

EAST COAST

ASSET MANAGEMENT

To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – CEO, Chief Investment Officer, and Co-Founder

Date: October 23, 2012

Re: Third Quarter 2012 Update – **Inventing a Flying Machine**

On September 1st East Coast celebrated its fourth anniversary, on behalf of our entire firm, we want to express our gratitude for your loyalty, trust, and friendship over the last four years. In our Q3 letter you will find an update on our portfolio and general market observations. Each quarter we highlight one component of our investment process – this quarter in the section titled *Inventing a Flying Machine* we widen the lens and discuss the investment process in total. As is our standard practice, client reporting, including performance and positioning, will be sent under separate cover.

Market Summary¹

	<u>S&P 500</u>	<u>MSCI AC World Index</u>	<u>MSCI Emerging Markets</u>	<u>MSCI EAFE Index</u>	<u>Barclays Aggregate Bond Index</u>	<u>Gold – \$/Troy Oz.</u>	<u>Crude Oil</u>
<u>Price 09/30/2012</u>	<u>1440.67</u>	<u>1311.50</u>	<u>1002.66</u>	<u>1510.76</u>	<u>1475.50</u>	<u>\$1,772.10</u>	<u>\$92.19</u>
<u>Q3 2012</u>	<u>6.35%</u>	<u>6.84%</u>	<u>7.90%</u>	<u>7.00%</u>	<u>1.63%</u>	<u>10.94%</u>	<u>8.51%</u>
<u>YTD</u>	<u>16.45%</u>	<u>13.58%</u>	<u>12.19%</u>	<u>10.53%</u>	<u>3.78%</u>	<u>13.33%</u>	<u>-6.72%</u>
<u>2011</u>	<u>2.11%</u>	<u>-4.98%</u>	<u>-18.37%</u>	<u>-11.67%</u>	<u>7.69%</u>	<u>10.06%</u>	<u>8.15%</u>

Global equity indices performed reasonably well in the third quarter, the S&P 500 gained 6.35% and the MSCI World Index appreciated 6.84%. Year-to-date returns have now eclipsed double digits with a 16.45% return for the S&P 500 and a 13.58% return for the MSCI World Index. Gold continues to outperform both bonds and cash, appreciating 13.33% on a year-to-date basis. The Barclays Aggregate Bond Index has appreciated a more modest 3.78% for the year.

The equity markets received positive news from Europe this quarter which helped remove some of the tail risk that had been tempering returns. We have been satisfied with the performance of our portfolio holdings in this environment. We remain focused on measurable market dynamics and continue to be cognizant of geopolitical and economic concerns outside of our control. We will act accordingly if we discover risks that should be mitigated.

¹ The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index, MSCI Europe Asia Far East (EAFE), and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast's investment strategy will not seek to replicate the performance of these or any other indices.

Our Flight Plan:

Valuation is the primary driver that informs our investment strategy. Over time the market is meritocratic and rewards investors when they have purchased a stream of future cash flows at a discount. Conversely, the market will tend to punish market participants who have overpaid. Every investment has an expected rate of return from its quoted price over a given time horizon, it is our primary objective to determine what that expected return is and allocate capital accordingly.

Since early 2009, there has been a secondary driver informing our investment strategy – the developed world’s central bank monetary policy. As noted in earlier letters, central banks have three exit strategies to mitigate their debt burdens: increase taxes, reduce spending, and print money. We expect them to employ a combination of all three strategies but history shows that the printing of money will be the most politically and economically viable. These actions potentially have critical implications for accumulated wealth, future interest rates, and inflation.

Our flight plan, or investment strategy, seeks to address today’s valuation and monetary policy realities. The merit of asset class expected returns and investor fear can be placed into one of three categories: tailwinds, headwinds, and turbulence.

