

April 21, 2011

Dear PCM Clients and Friends:

We have often said that Minnesota has two seasons—winter and road repair. This year it will be pothole repair as well as road repair, because the long difficult winter here in Minnesota has taken its toll on our roads, which frankly, were none too good to begin with. Hennepin County, where we live and work, has increased its pothole repair budget by \$1 million, which seems modest when compared to the number of potholes we see—or don't see—and hit them. Obviously, good for the front end repair people.

One of our gripes over the years has been our roads. After World War II, our freeway system was started and was quite adequate for many years, but now it is sorely lacking. What happened? We think we know. The money that should have gone into our infrastructure of freeways and commuter trains went for foreign aid to countries that dislike us, and to wars fought on foreign soil. Something is wrong here.

A MESSAGE FROM PERK

“The priority is that all of us continue to zealously guard Berkshire’s reputation. We can’t be perfect, but we can try to be. As I have said in these memos for more than 25 years: ‘We can afford to lose money—even a lot of money. But we can’t afford to lose reputation—even a shred of reputation.’ We must continue to measure every act against not only what is legal, but also what we would be happy to have written about on the front page of a national newspaper in an article written by an unfriendly, but intelligent reporter.”

The above is a direct quote from Warren Buffett's July 26, 2010 letter to the fifty plus managers of the various Berkshire Hathaway businesses. I have always appreciated his advocacy of the very highest ethical standards in business and, in fact, all aspects of life. So much so that I emailed his letter to the members of each board where I serve. But now, we have learned that David Sokol, a top candidate to get Buffett's job when he retires, had purchased shares of Lubrizol common stock prior to recommending to his boss that Berkshire should acquire Lubrizol. Sokol had bought and sold a few shares of Lubrizol in December, but then in early January bought 96,000 as part of a 100,000 limit order he had placed. A week later Sokol brought the idea of buying Lubrizol to Buffett, and even though Buffett said that Sokol had admitted in his first discussion that he owned stock in the company, Buffett said that “Sokol's purchases were made before he had discussed Lubrizol with me and with no knowledge of how I might react to the idea.” And further, he said he did not know what Lubrizol's reaction might be if there was an interest. On March 13, just a little over two months after Sokol bought his shares, the Berkshire board voted to buy Lubrizol at \$135 a share compared to the \$104 that Sokol had paid for his

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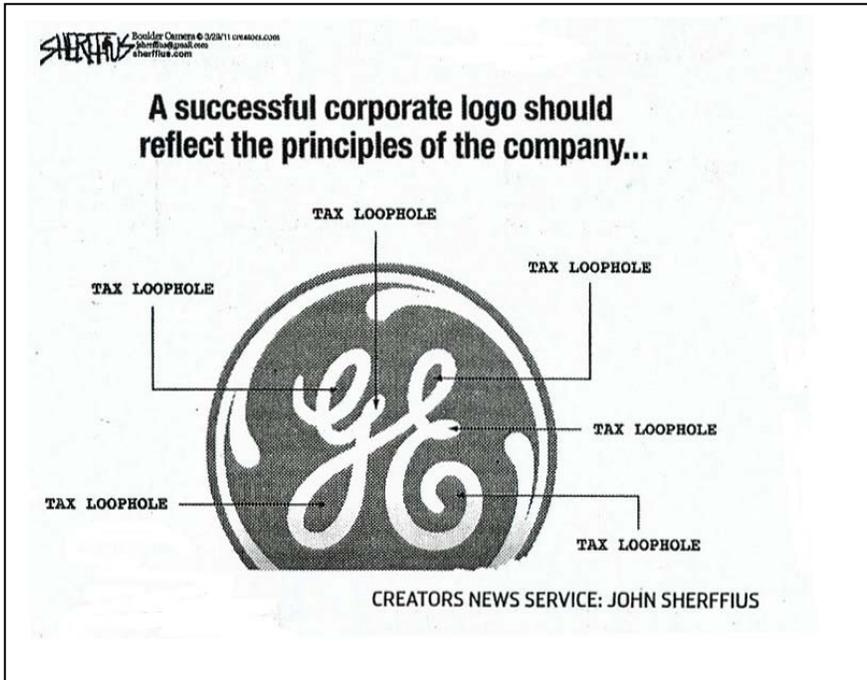
INVESTMENT MANAGEMENT

stock. In the press, Buffett seems to have almost defended Sokol's ownership of the stock but, nevertheless, Sokol resigned on March 28. Makes one wonder, doesn't it, as to how many of the 50 odd Berkshire company managers really follow the rule that the "Sage of Omaha" has set down concerning reputation, which we assume means such things as insider trading. Stay tuned, because I'm sure we have not heard the last of this yet.

