

First Quarter, 2010 Overview

The S&P500 gained 5.4% during the 1st quarter, 2010 – continuing its upward trend from the low experienced twelve months ago. The 1st quarter’s positive result was associated with a decline in market volatility, as the S&P500 gyrated between 1045 and 1180 over a 90-day period. As this letter is being written, the S&P500 has now rebounded over 75% from the March, 2009 low – quite a run. However, with the large rebound in the stock market, investors remain queasy as they have not yet recovered from the sickly ride experienced during 2008 and early 2009. In our opinion, it is still a wrenching environment for investors as they have not forgotten the sting of a major market fall.

The explanation for a continued rise in the stock and fixed-income markets during the 1st quarter is focused around two points: First, the economy is experiencing a recovery – although a slow one – and company earnings are rebounding very strongly. Second, throughout 2009 and the 1st quarter, 2010, many investors flocked to fixed-income investments in order to obtain moderate returns during an uncertain environment. As a result, fixed-income investments rose significantly in the past fifteen 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.

Although the markets have been successful in generating a “significant rally” during the last year, 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. Although many expect this volatility to take place in the stock market, the most likely place for volatility to occur is where many investors ran to with extreme – the fixed-income area.

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.

This is not a general statement on the short-term direction of the stock and fixed-income markets. You should note, however, that we *omitted* fixed-income securities from our positive 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 area. With this said, we believe that our equity stakes in great companies remain “fairly priced” at their current levels. We also believe that these excellent businesses will continue to gain value over the next 10 years, despite short-term gyrations in the markets. *Notice that this is a repeat statement from our year-end letter, and going forward we expect equities to rise moderately and fixed-income returns to flatten. WHY?*

Answer in a nutshell – An investment in a 2-year risk-free U.S Government bond currently offers the purchaser an annual payout rate a little over 1%– not that great. However, an alternative investment in the S&P500 index offers an annual dividend yield of approximately 2%, and a 2010 earnings yield of around 6.5%. Clearly, an investment in the stock market today provides a better return than an alternative investment in government bonds. Investors are beginning to see this difference, and the higher yielding stock market is acting like a magnet, attracting money seeking higher returns – driving the S&P500 higher. We see this trend continuing until this so-called yield difference contracts either by falling bond prices (and higher yields) or by a higher stock market, or both.

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

As we have stated before, we are 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. 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 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, and Procter & Gamble—had a very good 1st quarter, and we expect good results for the remainder of 2010.

Our combined consumer group represents a global powerhouse business, and has done well throughout the recent difficult economic downturn. We believe that each of these three holdings will grow their annual sales volume during 2010 between 2.5% to 7%, and operating profits between 10% to 12%. In addition, the average annual dividends being distributed to shareholders for these businesses currently equals 3% – better than the 2.6% one can earn through an investment in 5-year U.S. Treasuries.

As we have stated in the past, we will 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, and Procter & Gamble 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[®], 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. Basically, 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—were profitable in 2009, and we expect these businesses to produce better results in 2010 as the economy rebounds from the recession.

As a result of the recent sale of Burlington Northern to Berkshire Hathaway, we replaced a large portion of this holding with Lockheed Martin. A short overview of this company: Lockheed Martin is a \$45 billion global security and information technology company. The majority of Lockheed Martin's business is with the U.S. Department of Defense and U.S. federal government agencies. As a side note, 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.

ORGANIZATION: Lockheed Martin's operating units are organized into broad business areas.

- **Aeronautics**, with approximately \$12.2 billion in 2009 sales, includes tactical aircraft such as the F-16 and F-35 fighter jets, airlift, and aeronautical research and development lines of business.
- **Electronic Systems**, with approximately \$12.2 billion in 2009 sales, includes missiles and fire control, naval systems, platform integration, simulation and training and energy programs lines of business.
- **Information Systems & Global Services (IS&GS)**, with approximately \$12.1 billion in 2009 sales, includes federal services, government and commercial IT solutions.
- **Space Systems**, with approximately \$8.6 billion in 2009 sales, includes space launch, commercial satellites, government satellites, and strategic missiles lines of business.

The so-called 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 U.S. defense infrastructure, and it would take a substantial amount of time and capital to create alternative organizations with expertise to compete with UTC and/or Lockheed Martin. Although the defense business is somewhat capital-intensive compared with most consumer-product businesses, certain attributes make this type of investment attractive in the current environment. When facing a challenging global environment under stressful times, countries continually invest in defense projects to protect their citizens and economic infrastructure. Any increase in long-term defense spending (and revenue) over an established infrastructure that is difficult to duplicate spells higher profits for companies such as UTC and Lockheed Martin.

Under rebounding 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 currently equals around 2.6%. In addition, we believe these businesses have gained competitive advantage during the recession, and are poised to grow significantly as the economy rebounds.

Healthcare Group

Our primary healthcare holdings, Johnson & Johnson and Medtronic, achieved profitable growth during 2009, and we expect these medical businesses to grow their operating earnings throughout 2010. As a side note, we have also added smaller positions to our portfolio of healthcare companies, as suitable—Stryker and Abbott Laboratories.

J&J and Medtronic will grow their combined sales and earnings per share at approximately 5%, and 9% respectively in 2010. This result provides both firms cumulative sales and profit growth through the recession. Both J&J and Medtronic are continuing to focus on markets outside the U.S., and we still 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.