Tailwinds:

- **Equities:** Valuation and monetary policy have created a very favorable tailwind for the ownership of equities. We continue to advocate for an allocation of equities at the high-end of our tactical ranges. While our expected returns have fallen as prices have moved higher, we still feel our low-to-mid double-digit absolute return projections are compelling. With uncertainty surrounding the survival of the Eurozone, we have spent time analyzing European and emerging market equities and have made additions where appropriate to existing holdings.
- **Great Businesses:** It is our preference to own a business where we expect intrinsic value to grow on a compounded basis. Last quarter, we described what we look for in a great business in the section titled *The Six Sides of Great*: attractive operating economics, sustainable competitive advantage, a growing market opportunity, pricing power, low capital intensity, and an effective management team that thinks and acts like owners. Current market conditions have been favorable for owning and finding these businesses at attractive valuations. We have augmented our margin of safety by owning a portfolio of “higher quality” businesses with pricing power as we anticipate periods of turbulence. From a return standpoint, we consciously traded some speed (return) for more altitude (quality). While many lower quality businesses have had stronger returns off the bottom, our decision to own higher quality businesses gave us the confidence to allocate a larger amount of capital to equity investments, benefitting our portfolio’s absolute returns.

Headwinds:

- **Intermediate-Long Term Fixed Income:** It is only a matter of time before investors will require a higher cost of capital to own fixed assets, only to realize they are being returned depreciated dollars at maturity. The reality of a post credit crisis money printing regime is that money creation initially diffuses the deflation inherent in a deleveraging cycle.

Eventually there will be an inflection point where interest rates rise, perhaps quickly, reflecting the legitimate fear that excess money is causing inflation. The value of intermediate-long term fixed income securities could drop precipitously when this change occurs.



- Cash and Equivalents: Purchasing power erosion is a clear and present danger. We are balancing our desire for adequate liquidity with this reality in mind.

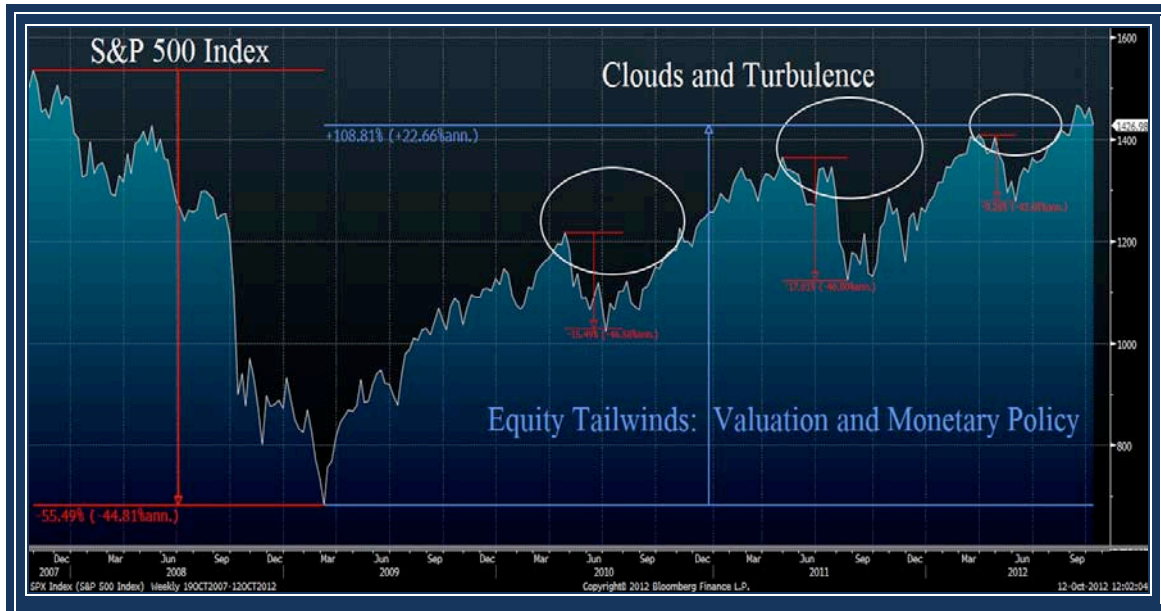
Turbulence:

Our established flight plan continues to anticipate rough patches of air. Over the last three years we have experienced three defined periods of volatility brought on by clouds of uncertainty. As you can see in the chart on the following page, the peak to trough periods of turbulence dispatched corrections between 9% and 17%. In all three corrective phases, many investors assumed the worst and concluded that a strategy involving equity investments was foolish and doomed. These periods look more like turbulence along the upward trajectory of the market rather than an all out dislocation forewarned by market pundits. Rather than waiting for blue skies we have travelled further toward our destination by fastening our seatbelts and operating in Airplane Mode².

