

## Second Quarter 2010 Long/Short Strategy Comments

Equity markets fell substantially during the second quarter as investors, including Llenroc, became increasingly concerned that global economic growth has been dependent on fiscal and monetary stimulus and may not be self-sustaining. Llenroc Capital's long/short strategy declined (-4.2%) in the quarter versus a (-11.4%) return for the S&P 500. Although we are not pleased to have lost money even in a challenging quarter, we were able to hold our losses to a minimum.

Though the second quarter decline was material, it was not straight down. This afforded us the opportunity to adjust certain long and short positions based upon our evaluation of company and industry-specific fundamentals. We increased our long exposure from 71% at the end of March to 81% at the end of June due in large part to an increase in our position in Verisk Analytics. We also modestly increased our short holdings from (-25%) of equity at the end of March to (-27%) at the end of June. Our long/short portfolio remains invested in attractively priced high quality companies (on the long side) and low quality companies and companies with suspect business models (on the short side).

Poor investor returns over the last decade, and particularly over the last few years, have prompted investors to ask themselves what is a realistic expectation of future investment returns; should they attempt to "beat the market," take a passive approach and match the market or simply attempt to earn a reasonable return on their investments consistent with their long-term financial goals. In this quarterly letter we describe our "absolute return" approach to investing and, correspondingly, why we hold a concentrated portfolio of equity investments.

### ABSOLUTE RETURN

The primary measure of success for the vast majority of mutual fund managers and other investors is whether or not their portfolio outperforms a benchmark. Unfortunately, as an increasingly common saying among investors states: "I can't eat relative returns!"

For longer than many would like, investing in broad equity markets has delivered undesirable returns. Although the broad market generated excellent returns from 1982 – 1999, real returns were negative for the decade before that time, as well as for the decade we recently completed. Given the risk that stock market returns in the next decade may resemble these two lost decades, we believe pursuing an absolute return strategy to be the most prudent and conservative investment approach.

We think of each long and short position in our portfolio as an opportunity to make money (versus the corresponding risk of losing money). Our focus is therefore to earn a positive absolute return rather than a return that is better than some arbitrary benchmark, which has little to do with our investors' underlying financial objectives—such as the S&P 500. Within this context, our goal is to generate top decile returns on an after-inflation, after-tax basis. Our approach stands in stark contrast to the vast majority of relative-performance fund managers.

The cornerstone of our absolute return approach is the fundamental assessments we perform on each of our long and short holdings. The following four paragraphs reprise the assessment discussion from our third quarter, 2009 Investor Letter.

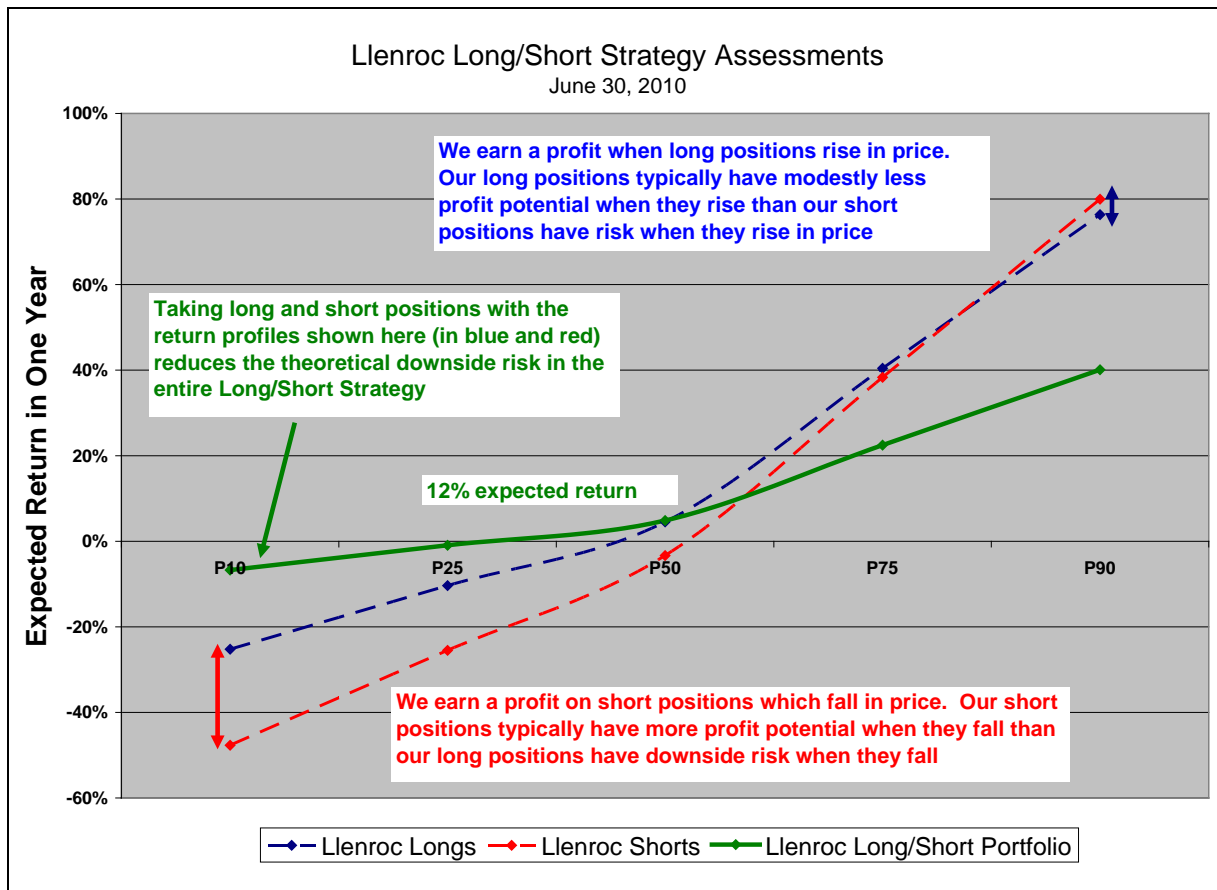
**Assessments:** *We identify and discuss specific fundamental events which would materially impact a company's business and which would therefore cause a substantial rise or decline in the company's share price. We perform these "assessments" on a regular basis for all our long and short holdings in order to determine the risk of a substantial decline in the value of each position. We look at a substantial decline in value as the true risk in each position rather than a modest decline, where substantial declines are often the result of significant fundamental events. News events and our conversations or meetings with companies/suppliers/competitors may cause us to add to or remove events from our list which typically results in an increase or decrease in the risk associated with each position.*