On another Buffett subject, we note the well hidden recent exchange of documents between Berkshire and the SEC concerning the pricing of some of the holdings in the Berkshire Hathaway portfolio of at least 25 large corporations, valued at \$52.5 billion. But the question is, what is that portfolio really worth at the various quarter ends? Several of the holdings which are under water, namely Wells Fargo, Kraft Foods, Sanofi-Aventis, Swiss Re and U.S. Bank are therefore carried at cost or more than market. And Berkshire has resisted the SEC request to "Mark to Market" as all SEC registered advisors such as Perkins Capital Management are required to do. The stated Berkshire excuse is that all five stocks will rebound and that since there are no plans to sell them at the current lower price they can be carried at cost. In the end, Berkshire agreed to write down U.S. Bank, Swiss Re, and Sanofi, but did not mark Wells Fargo and Kraft to market. It seems to us that this is just another example of expediency, which detracts from the Berkshire image of honor and honesty, no matter what. Can you imagine what the financial world would be like if pools of capital were allowed to keep some investments at cost, and others at market just because those that are selling below cost seem undervalued and, therefore, can be carried above market? Any performance numbers would not be accurate and, therefore, totally unacceptable. Is the same inaccuracy implicit in the quarterly or annual valuation of Berkshire's assets? Maybe a small matter in terms of dollars, but a very large matter in terms of honesty and integrity.

While I am up on a soapbox, I may as well comment on the highly disturbing situation in which Corporate America vigorously pursues the opportunity to reduce corporate taxes by utilizing offshore companies and subsidiaries. All of this was the subject of a *60 Minutes* show on ABC Sunday night March 27, titled "The New Tax Havens," and narrated by Leslie Stahl. Ms. Stahl went to Zug, Switzerland to see why so many American companies are now located in Zug, with a one office location or even just a mailbox. The two companies she highlighted were Weatherford International and Transocean Ltd, with \$25 billion and \$16 billion market caps, respectively. In her interview with the Cisco Systems CEO, he said he could bring back substantial overseas profits of perhaps \$40 billion if domestic tax rates were competitive. The estimate is that \$1.7 trillion which is now overseas won't come back to the U.S. and until and IF it does, it is used to build plants and equipment and hiring workers in other countries and not the U.S.

And on March 24, the *New York Times* somewhat tongue-in-cheek reported that GE had a very good year in 2010 as it reported profits of \$14.2 billion with \$5.1 billion coming from overseas operations. The fly in the ointment, however, is not only did GE not pay an American tax bill, but in fact got a tax benefit of \$3.2 billion. The success of its strategy of heavy lobbying and innovative accounting (including a 975 person tax department that enables it to reduce its tax burden) is becoming quite clear. The genesis of all this, of course, is in the 35% top corporate tax rate here in the U.S., one of the highest in the



world. President Obama is said to be considering an overhaul of the corporate tax system and has designated GE's CEO, Jeffrey R. Immelt, as his liaison to the business community and as chairman of the President's Council on Jobs and Competition. One of the items of discussion is supposed to be the corporate tax rate.

Looks to me like GE will be in the catbird seat and the status quo is likely to continue.

FIRST QUARTER REPORT CARD

This first quarter commentary is virtually a replay of our commentary in January when we reviewed the fourth quarter and the year. The message was that small- and micro-cap stocks have outgunned their larger brothers for over a year now, simply because they do best coming out of a bear market bottom, since they suffer much more on the way down in

Indexes	% Return 1Q 2011
Russell 2000 Total Return	+7.94
S&P Small-Cap 600 Total Return	+7.71
Dow Jones Industrial Average	+6.41
Russell 3000 Total Return	+6.38
Russell 1000 Total Return	+6.24
S&P 500 Composite	+6.16
Wilshire 5000	+5.55
Value Line Composite	+5.47
NYSE Composite	+4.83
NASDAQ Composite	+4.83

a bear market, and therefore, bounce back quicker. And so, the first quarter was a continuation of last year's performance since the March 9, 2009 market bottom. The Russell 2000 and the S&P Small-Cap 600 were at the top of the list, up 7.94% and 7.71% respectively. At the bottom of the list were the NYSE Composite and the NASDAQ Composite tied at +4.83%. This trend toward small stocks will continue until the money that wants to buy the larger stocks decides they are a better value because of their underperformance and begins to

invest in them. This does not mean smaller company stocks will go down, just that they may give relative underperformance while still going up.