It is critically important to differentiate between periods of turbulence from that of true risk. Investors who can remain focused on price and value while filtering out superfluous noise have

² Airplane Mode is a setting on electronic devices to suspend the sending and receiving of signals that could potentially impact aircraft avionics. In a similar vein, filtering noise is a key element of our flight plan. The signal-to-noise ratio is a measure used in science and engineering to compare the level of desired signal to the level of background noise. We look to maximize our use of Airplane Mode to improve our ability to receive desired signals and minimize superfluous noise.

often been rewarded with compounding success. True headwinds and tailwinds are driven from valuation – this is the most important piece of wisdom to keep front and center in an investor’s mind. We are not sure what the next period of turbulence will look like, but as we view the horizon we see clouds around the European Debt Crisis, and spending cuts and tax increases that have been deemed the “U.S. Fiscal Cliff.”



- European Debt Crisis: This quarter we heard a more unified voice from the European Central Bank (ECB) on their intention to keep the Euro intact and to support the financially distressed countries with conditions of measured austerity. We have been communicating to you that the situation in Europe is fluid with the most probable outcome being a unified response from the ECB. This response would culminate in the use of monetary policy to mitigate overall debt burdens while building a more sustainable future for those countries in the Eurozone that are willing to evolve.

I recently travelled to Germany to attend a German Equity Conference hosted by one of the oldest German banks, Berenberg Bank. While my primary objective was to meet with management teams of a number of German publicly traded companies, I also had the opportunity to meet a member of the Executive Board of the European Central Bank, Mr. Jorg Asmussen. Mr. Asmussen made it clear that it is their intention to try to eliminate the tail risk that is priced into the markets with regard to a Eurozone break up. It was insightful to hear firsthand the conviction and confidence toward an outcome that we had already believed most probable, a Eurozone that remains unified.

- U.S. Fiscal Cliff: In February of this year, Ben Bernanke (before the House Financial Services Committee) coined this term when he described “a massive fiscal cliff of large spending cuts and tax increases” scheduled to take effect on January 1, 2013. Some investors feel that unless this combination of spending cuts and tax increases is halted by Washington, it will grind the fledgling recovery to a halt, resulting in a reversal of recent

market appreciation. The fact that we are in an election year with both parties very close in the polls makes for even more uncertainty among investors.

We feel the U.S. Fiscal Cliff concerns will be inevitably solved by either a Democratic or Republican administration. Both parties are running on a “jobs first” platform and both parties are going to do what is necessary to support this recovery. The same fears that created the turbulence in the wake of the debt ceiling debate will continue to fuel volatility around the U.S. Fiscal Cliff debate. This fear may provide an opportunity to make investments in our portfolio that were not as attractive at higher valuations.

Portfolio Changes – ECAM Core Equity Strategy:

Equity market weakness in the second quarter was followed by strength in many of our portfolio positions in the third quarter. Beyond changes to some position sizes during the third quarter, we exited one long-term position initiated in 2009 and added one new position to the portfolio.

The position we exited was a business that had reached the high-end of our valuation range. This business receives the majority of its revenue and operating earnings by holding an enviable position as a sole source provider of replacement parts to the aerospace industry. We struggled with selling this position on valuation concerns, as we believe the long-term compounding merit of the business is sound. We hope to be able to own this business again if Mr. Market³ becomes pessimistic with this business, industry, or marketplace versus his more optimistic attitude when he purchased our shares.

We are still in the midst of building our new position, so I will share more details regarding that investment outside of this letter. At a high level this business is a recent spin-off with very compelling operating and spin-off dynamics – an incentivized management team, reasonable valuation, a number of forced institutional sellers, and a strategy underway that should materially improve their operating economics over the next five years.

³ Mr. Market was a metaphor introduced to the world of investing by Ben Graham in chapter eight of his book *The Intelligent Investor*. Ben Graham would often cite the manic depressive nature of Mr. Market in his writings and in his Security Analysis class at Columbia Business School.

