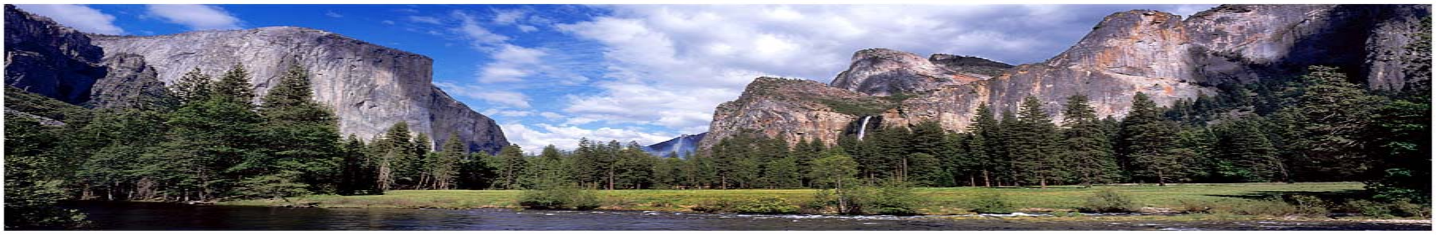
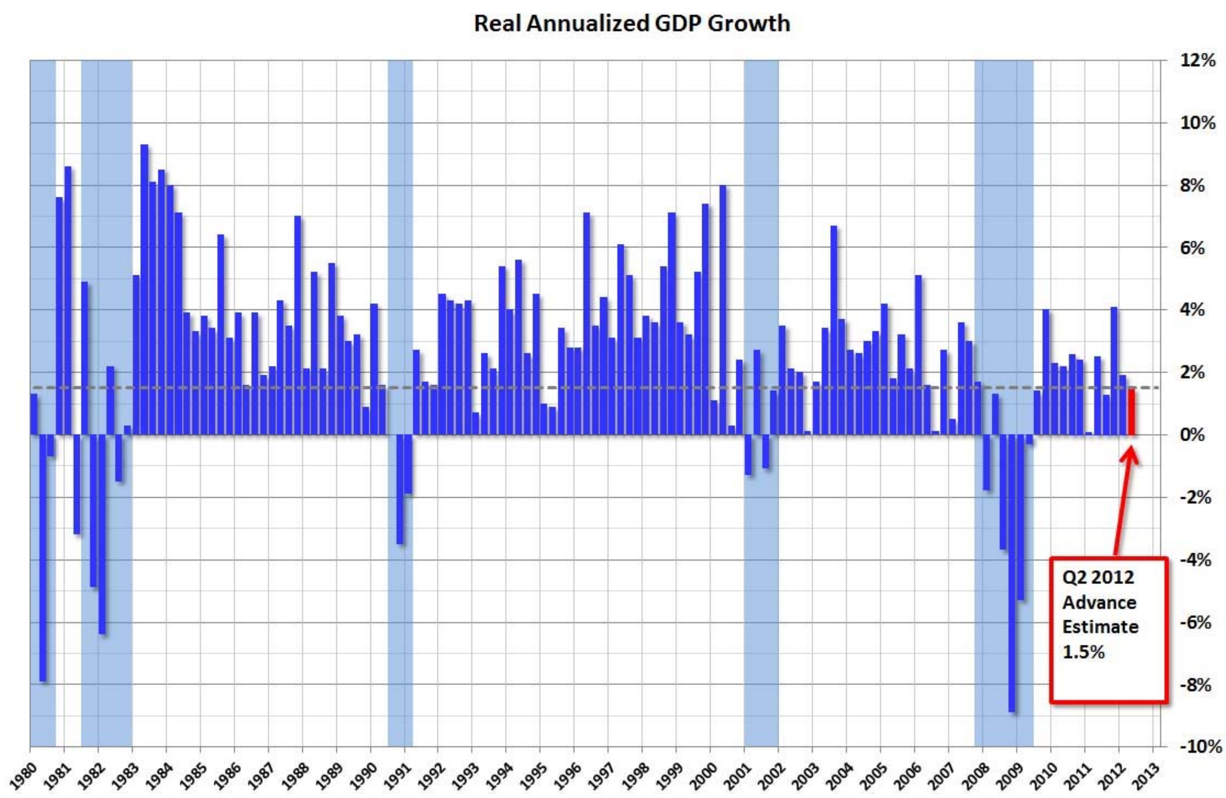


YOSEMITE CAPITAL MANAGEMENT

Third Quarter 2012 – COMMENTARY

“Banking establishments are more dangerous than standing armies.” – Thomas Jefferson

The economy of the United States has continued to grow in a slow and choppy manner, as we have expected. The fact that real GDP growth has been positive in all 12 quarters since the Great Recession ended in June 2009 (per the NBER) is good news, though the additional fact that the growth rate during the recovery has fluctuated around a very low 2% per year indicates the economy remains far from healed.