*We call extreme negative events "P10 events" as we consider them to have a 10% chance of occurring over the next year while we call extreme positive events "P90 events" as they are in the 90<sup>th</sup> percentile (top 10%) of possible positive outcomes over the next year. We discuss events which would be within the realm of possibility such that they would surprise us and other investors, but not be a complete shock. We focus on surprising events as they are possible to predict and would materially affect a company, while we do not waste time thinking about shocking events which would be sheer luck to accurately forecast. A surprising event might be the loss of a significant customer contract while a shocking event might be the complete destruction of a company's sole manufacturing facility.*

*Once we have identified these P10 and P90 events for each holding, we estimate where share prices would go should one or more of these P10 or P90 events come to pass. We then compare the current share price of each holding to these P10 and P90 prices to determine the absolute and relative upside and downside potential of each of our holdings under various extreme fundamental scenarios. We consider the "risk" for each holding that extreme events drive the share price much higher or lower when establishing and reviewing our position sizes.*

*The process of identifying and reviewing these assessments helps us to think about significant events which could happen and the risk/opportunity to our positions should they come to pass. This is not strictly an academic exercise, as one would expect that of approximately thirty total long and short holdings, three might experience P10 and three might experience P90 events in any given year. We believe it is imperative to have considered these scenarios before they happen and be prepared to act decisively rather than be surprised by unanticipated events and spend perhaps crucial time determining the impact on the company.*

The output of our fundamental assessments process is a return distribution for each holding. A return distribution is the return we might expect for each company under five different fundamental scenarios we define as P10 (worst case), P25 (bad case), P50 (normal case), P75 (good case) and P90 (best case). Below, we graph the return distribution as of June 30 for: 1) the sum of our long holdings; 2) the sum of our short holdings; and 3) our long/short portfolio. Though our fundamental expectations and market prices for each holding will change over time, the return distributions in this chart are a reasonable representation of what we might expect over time from our long/short strategy. In other words, the (-6%) downside risk, +42% upside potential and +12% expected return for the next year for our June 30 portfolio is similar to what we might expect at any point in time.



One important caveat to consider when looking at this chart is that each of the three expected return lines assumes that the returns of all long and short positions are perfectly correlated. In other words, when a P10 event happens to one company, a P10 event is happening to all companies. In the normal range of economic environments, this would be highly unlikely to occur and the P10 return graphed above would not be experienced. On the other hand, in a Great Recession-type environment, it might not be unreasonable to expect P10-type prices to be reached for a large portion of companies as a rapidly falling tide can push down all ships. This analysis thus may not be academically rigorous, but it is practically very descriptive in that it gives us an idea of how our long/short portfolio might perform in extremely treacherous environments.

Given that we just came through a P10-type environment, it's worth looking at how we performed versus what we expect for the current long/short portfolio. If one takes a single calendar-year time horizon, we substantially over-shot the downside potential in 2008 (a -27% return vs. a -7% expected return). On the other hand, we overshoot the upside potential in 2009 (a +45% return vs. a +40% expected return). If one looks at 2008 and 2009, our long/short strategy returned +9% (before fees) versus a +24% expected return. We clearly underperformed our expected return for the current long/short portfolio, but our results were at least positive during a period in which the majority of investors substantially dented capital.