Investment Process – Inventing a Flying Machine⁴:

At the turn of the twentieth century, a handful of adventurers were convinced that the dream of flight was attainable and thus the great aviation race was underway. Two leaders emerged, each with drastically different strategies. Samuel Langley, armed with a contract from the U.S. War Department and the resources of the Smithsonian Institution, was confident that he could solve the problem of flight with power. Langley’s mental image was that of a stone skipping across water, and the energy applied to that stone forcing it to stay afloat. The Wright Brothers from Dayton, Ohio, were the other leaders in this race. While tinkering in the obscurity of their bicycle shop, they believed that solving the problem of flight would be solved through balance – a combination of wing design and pilot control. Wilbur Wright’s observation of birds shaped their methodology – a bird’s wing design would provide the key to lift, with the ability to turn being produced by the pilot “banking” or “leaning” like a bird or bicyclist.



© EAST COAST ASSET MANAGEMENT, LLC

In 1900, Langley focused the lion’s share of his attention on designing a lightweight powerful engine, while the Wright Brothers devoted their time to designing a wing that could provide efficient lift and be controlled by a pilot. They observed that birds changed the angle of their wings to make their bodies roll left or right, and by twisting a cardboard box in their bicycle shop they were able to emulate this motion and discover the concept of wing-warping, one of the keys that would unlock the secret of flight.

In the same year, the Wright Brothers travelled to Kitty Hawk, North Carolina, an area with ideal wind conditions, to further test their flight theories. From 1900 – 1902, the Wright Brothers would experiment, test, and refine their ideas on wing design. They wanted to verify lift data and as such created a wind tunnel to test over 200 wings for the most efficient lift-to-drag ratio. Orville Wright envisioned a vertical rudder not as a steering mechanism but as a tool to align the aircraft during a bank turn in various wind conditions. During September and October of 1902, they made nearly 1,000 glides, the longest lasting twenty-six seconds and covering 622 feet. They practiced with a large margin of safety, as most flights never exceeded six feet off the ground. In this time, they created three-axis control: wing-warping for roll, forward elevator for pitch (up and down), and rear rudder for yaw (side to side). On March 23, 1903, the Wright Brothers applied and eventually were approved for their famous patent (No. 821,393) for a “Flying Machine,” based on their successful 1902 glider.

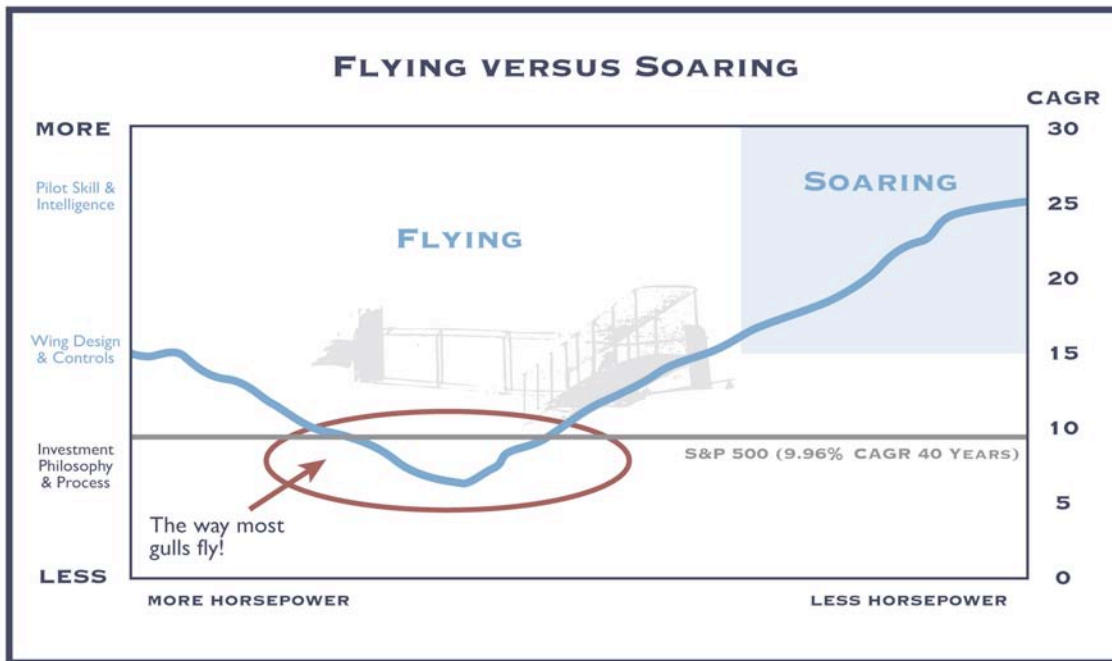
Backed by nearly \$50,000 in government funds and expertise, Langley continued to fail at building an engine powerful enough to maintain flight of his great Aerodrome. His research on wing design was inferior and even if the Aerodrome were able to maintain flight, neither the wing design nor pilot skill had yet to be tested.