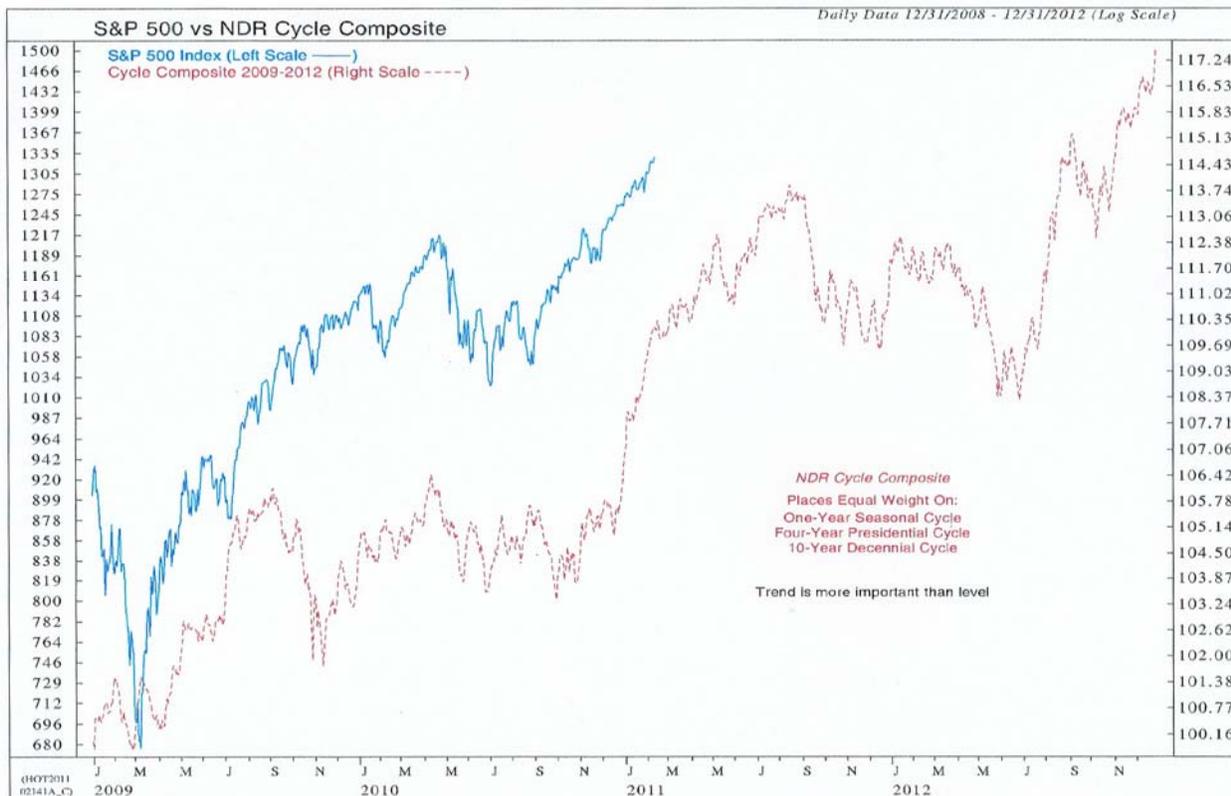
2011 MARKET EXPECTATIONS

In our January letter we posited in our paragraph titled “The Year Ahead” that the 2010 bottom, as recorded again in the 10th year of the decade, could provide a rising market well into 2011, at least to April and possibly until the end of summer in August. We are repeating that very important table titled “Declines Into 10th Years & Following Rises.” Let’s review it again. It shows that the 2010 decline began at the end of April, dropping

DECLINES INTO 10TH YEARS & FOLLOWING RISES				
<u>Start Of Decline</u>	<u>% Decline</u>	<u>End Of Decline</u>	<u>Next High</u>	<u>% Rise</u>
5/17/1890	-22.6%	12/8/1890	3/4/1892	+30.3%
9/5/1899	-31.8%	9/24/1900	6/17/1901	+47.8%
11/19/1909	-26.8%	7/26/1910	6/19/1911	+18.3%
11/3/1919	-44.2%	12/21/1920	5/5/1921	+19.9%
9/3/1929	-58.7%	12/16/1930	2/24/1931	+23.4%
9/12/1939	-28.3%	6/10/1940	11/9/1940	+23.5%
6/12/1950	-13.5%	7/13/1950	1/5/1953	+48.8%
1/5/1960	-17.4%	10/25/1960	12/13/1961	+29.8%
7/3/1969	-28.8%	5/26/1970	4/28/1971	+50.6%
2/13/1980	-16.0%	4/21/1980	4/27/1981	+34.9%
7/17/1990	-21.2%	10/11/1990	1/31/1994	+68.2%
1/14/2000	-14.9%	10/18/2000	5/21/2001	+13.6%
4/26/2010	-13.5%	7/2/2010	?	-
Average	-26.0%		13.6 Mos.	+34.1%