### CONCENTRATE OR INDEX?

Many academics and financial advisors believe broad diversification within equities and across asset classes reduces risk. Unfortunately, the returns of equity indexes and many other asset classes over the last decade, particularly in 2008, illustrate that broad diversification did little to protect investor capital.

The mathematical benefits of diversification within an asset class approach zero after the number of portfolio holdings rises above twenty. Investors holding fifty or even hundreds of companies derive negligible diversification benefit from additional positions but nearly eliminate the opportunity to profit from their investment skill due to the declining return potential of additional investment ideas.

We think this misguided view of diversification contributed to the current housing crisis. Investment banks convinced financial institutions (banks, pension fund managers, etc.) it was less risky to hold a security which invests in thousands of underlying commercial or residential mortgages rather than a concentrated group of those underlying loans. They argued that diversification trumped understanding the underlying borrowers and their specific ability to make their mortgage payments.

Alternatively, many community banks such as Bank of Marin (our local bank) and First Financial Bankshares in Abilene, Texas (we have a number of clients in their backyard) chose to lend the old fashioned way and know each and every borrower and their ability to make their mortgage payments. Just as these two banks delivered solid results in the downturn by “doing their homework” on their borrowers, Llenroc Capital generated positive returns over the past 2.5 years by holding a limited number high quality companies in which we performed substantial due diligence.

Another reason the majority of investment managers over-diversify is not to reduce portfolio risk but to reduce professional risk. Broad swaths of our industry engage in a form of “closet indexing” by building portfolios with even hundreds of positions in order to not deviate from their benchmark index and risk losing clients or their jobs. As John Maynard Keynes wrote, “It is better to fail conventionally than to succeed unconventionally.” Fortunately, many investors and their wealth managers have come to recognize the truth of this statement. One common solution has been to pursue a Core-Satellite Strategy; hold a cadre of low-cost index-type assets such as Exchange Traded Funds (ETFs) and index funds and attempt to deliver strong absolute returns by retaining firms with demonstrated investment skill.

We define risk as the probability of permanent capital impairment, and appreciate the impact of over-diversification on investment returns as one adds an increasing number of companies to a portfolio. We therefore continue to search out a handful of businesses with the ability to withstand competitive forces and grow free cash flow and which sell for reasonable valuations. We are confident that over the course of a business cycle, these companies, bought at attractive prices, will generate attractive positive returns in the vast majority of economic environments.

### **INVESTMENT PERFORMANCE**

CAA Partners LP returned (-4.2%) net of fees in the second quarter of 2010 versus a (-11.4%) return for the S&P500. The reversal in cyclical and low quality companies was swift as risk premiums expanded. The table below details the performance of our long/short strategy over the last three years. More detailed performance data is available upon request.

<b>Long / Short Strategy Returns</b>	2010		2009			2009	2008	2007	2007– 2009
	YTD	Q2	Q1	Q4	Q3				
Long equity only (gross of all fees)	-7.3%	-11.9%	5.2%	18.7%	17.4%	69.5%	-38.5%	-0.4%	3.8%
Short equity only (gross of all fees)	15.3%	18.5%	-2.7%	0.2%	-20.1%	-29.5%	103.3%	-5.9%	34.9%
Total Portfolio Net (after fees & performance fee)	-2.1%	-4.2%	2.2%	12.5%	11.4%	36.3%	-27.0%	-3.9%	1.6%

#### **Index Returns**

S&P 500 (total return, including dividends)	-6.6%	-11.4%	5.4%	6.0%	15.6%	26.5%	-37.0%	5.4%	-16.0%
CS/Tremont Long/Short Benchmark Index	NA	NA	2.8%	2.4%	7.8%	19.5%	-19.8%	13.7%	9.0%
Barclay Hedge Equity Long Bias	NA	NA	3.5%	3.3%	11.4%	29.4%	-29.0%	10.6%	1.6%

#### **CONCLUSIONS**

Although valuations are lower than three months ago, the prices of many low quality and cyclical companies continue to price in strong economic growth. We continue to practice price discipline in our decision making process finding comfort in Benjamin Franklin’s comment, “He who is patient can have what he wants.”

Please feel free to call us at (415) 785-3670 if you have any questions or comments.

Llenroc Capital LLC

*This letter should not be construed as investment advice and should be kept confidential. Past performance is not indicative of future returns. The historical performance information reflected above has been prepared by Llenroc Capital, LLC and has not been compiled, reviewed or audited by an independent public accountant. The results for the current partial year are based on internal books and records for CAA Partners LP, which are subject to year-end audit adjustments. Net performance results include performance fees and allocations accrued but not yet payable or allocable. Returns experienced by individual investors will vary depending on their date of investment and their eligibility to receive “new issue” profits and losses. CAA Partners LP launched on September 1, 2006.*