⁴ The “Inventing a Flying Machine” illustration above is my depiction of the highlights of early aviation told through the most famous error in U.S. postage stamp history, *The Inverted Jenny*.

Given the fact that the Wright's glider was so efficient and their ability to control the aircraft so advanced, the challenge of adding power proved relatively simple. They turned to their shop mechanic, Charlie Taylor, who created a twelve horsepower engine in just six weeks. On December 17, 1903, Orville Wright flew the first powered heavier-than-air flight of 120 feet in twelve seconds at a speed of 6.8 miles per hour. Over the following two years the Wright Brothers would continue modifying their designs to maximize stability and control, setting the stage for a series of six dramatic "long flights" ranging from seventeen to thirty-eight minutes with distances ranging between eleven and twenty-four miles.

The great race for first flight tells a story that resembles the competitive landscape of the investment management industry. In order to produce superior compounded returns over time I believe one must not only have a differentiated view but more importantly a differentiated investment process. The vast majority of professional investors attempt to unlock the key to compounding success through horsepower at the expense of wing design/investment process and pilot control/manager skill.

Just like the Wright Brothers, East Coast places a disproportionate amount of emphasis on maximizing our margin of safety and compounding success through refining our wing design/investment process and improving our ability to navigate varying investment climates. Only after we have collected rational insights from our investment process do we then attempt flight. It is only then that we determine what level and kind of horsepower is required and at what point we will have sufficient lift and insight to soar.



© EAST COAST ASSET MANAGEMENT, LLC

When we study the best compounding records, the vast majority of successful records were produced by a single manager or a small team where process, skill, intelligence and control were coupled with a value philosophy. I believe one of the key insights into having an edge is through building this type of insight into a business plan. While assets under management can produce drag as managers meet success, the biggest anchor that grounds returns is the misallocation of resources toward horsepower at the expense of all else.

We conclude that the vast majority of managed wealth in the world is run under the Langley model and not under the Wright Brothers (WB) model. At East Coast, we seek to emulate processes that work the most effectively at compounding wealth. In this light, we heavily weigh the importance of following a WB model where we favor intelligence, skill, process, and margin of safety.

Soaring – Process, Checklists, and Sourcing Lift:

The Wright Brothers solved the problem of flight by first learning to glide. Eight years after their first powered flight in 1903, Orville returned to Kitty Hawk to conduct new experiments with control in a non-powered glider. Orville's flights in October 1911 were some of the world's most dramatic glider flights, not only did they deepen man's understanding of flight, they also served as the birth of the recreational sport of "soaring." On October 24, 1911, flying in a fifty mile per hour headwind Orville set the world soaring record of nine minutes and forty-five seconds, a record that would stand internationally until 1921, and in America until 1929.

Soaring pilots look to stay airborne by looking for sources of rising air, or lift. The most commonly used sources of lift in order of magnitude are thermals, ridge lift, and wave lift. If a soaring pilot can correctly identify these sources of lift, the pilot can soar long distances indefinitely without utilizing any horsepower.