Technology Group

Our technology holding, Microsoft, continues to announce positive results, and the company is emerging from the recession storm better than most technology firms. The company recently announced a quarterly year-over-year increase in earnings of 35%. The Windows franchise was up 29% for the quarter, growing faster than overall PC sales at 25%. 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 very beginning of the new product cycle that will significantly add to its sales and profit growth over the next 48 months. The company is just rolling out their next-generation operating system – Windows 7 – for consumers and businesses, and Office 2010 will also be offered to both groups in the upcoming quarters. As a result of this new product offering, we are anticipated 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 – yes, we expect this product to be very popular. With this said, we don't think Microsoft will be left in the so-called “dust.”

Although investors are concerned about Microsoft's ability to build future products that will help the company adapt to the changing Internet-centric and mobile computing environment, we believe this pessimism is somewhat exaggerated. Besides launching their new Windows 7 operating system, Microsoft is not “standing back” in the highly competitive “emerging product” arena. Microsoft launched its new search engine worldwide – Bing, is coming out with their new mobile operating system for smartphone users, and is rumored to be developing a dual screen tablet that will compete head-on with the iPad!

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 and Apple will all benefit.

In the meantime, Microsoft has almost \$40 billion of cash on its balance sheet, and is expect to produce approximately \$17 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 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 displayed a \$21.8 billion increase in net worth during 2009 (from \$113.7b to \$135.8b), which increased the per-share book value by 19.8%. Much of this so-called “snap-back” was due to the recovery in the stock and fixed-income markets. Even though Berkshire's book value has now grown around 12.5% from the end of 2007, Berkshire's stock price is down over 16.5%. 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, 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 a hardening of insurance prices during 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 24 month deal summary for Mr. Buffett:

- 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 quarter, 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 1st quarter, 2010, we expect Berkshire to have roughly \$20 billion of cash remaining on its balance sheet; a level we believe is on the lower end of Mr. Buffett's targeted “buffer.” This likely indicates little potential for large deals during the upcoming year. A closing note – As a result of the BNSF acquisition Berkshire Hathaway split its stock, and this action created an atmosphere for Berkshire to join 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 24 months as consumers curtailed their retail purchases. Although we expect a recovery in 2010, we don't believe 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.) An additional point: during difficult economic times, consolidation occurs as large retailers put pressure on smaller competitors. This statement came true in the 1st quarter, as Walgreens announced a \$1.0 billion purchase of Duane Reade, New York City's largest drug store chain with 257 locations. We can see that the challenging economic climate provides opportunities for our retailers to increase their market share and long-term shareholder value.

An ongoing valuable lesson regarding stock market "direction": a disparity has occurred in the past 15 months between the negative retail business environment and the associated retail stock prices. Home Depot and Walgreens have shown a 58% and 45% respective increase in their stock prices since January, 2009; while the S&P500 has risen a lower 35%. As we can see in this instance, "guessing" when to "get in at the right time" is an impossible game. The ongoing true test is the current and probable business returns these companies will produce over time. It is our opinion that Home Depot and Walgreens are still worth more than their current stock prices, and we remain interested in owning these growing enterprises.

Media Group

Our primary media holdings— Disney and Comcast —had a challenging 2009 given the backdrop of a weak economy, however, we expect both companies to turn the corner during 2010, as their growth resumes in concert with an 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 will likely reverse 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 Group

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 and Royal Dutch Shell. 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. We have not changed our view about this 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 \$1100/oz. In fact, it is quite possible that we may accelerate a deterioration of the dollar with the significant amount of money the U.S. being provided to bail out the banking system – watch out for states and municipalities next. 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 will not be the only driving issues. We also have 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 – just think of Greece. This fact further 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. 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 2.7% – basically, “we are being paid” for our insurance against future inflation.

Fixed-Income Investments

The Morningstar bond index continued to rise in the 1st quarter, returning 2.4%. This result follows a 14% gain in 2009. The credit market has recovered quickly as fixed-income investors are once again aggressively buying various fixed-income securities. In fact, in the past year investors have been so skittish about the stock market that they have thrown a net \$465 billion into bond funds, as compared to \$4.5 billion placed in equity funds. This disparity has continued through the 1st quarter, 2010 as another \$100 billion has found its way to bond funds, while \$30 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. We are now at a point that puny U.S. Government bond yields exceed the yields on corporate bonds such as Abbott Laboratories, Berkshire and Exxon. In other words, according to bond purchasers, the U.S. Government’s debt is riskier than these high grade corporate bonds. We would not go that far. This anomaly has occurred because far too much money is chasing too few opportunities, bidding up bond prices to what we think are approaching 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 continues to maintain low interest rates and continues to create liquidity in the market, all with the goal of assisting banks to recover losses and allow leveraged borrowers to refinance their debts. As incoming data such as continued housing difficulties and rising mortgage default rates lead to a prolonged loosening of monetary policy, the resulting increased money supply can lead to an increase in long-term interest rates as inflation takes hold of the economy. This scenario may also be exacerbated by the future necessity to bail out states and municipalities that are facing financial failure.

In the 1st quarter, we have had several tranches of municipal, and corporate bonds come due. We will continue with our strategy of avoiding longer-term fixed-income investments, which are more sensitive to rising interest rates, and will carefully allocate money to short duration fixed-income securities (one to five years) as interest rates and default rates rise in the future. We will avoid speculative investment activity, and will 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 warm spring.