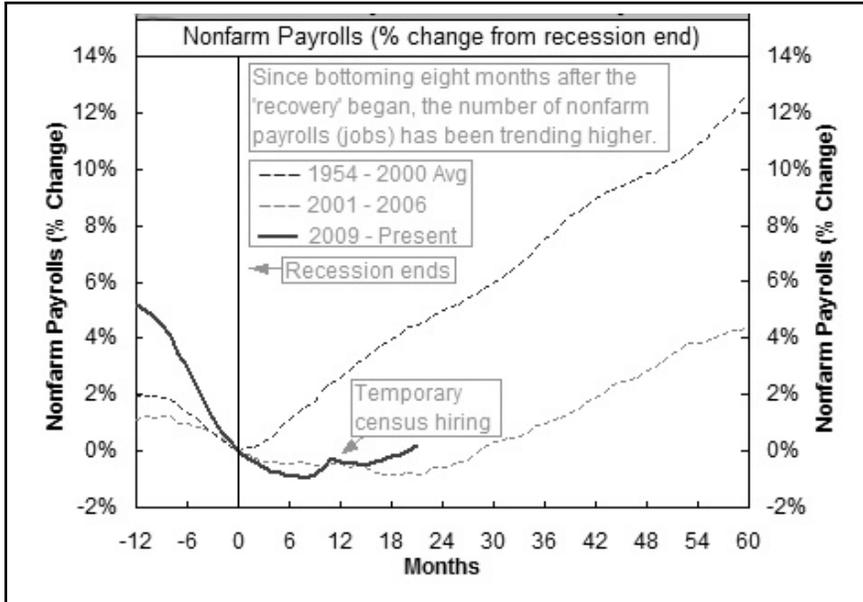
Source: Growth Fund Research, Inc.

13.5% to the July level. We won’t know the date of the next high until with hindsight we find when it was, but looking at the table we see in most cases the next high was in the



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11th year and that the average rise was 34%. If the market achieves the average gain from the Dow 9686 low on July 2, we could be looking at Dow 13000 by the projected 2011 high, a gain of 6.5% from present levels. The average time from the end of the decline to the next high was 13.6 months, which puts us at about mid-August, right in line with the Ned Davis Cycle Composite Projection. And as we have noted many times in past letters,

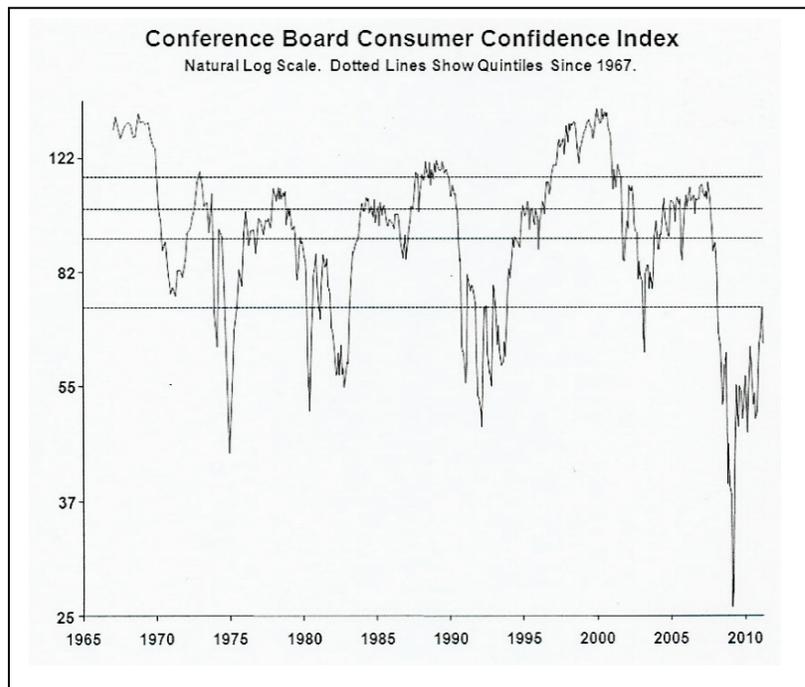


often the 2nd year in the decade marks a significant bottom (1932, 1942, 1952, 1962, 1982, and 2002) so the chart projection lines up with that potential 2nd year bottom in 2012.

With all the problems in the world, ranging from the Japanese earthquake Tsunami impact to the Mideast imponderability, it seems almost incongruous that the market could have been as strong as it has been and leaves us to wonder what the market

knows that we don't. We postulate that the market sees the economy as being considerably stronger than portrayed in the news and that the recovery is now beginning to take hold and will last for some time to come. Looking at the chart, one can see that the change in non-farm payrolls is not as good as the average recession, but is better than 2001-2006 and accelerating. The market, an amalgamation of all available information, is smarter than any one of us. Today, it is projecting higher prices.