This concept of sourcing lift and measuring the expected magnitude and duration of lift from a categorized source aptly describes our process of vetting a prospective investment. If a sourced idea stands up to initial merit, it is run through one of three checklists⁵ once we determine if it's a compounder, transformation, or work-out. Our checklists have been invaluable in helping us reduce pilot error and they have become a platform to remind us of previous lessons learned. These lessons can be soon forgotten when animal spirits and biases emerge to prove a theory. Our checklists were built to *invert* our thinking the way a scientist would seek to prove the *null* hypothesis. For example, if we want to know if the investment is mispriced, the checklist seeks to invert the question to solve why the investment is NOT mispriced. We have found that this inversion helps reduce the biases that bleed into any investment process.

⁵ The pilot's checklist was first created after a fatal aviation accident occurred on October 30, 1935, on the Wright Airfield in Dayton, Ohio, when the Boeing Model 299, which would become the B17, was being run through final evaluations. The investigation found pilot error was the cause of the accident as the pilot and co-pilot had neglected to release the elevator lock prior to take off. Many argued the aircraft was too difficult for pilots to fly, so Boeing responded by creating checklists for takeoff, flight, before landing, and after landing. With the checklists, careful planning, and rigorous training, the aircraft managed to fly 1.8 million miles without a serious accident and utilizing checklists became the standard in the airline industry where margin of safety means life or death.

The goal of our checklist is to solve the following equation: $JOC = [IRR*(MoS+H4)]^M$. This compounding objective (JOC – Joys of Compounding) looks to answer the following questions: What is our range of expected returns (IRR)? Do we have a meaningful and measurable margin of safety (MoS)? Do we understand the critical data points of the investment (H4)? And finally do we have insight into why the marketplace may be mispricing this investment (M)? Every investment team has limited time and resources, making the efficiency and effectiveness of sourcing extremely important.

This summer I had the opportunity to take a glider flight in Vermont over Mount Mansfield. During our flight I asked the pilot, “What are the two most important signals you look for when you are searching for lift?” He answered, without hesitation, “Clouds and soaring birds.” Reflecting on his response, his answer mirrored the two areas that signal the majority of our potential investments.

Under a Cloud:

When prospecting for lift in soaring or in our investment process, the most lucrative place to look is under a cloud. In soaring, clouds advertise lifting air from ground level to cloud level. Air contains moisture, and as air rises it expands and cools down. Cooler air holds less water vapor and as the water cools vapor condenses into tiny water droplets, forming a cloud. Over two-thirds of our sourcing categories for prospective investment opportunities are advertised to us because they are under a cloud. The cloud creates a misunderstanding of the investment’s long-term prospects and thus the mispricing we are in search of. Clouds can come in many forms and we find them important sourcing signals for all three of our investment categories: compounders, transformations, and work-outs.

Examples of Clouds:

- Market and industry sell-offs that produce a cloud over an asset class or industry
- Post-bankruptcy reorganization – the lasting cloud of a failed strategy
- Spin-off and demutualization – cloud of uncertainty and lack of knowledge of the new entity accompanied by forced sellers
- Industry transformation – lasting cloud of the previous status quo that prevents a clear view of a secular change and inflection point
- Political and economic cloud – similar to what we are experiencing in the Eurozone and have experienced in the U.S. over the last three years

Soaring Birds:

Glider pilots love to spot soaring birds that are taking advantage of lift. During my day gliding in Vermont, although it was a cloudless day, we were able to follow a red-tailed hawk into a thermal where our variometer then began to measure 300 feet per minute of lift, eventually gaining over 1,500 feet of additional altitude.

We look for two types of soaring birds: intelligent investors, and talented, properly incentivized company operators. At last count, there were only 111,000 active civilian glider pilots and 32,920 gliders in the world. There are far less investors who have the wisdom, and even more importantly, the freedom to soar. Collaborating with our network of respected investors has aided in signaling some of our greatest investment ideas. While some of these investors are quite well

known, many are not and choose to run smaller pools of capital, often times where they are their own largest investor. They fully understand the tradeoff between the WB model and the Langley model. The rare few of these soaring birds/intelligent investors who end up successfully scaling their businesses while maintaining compounding success are to be admired.

We also spend a good deal of time talking to owner-operators both in private and public companies. We ask them a number of questions such as:

- What does their competitive landscape look like and how is it evolving?
- Who is their strongest competitor and who do they respect?
- Who is gaining market share in their industry?
- Are they seeing pricing pressure or are they experiencing pricing power?
- How do they plan on allocating owner earnings?

