leveled off at 86 million barrels per day. While the current recession dampened demand by a few percentage points, the long-term widening gap between consumption and production will likely lead to higher oil prices, despite any short-term downturn in oil prices. We are beginning to see this trend as the world economies rebound. On top of this, oil is becoming more difficult and expensive to find – witness the recent BP deep water drilling disaster in the Gulf of Mexico.

As a result of these challenging issues, we continue to believe that the price of oil will "plateau" at a higher level in the future (although we do not have a specific price in mind) than it has in the past, with the rapid growth of economies in countries such as China and India driving increased energy demand.

Given these facts, we are committed to a long-term investment in commodities. As commodity prices rise, the earnings from our companies within the commodity group increase exponentially. With this said, the prices of these companies can be erratic. But, we strongly believe that loose monetary policies, coupled with rising demand and restricted supply will ultimately lead to higher prices – and our commodity holdings will increase in value. In the meantime, our combined commodity group is producing an annual dividend for shareholders of approximately 3% – basically, "we are being paid" for our insurance against future inflation.

Fixed-Income Investments

The Morningstar bond index continued to rise in the 2nd quarter, returning 2.7% - this bond index is up 5.2% for the first half of the year. This result follows a 14% gain in 2009. The credit market has recovered quickly as fixed-income investors are aggressively buying various fixed-income securities. In fact, during 2009 investors were so skittish about the stock market that they threw a net $385 billion into bond funds, as compared to $4.5 billion placed in equity funds. This disparity has continued through the 1st half, 2010 as over $150 billion of new money has found its way to bond funds, while only $24 billion was added to equity funds. Bottom line: Investors are scared of the stock market when they should really be concerned with the

fixed-income market. It is our opinion that too much money is chasing too few opportunities in the fixed-income area, bidding up bond prices to what we think are bubble levels. Besides, we need to remind ourselves that the “deterioration” in credit quality remains among most fixed-income instruments (including governments), and the “real risk” still resides in the credit market, not the stock market.

We continue to emphasize several points about fixed-income instruments that concern us. Several risks associated with this “secure investment vehicle” loom, including issues such as the possibility of future rising interest rates and even greater chances of default. We believe that long-term market interest rates may move upward in the future as the Federal Reserve begins to struggle with maintaining low interest rates and high liquidity in the market. The Federal Reserve could pull back on their goal to assist banks to recover losses and allow leveraged borrowers to refinance their debts. On the other side of the Federal Reserve coin – if incoming data shows continued housing difficulties and rising mortgage default rates, we may experience a prolonged loosening of monetary policy – resulting in a permanent increase to the money supply. The market response will be a rise in long-term interest rates as inflation likely takes hold of the economy. This latter scenario of increasing the money supply may also be exacerbated by the future necessity to bail out states and municipalities that are facing financial failure.

In the 1st half, we have had several tranches of municipal, and corporate bonds come due. We continue with our strategy of avoiding longer-term fixed-income investments, which are more sensitive to rising interest rates, and are carefully allocating money to short duration fixed-income securities (one to five years) as interest rates and default rates may rise in the future. We are avoiding speculative investment activity, and maintain our attitude of finding the best yielding securities, understanding the risks we are taking with each individual fixed-income allocation.

In summary, we continue to be comfortable with our current businesses and the future worldwide prospects for each of our operating companies. We are also comfortable with our fixed-income investments and feel the returns are fair for the risks we are taking. We want to assure you that we continue to be mindful of the risks in today’s markets, and will allocate capital in such a manner as to minimize any “long-term” effect on the value of our holdings.

Thank you for your continued support. We look forward to serving you during the remainder of 2010, and wish you and your family a fantastic summer!

The examples and descriptions of investments in this client letter do not represent all of the investments purchased, sold or recommended by Founders and instead represent the ten largest equity positions held by Founders’ clients and/or the two largest equity positions in each industry group to which Founders has allocated capital. The performance of these investments was not a criterion in determining the representative list. It should not be assumed that the investments identified and discussed were or will be profitable.