In fact, looking at the chart showing the history of the Consumer Confidence Index, we find the answer we are looking for. The Consumer Confidence Index, which is a well accepted proxy for overall economic confidence certainly displayed a lack of confidence when it went to the lowest level

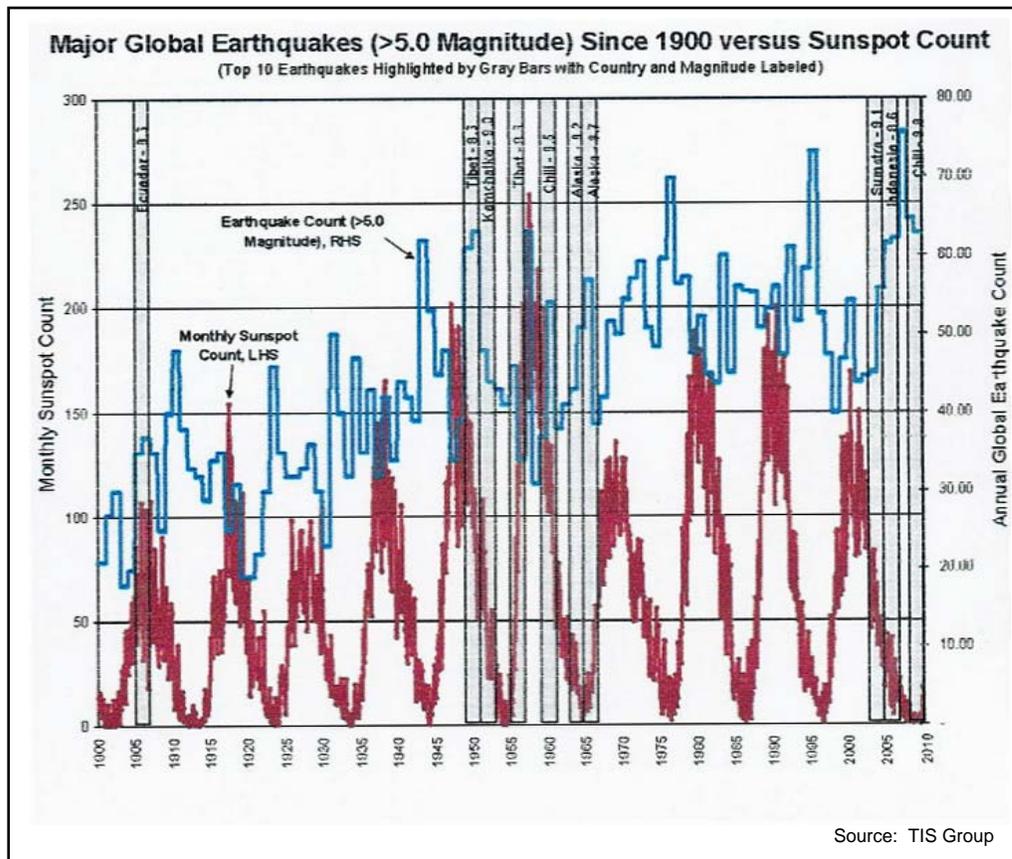


in four years during the 2008-2009 financial crisis. Economic recoveries begin when confidence is very low (people are fearful) and ends when the majority are confident in the future. Clearly, confidence has a long way to go to reach that area of overconfidence.

A TRUE BLACK SWAN

The Black Swan event was described by Nassim Nicholas Taleb in his 2007 book titled "The Black Swan." As he described it, a Black Swan event is an "Outlier" as it lies outside the realm of regular expectations; it carries an extreme impact; and we concoct an explanation for its occurrence after the fact, making it explainable and predictable after all. He summarizes it as having: "low rarity, with an extreme impact, with retrospective predictability."

All this describes the recent Japanese earthquake and Tsunami. Most certainly it was rare, although not as rare as we will subsequently show. It certainly had an extreme impact, which continues even now and will for a very long time into the future. But the interesting thing to us is that explanations are being offered to explain its occurrence after the fact, making