Source: Calculated Risk

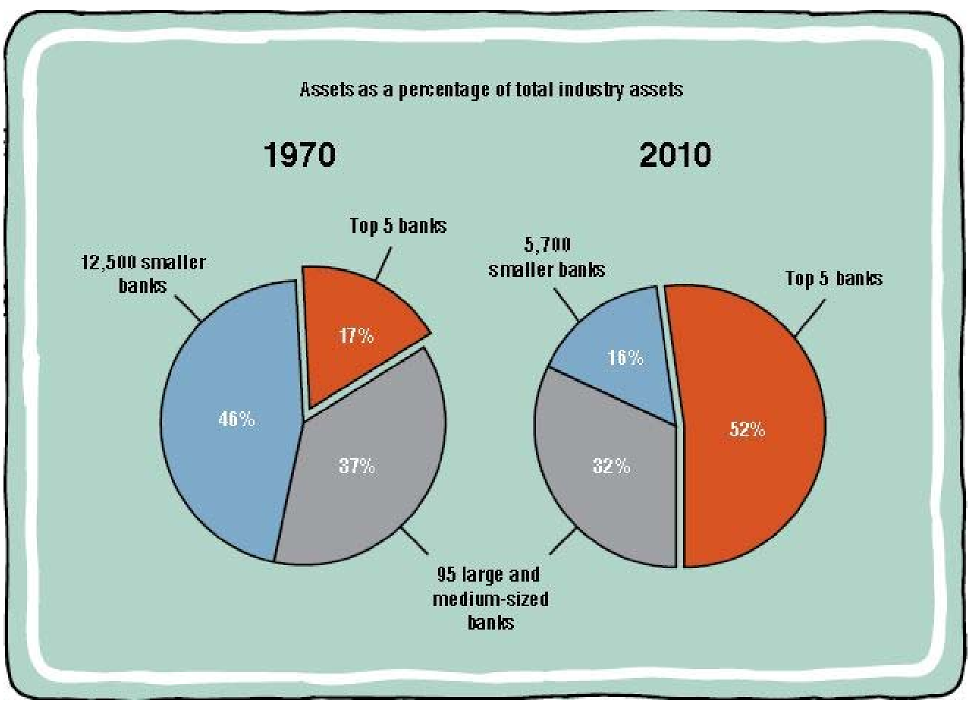
Weights on the economy include a constipated residential real estate market, consumer deleveraging (paying down debt), the Euro crisis, a slowdown in China, and a dysfunctional financial system. We have briefly discussed all of these in our last several letters.

There is some evidence of improvement in the residential real estate market with increased sales activity and prices in many markets around the country. However, it is too soon to determine if this is the beginning of sustained progress or simply seasonal activity. Also, a major factor that is potentially on the verge of occurring is additional distressed sales coming to the market, a delayed response from the now-ending voluntary foreclosure abatements by banks during the robosigning settlement discussions with the U.S. Department of Justice. This unclogging of part of the residential real estate market could be messy and cause a stink if it halts and even reverses the nascent price increases, though the action is necessary for the real estate industry to return to health in the long run.

Consumer deleveraging is by definition a very slow process. Personal disposable income that goes toward paying down debt means less is spent on new goods and services, which in turn inhibits economic growth. All else equal, less economic growth stifles new job creation and prevents significant increases in personal disposable income. The vicious cycle takes time to play out and is a major reason why recoveries from credit busts are naturally sluggish for a prolonged period of time.

The nature of the situations in Europe and China require structural changes that will take several years to make substantial headway, though any interim steps in the right direction can contribute to a stronger global economy.

Unfortunately the problem of a dysfunctional financial system likely requires a political solution, and we are not hopeful of this happening anytime soon. Specifically, the largest financial institutions by the very nature of their size are risks to the entire financial system. Called Too Big to Fail (TBTF), this term also suggests Too Big to Regulate, Too Big to Manage, Too Big to Succeed, and Too Big to Care. As such they need to be dismantled, separating commercial banking, investment banking, and insurance operations into separate entities. In other words, the affiliation restrictions in the Glass–Steagall Act that were repealed through the Gramm-Leach-Bliley Act in 1999 need to be reinstated.



Source: Federal Reserve Bank of Dallas, 2011 Annual Report, "Choosing the Road to Prosperity", page 6, Exhibit 2http://www.dallasfed.org/assets/documents/fed/annual/2011/ar11b.pdf

There also needs to be serious limitations on how financial institutions use derivatives and leverage. A good start would be to revisit the Commodity Futures Modernization Act of 2000 that exempted most over-the-counter derivatives transactions between "sophisticated parties" from being regulated as "futures" under the Commodity Exchange Act of 1936 or as "securities" under the federal securities laws.

In spite of the TBTF companies being among the major participants at the epicenter of a financial debacle that led to the worst recession since the Great Depression, the best the political establishment could do in response was to pass the Dodd-Frank Act. This measure did nothing to directly address one of the root causes of the problem, which could have been accomplished by breaking apart the perpetrators. Thus Congress and the White House left major risks to the system in place. Instead they prescribed procedures for how bankrupt companies would be liquidated during the next crisis. That is like a doctor doing nothing to prevent a patient's clogging arteries from causing a heart attack but instead providing procedures to follow after a heart attack occurs.