At times, we can be constructive in helping them think through value propositions, such as if a share buyback would be economical at a given price. These discussions with management teams help us form a mosaic of knowledge which produces insight into many of our investments and is often a viable source of idea generation.

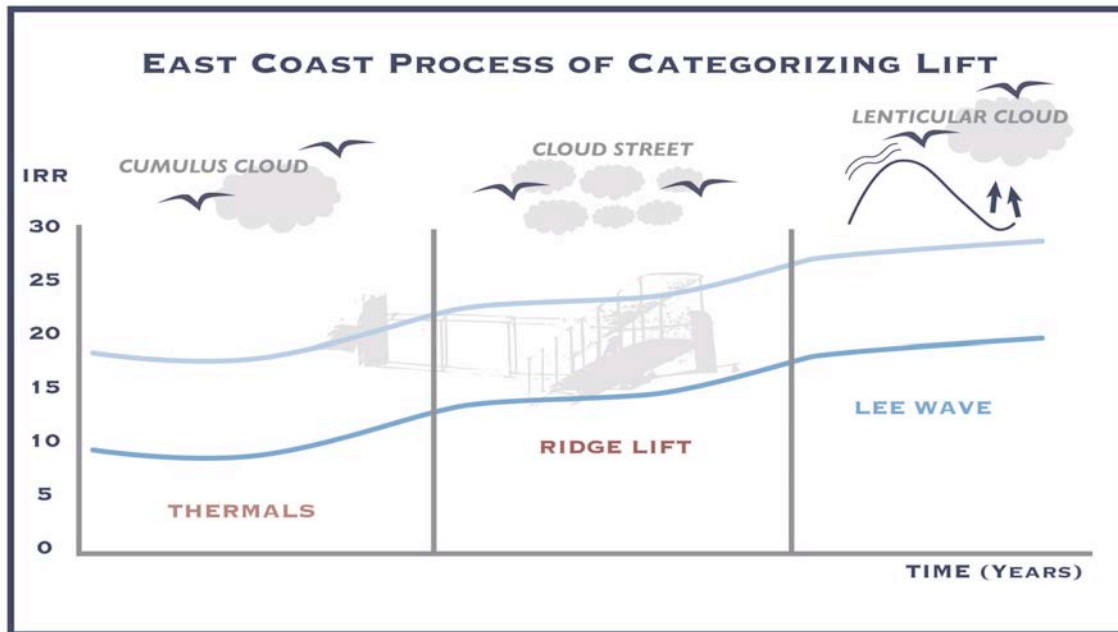
Soaring – Categorizing the Magnitude of Lift:

It is one thing to find lift, but it is equally important to know the type of lift we are experiencing so we can understand the duration and the potential altitude gain. As I mentioned earlier, the three main sources of lift in order of potential altitude and duration are thermals, ridge lift, and wave lift. The opportunity set will determine what kind of lift is most prevalent in our portfolio.

Thermals:

Thermals are the most common form of lift and are often found under cumulus clouds. As the earth heats up, there are columns of rising air between the ground and puffy cumulus clouds. The duration and magnitude of lift can be modest so a glider pilot must fly from thermal to thermal to maintain lift: this is called “thermaling.” Skilled pilots can do this very effectively and stay in the air for long periods of time when conditions are favorable.

At East Coast, investments we define as thermals are our work-out category ideas. These are investments that we determine to be undervalued or trading at a sufficient discount. As this gap closes, we will be rewarded by a favorable internal rate of return (IRR) over an estimated time horizon. Thermals often have some perceived catalysts and tend to be a very popular area trafficked by the hedge fund community. We view thermaling as a means to an end. When thermaling, we pay close attention to our variometer, driven by valuation and critical data points^{H4}, so we can be disciplined in our entrance and exit strategy. We currently have less than one-third of our portfolio allocated to thermal-type ideas.



© EAST COAST ASSET MANAGEMENT, LLC

Ridge Lift:

As wind flows over an object it creates an updraft. When wind flows over a ridge, it creates a lift zone on the windward side of the ridge. Orville Wright used ridge lift to achieve his record glides in 1911. Using ridge lift, glider pilots can fly in excess of a thousand kilometers along mountain ranges such as the Appalachians. Along a ridge you will often see a series of clouds, called cloud streets, along which a pilot can fly in a single efficient direction while gaining lift.