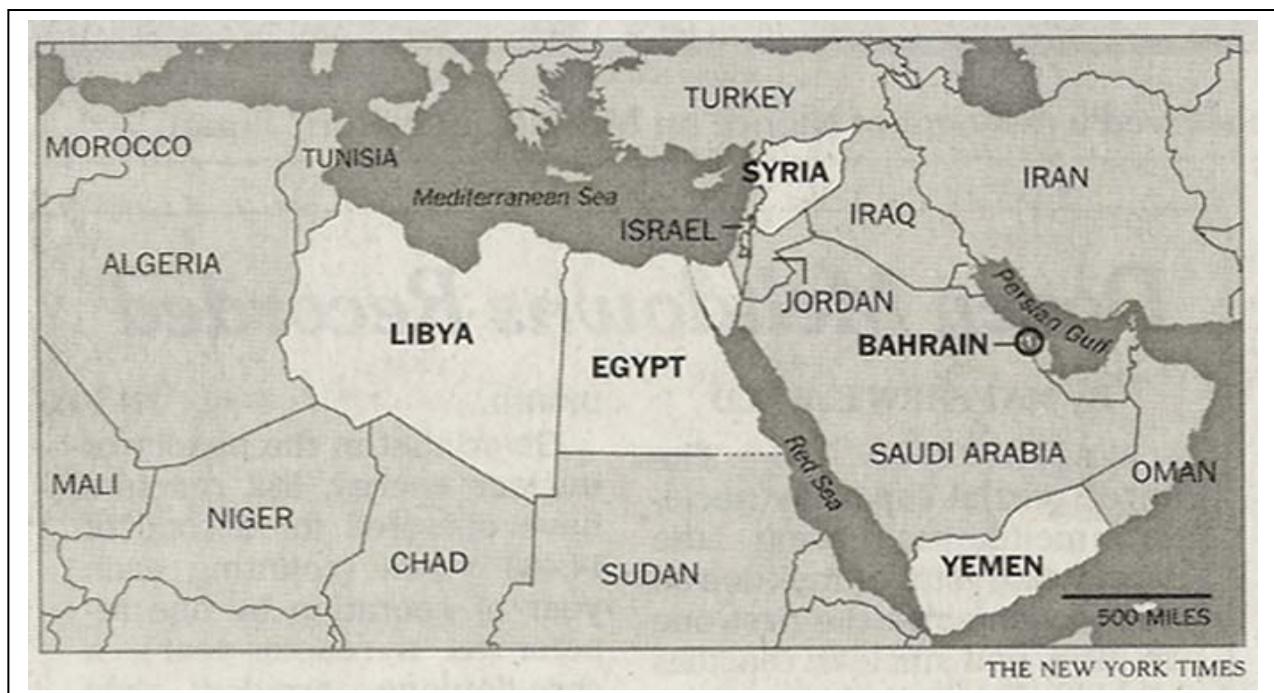
Source: TIS Group

it explainable and predictable. In this instance, it is contended that the earthquake cycle correlates with the solar cycle with earthquake frequency peaking at low points in the solar cycle. Lower than usual solar activity is being looked at for over the next 10 years so we can expect more earthquakes. Sunspot activity vs. earthquakes is shown in the chart and certainly the correlation is clear. During this recent period of declining sunspot activity and low activity since about 2004, we have seen four major earthquakes—Sumatra in December 2004 at 9.9 severity, Indonesia in 2005 at 8.6, Chile in 2010 at 9.9 and now Japan at 9.9. In addition, it is clear that earthquakes occur in about a 50-year cycle, so

that we may very well be in a period of earthquake activity for some years to come. All of this fits Taleb's Black Swan theory.

EGYPT, LIBYA & BEYOND

It is the "Beyond" that worries us as the Near East erupts, country-by-country, against years of heavy handed repression by despot rulers. We know the beginning of the recent eruptions was in Egypt where protesters secured the resignation of Mubarak on February 11 after nearly 30 years of autocratic rule. But maybe it really started in Iran last year where the protesters were put down forcibly by Ahmadinejad before it got very far. Now comes Libya, where Qaddafi has ruled for 30 years with a heavy hand, while all the while he and his sons lived in luxury just as Saddam and his sons did in Iraq. Next came

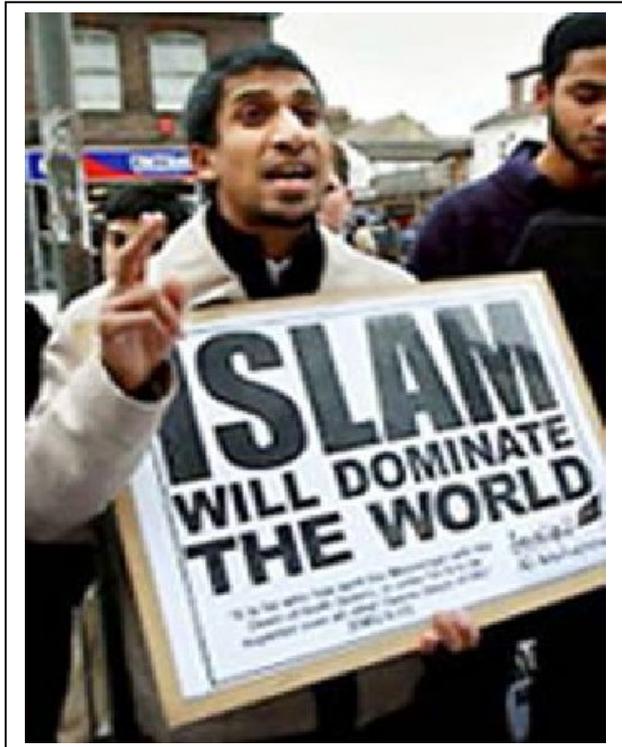


Bahrain, where the kingdom's Sunni Muslim monarchs have allied themselves with the Sunni rulers of Saudi Arabia; however, the majority of the Bahrain people are Shia, the dominant religion in Iran. The protesters in Bahrain are calling for the same thing as the other countries—the overthrow of the ruling family, in this instance, the Al Khalifa. Next more than 100,000 protesters converged in the capital of Yemen, objecting to the hard handed rule of President Ali Abdullah Saleh, whose security forces fired on the protesters as they were marching to his office. Now Syria is seeing the same thing, where the government of Bashar al-Assad is taking a very hard line, with his security forces firing on demonstrators, killing them. The map shows the countries in this hot box where poor little Israel is literally boxed in. In our view, none of this could have happened, but for the advent of the Internet, together with mobile devices which enable the masses to not only see what is going on in the rest of the world, but to communicate with each other. Mobility is, in fact, transforming humanity in front of our eyes. However, it is also a double-edged