The necessary changes require our political class to demonstrate common sense, ability to compromise, integrity, courage, and a willingness to forego campaign contributions from these companies. We see little chance of any of these, let alone all of them, occurring in the current environment of rank partisanship where all actions are about getting power, preventing the opposition from getting power, appeasing campaign contributors, raising money for the next election, claiming credit for anything positive, and assigning blame for anything negative.

Thus the economy is likely to continue to grow only in a slow and choppy manner at best, which is positive but far from ideal.

All of this leaves the financial markets responding to the monetary morphine provided by central bankers around the world. Domestic bond yields are at all-time lows, and though it is obvious they cannot stay at these levels indefinitely, they can stay low for longer than many believe thanks to the easing actions of the Fed. The stock market pushes higher on any hint of an improving domestic economy (which is logical since the stock market should anticipate changes to the economy), but by advancing merely on hopes for another hit from the Fed via QE3 increases the risks of stock prices exceeding their fundamental values.

Another situation has arisen concerning the long-proven benefits of having portfolios with diversified asset classes. Normally such an approach serves investors by providing higher returns and/or reducing volatility. This has been the case for bonds where a mix of corporate bonds, TIPS, municipal bonds, and foreign bonds has served investors well, and we perceive this may be the case for some time in the future. But this has not been the recent case for equities, where asset class diversification into foreign stocks, domestic small cap stocks, and at times commercial real estate, has actually been detrimental to investors in 2011 and so far in 2012. Returns coming from narrower segments of the market are often an early (sometimes very early) yellow flag that further suggests Managing Risks should take a higher priority than Managing Returns.

The phase in the cycle requiring more prudence does NOT necessarily mean another stock market debacle is at hand. As stated earlier, there are positives that are manifesting themselves, they are just not exceptional, and a little something is better than nothing. Investors have to play with the cards they are dealt, and this may mean having lower expectations. Keeping in mind that successful investing is a marathon that lasts years, those who tolerate the inevitable bouts of market volatility will prosper, and those who actually embrace volatility will thrive.

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In spite of our lack of faith in the political class to work together to find common ground and solve some of our major problems, we still firmly believe that engaging in the political process is a vital role of all citizens in the United States. Therefore it is appropriate that we reprise what we wrote prior to the mid-term elections in 2010.

> One of the most important rights that adult citizens of the United States possess is to elect members of the government at the federal, state, and local levels. Through this process Americans live the principle enshrined in the Declaration of Independence that the people choose the government rather than being subjects of the government.
>
> But in recent decades, only about 50% to 60% of eligible Americans vote in presidential and mid-term elections, and far fewer in other elections. People give various excuses for not voting, including believing such things as their vote doesn't affect the outcome, special interests control the politicians, the general outcome is the same under either major political party, politicians in general are corrupt, the parties are controlled by their extreme factions, etc.
>
> While we understand the frustrations behind these arguments, we believe that choosing to not participate is not the answer, in part because this actually incentivizes the bad behavior just described. To not vote is akin to leaving one's front door wide open when away believing that thieves will always find a way in so why bother trying to stop them. To not vote is similar to giving a mugger a bigger stick with which to beat you while they steal your money.
>
> Instead we submit that voting is the biggest weapon against corruption, extremism, special interests, etc., and that voting is a major way to redirect the course of government. Voters are not limited to candidates of the two major parties -- one's actual choices number among the millions of citizens, including candidates of smaller parties, your neighbor, and even yourself. Consider that if every eligible non-voter decided to cast a ballot, every single member of Congress, judges, and the President could be different! By extension, that also means every cabinet member, regulator, and appointee could also be different. Consider that even if the results of an election are the same, if enough people voted for a smaller party or write-in candidate, the winning official would face a powerful message that their victory by plurality by definition means the majority actually voted against them! That would be a definite mandate to reach out to find common ground, possibly lessen the importance of political contributions, and potentially change the very tone of American politics.
>
> We encourage all registered voters to take matters into your own hands and vote your conscience in every election. We encourage all eligible non-registered citizens to register to vote with your state's Secretary of State in accordance with that state's deadline for the next election and then cast a ballot in every election thereafter. (For California residents, voter registration information is at *http://www.sos.ca.gov/elections/elections_vr.htm* and the deadline is 15 days prior to an election.)

As citizens, we have a choice through the ballot to fight back against Wall Street's greed and selfishness, reject lies and spin by the government, prevent frivolous public spending, minimize the extreme factions of political parties, reduce the importance of money in the political process, ensure accountability of government officials, encourage honesty from government contractors, and return the economy to the functions of legitimate business – in short, get the American government back to its citizens.

Happy voting!

John Kleponis, CFA

Chief Investment Officer

Paul Heckler

Managing Director

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The S&P500 Index is designed and maintained by Standard & Poor's (a division of The McGraw-Hill Companies), is a free-float market capitalization weighted index that includes 500 leading companies in leading industries of the U.S. economy, and is intended to be an ideal proxy for the total market. This index is calculated on a total return basis with dividends reinvested and is not available for direct investment.