sword as it enables countless undeveloped countries to see how parts of the rest of the world lives, especially that women are treated as equals to men. This is a revelation that cannot be underestimated as social media changes the entire world, but especially the Arab world. These social mobile tools have become the tools of revolutionaries giving them the hope that they have needed for years. The good news really is that revolutions set the stage for a massive ultimate increase in wealth.

But we must be careful what we wish for. The democracy which we had hoped for Iraq is not materializing, nor is it likely to in the form in which we might like. We think there may be some sort of non-tyrannical society, but only if it is done within the traditions of that country. Just because we see their leaders in western suits and ties, does not mean they will adopt a western democratic system. It will necessarily be a society that works within their system and their traditions.

We have written in past letters about the possibility that the Mideast becomes the arena for World War III. As unsavory as it sounds, this is how the United States got out of the depression of the 30s—gearing up for World War II. We believe we should have no illusions about the potential of this Mideast tinderbox. When this is all over no one knows now who will be ruling the Mideast or the Mideastern countries. But one thing is certain and that is, this war would be a religious war as the Muslim Brotherhood will view this as an opportunity of a lifetime, in fact, an opportunity that they may have been waiting a lifetime for. It would be their goal to use the Muslims of the Mideast to further their stated goals of world domination as they stated 10 years ago in one of their publications. In 2004, the Muslim Brotherhood's supreme Imam Mohammad Akef said that he had "Complete faith that Islam will invade Europe and America." In fact, they have already established a beachhead in European countries, such as France, Great Britain, and Scandinavia. Make no mistake about it, we will be facing a religious war in the Mideast, perhaps sooner rather than later.



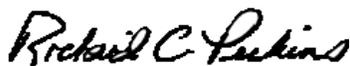
To emphasize the position of Israel, that country is without a doubt an island within a sea of opponents, from Hamas and Hezbollah who are determined to take over, not to mention Iran who has denied the Holocaust and has pledged to eliminate Israel from the face of the earth. Hopefully, the United States still has the will and the desire to protect Israel. A very difficult situation to say the least.

We always like to end with a good cartoon. When at the grocery store, we are always asked if we want paper or plastic, and we usually choose paper because we worry about the environment. Paper bags cost more (5¢ vs. 2¢) but it still makes sense to use paper. The cartoon is about as appropriate as you can get.

Sincerely,



Richard W. Perkins, C.F.A.
President
Senior Portfolio Manager

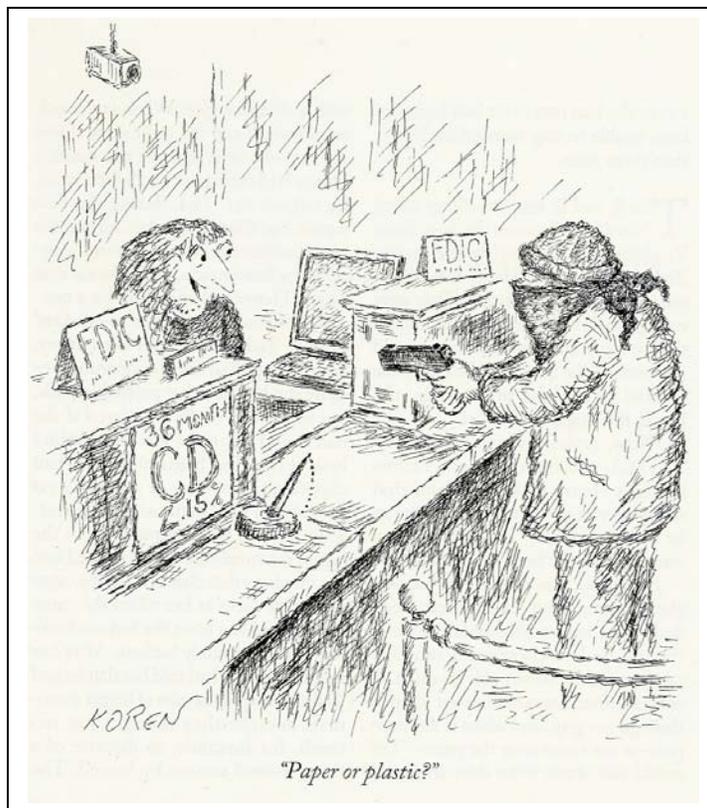


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Portfolio Manager

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A NOTE TO THOSE WHO RECEIVE THE PCM QUARTERLY LETTER VIA EMAIL

Periodically, after we email our letter to readers, some will be returned to us because the recipient's inbox is full and unable to accept additional emails. There are also instances where emails are not deposited directly into a recipient's inbox, but instead end up in a junk mail or spam folder, as is often the case with Gmail and AOL addresses. If you have not received your quarterly letter via email by the end of the month following the calendar quarter end, check your junk mail and spam folders. Alternatively, let us know and we will send again.

Also, if you change your email and/or regular mailing address, please let us know at info@perkinscap.com.

THE TRAVELER

It's a slow day in a little east Texas town. The sun is beating down, and the streets are deserted. Times are tough, everybody is in debt, and everybody lives on credit. On this particular day, a rich tourist from back east is driving through town. He stops at the motel and lays a \$100 bill on the desk saying he wants to inspect the rooms upstairs in order to pick one to spend the night.

As soon as the man walks upstairs, the owner grabs the bill and runs next door to pay his debt to the butcher.

The butcher takes the \$100 and runs down the street to retire his debt to the pig farmer.

The pig farmer takes the \$100 and heads off to pay his bill at the supplier of feed and fuel.

The guy at the Farmer's Co-op takes the \$100 and runs to pay his debt to the local prostitute, who has also been facing hard times and has had to offer her "services" on credit.

The hooker rushes to the hotel and pays her room bill with the hotel owner.

The hotel proprietor then places the \$100 back on the counter so the rich traveler will not suspect anything.

At that moment the traveler comes down the stairs, picks up the \$100 bill, states that the rooms are not satisfactory, pockets the money, and leaves town.

No one produced anything. No one earned anything. However, the whole town is now out of debt and now looks to the future with a lot of optimism. And that is how the United States Government is conducting business today.

A LESSON IN SOCIALISM

An economics professor at Texas Tech said he had never failed a single student before but had, once, failed an entire class. That class had insisted that socialism worked and that no one would be poor and no one would be rich, a great equalizer. The professor then said ok, we will have an experiment in this class on socialism.

All grades would be averaged and everyone would receive the same grade so no one would fail and no one would receive an A. After the first test, the grades were averaged and everyone got a B. The students who studied hard were upset and the students who studied little were happy. But, as the second test rolled around, the students who studied little had studied even less and the ones who studied hard decided they wanted a free ride too so they studied little. The second test average was a D! No one was happy. When the third test was done the average was an F.

The scores never increased as bickering, blame, and name calling all resulted in hard feelings as no one would study for the benefit of anyone else. All failed, to their great surprise. Then the professor told them that socialism would also ultimately fail because when the reward is great, the effort to succeed is great; but when government takes all the reward away no one will try or want to succeed.

BLONDE AND A DOG

A blonde and her husband are lying in bed listening to the next door neighbor's dog. It has been in the backyard barking for hours and hours.

The blonde jumps up out of bed and says, "I've had enough of this." She goes downstairs.

The blonde finally comes back up to bed and her husband says, "The dog is still barking, what have you been doing?"

The blonde says, "I put the dog in OUR backyard, let's just see how THEY like it."

YOU'RE JUST LIKE FRANK FELDMAN

A man walks out to the street and catches a taxi just going by. He gets into the taxi.

Cabbie says, "Perfect timing. You're just like Frank.

Passenger: "Who?"

Cabbie: "Frank Feldman. He's a guy who did everything right all the time. Like my coming along when you needed a cab, things happened like that to Frank Feldman every single time."

Passenger: "There are always a few clouds over everybody."

Cabbie: "Not Frank Feldman. He was a terrific athlete. He could have won the Grand-Slam at tennis. He could golf with the pros. He sang like an opera baritone, and danced like a Broadway star, and you should have heard him play the piano. He was an amazing guy."

Passenger: "Sounds like he was something really special."

Cabbie: "There's more. He had a memory like a computer. He remembered everybody's birthday. He knew all about wine, which foods to order and which fork to eat them with. He could fix anything. Not like me. I change a fuse, and the whole street blacks out. But Frank Feldman could do everything right."

Passenger: "Wow, some guy then."

Cabbie: "He always knew the quickest way to go in traffic and avoid traffic jams. Not like me, I always seem to get stuck in them. But Frank, he never made a mistake, and he really knew how to treat a woman and make her feel good. He would never answer her back even if she was wrong; and his clothing was always immaculate, shoes highly polished too—he was just a perfect man! He never made a mistake. No one could ever measure up to Frank Feldman."

Passenger: "An amazing fellow. How did you meet him?"

Cabbie: "Well, I never actually met Frank. He died and I married his widow."