We expect to earn an attractive return over a longer duration with our ridge lift investments. A lower IRR ridge lift investment may be superior to a higher IRR thermal investment because of the longer duration and greater margin of safety we receive. The majority of our ridge lift investments are compounders and transformations where we benefit from tailwinds related to the secular dynamics of their market opportunity and the businesses' competitive advantage. We find ridge lift can often be mispriced because many investors lack a sufficient time horizon for these investments to pay off. We currently have more than two-thirds of our portfolio allocated to ridge lift type ideas.

Lee Waves:

Lee waves, or mountain waves, are created when wind flows over a mountain and mixes with stable air on the leeward side of the mountain, causing the air to spike skyward. The current world distance record, speed record, and altitude record for soaring all have been set utilizing lee waves. Glider pilots can travel into the stratosphere on a lee wave. Lee waves are marked by a long, stationary lenticular (lens-shaped) cloud that, due to their shape, are often offered as an explanation for UFO sightings. I find the lens-shape of the cloud fitting as it is often the market's myopic view that is creating this extraordinary mispricing. If one could simply adjust the lens and focal point toward the horizon they would see the truth – a lift and compounding opportunity that could take you into the stratosphere. These opportunities have both the longest duration and the highest return potential.

Lee wave opportunities are a very rare phenomenon, yet glider pilots can travel to a few select locations in the world to ride these waves. As investors, the task is more challenging. An investor educated to look for lee waves might only be fortunate enough to identify a handful in their career. Warren Buffett's "Twenty Ticket Punch Card" concept addresses this reality.

"I could improve your ultimate financial welfare by giving you a ticket with only twenty slots in it so that you had twenty punches representing all the investments that you get to make in a lifetime. And once you'd punched through the card, you couldn't make any more investments at all. Under those rules, you'd really think carefully about what you did, and you'd be forced to load up on what you'd really thought about. So you'd do much better."

Lee waves are compounder opportunities that are being severely mispriced by the market. Such an opportunity was created when the credit card processors came public under a large lenticular cloud of litigation and investor uncertainty over what the future might look like for these demutualized entities. We feel it is important for our investment process to be calibrated to discover, measure, and size appropriately lee wave investment opportunities.

Following this letter, I wanted to include a story that has always had special meaning to me and was fitting for this discussion. The story focuses attention on continued learning and improvement. We look forward to meeting and talking with you soon.

*"Glanders, sailplanes, they are wonderful flying machines. It's the closest you can come to being a bird. "Asked by Ed Bradley: "What do you get out of gliding?"
"Self Satisfaction, the sense of accomplishment, trying to do a little better than you think you possibly can."*

Neil Armstrong (1930 – 2012)⁶
60 Minutes Interview (2005)

On behalf of the firm,



Christopher M. Begg, CFA
CEO, Chief Investment Officer, and Co-Founder

Investment Process/Personal Evolution – Inventing a “Learning” Machine:

⁶ On August 25, 2012, Neil Armstrong died and the world lost one of our great living heroes. Armstrong loved to fly and flew over 200 different aircraft models in his lifetime and often remarked that his glider was his favorite flying machine. Neil Armstrong carried a piece of wood and fabric from the Wright Brothers' 1903 Flyer in his PPK (personal preference kit) when he made his famous trip to the moon to honor the legacy of first flight. I dedicate this quarter's letter to Neil Armstrong.^{H4}

I don't think a discussion on investment process would be well served without sharing what I think is the secret to any successful *sustainable* compounding endeavor: creating a culture of learning and improvement. As the world evolves, so must your intelligence. I am certain we do not have all of the skills today to invest successfully for tomorrow's challenges, therefore our investment process must be based on timeless principles and be able to adapt to change. Our various checklists must be a constant work in progress and our mental models should be perpetually exposed to creative destruction and built back stronger and more relevant.

One of my favorite examples of this love of learning is the story of *Jonathan Livingston Seagull*. Jonathan Livingston Seagull is the main character in the 1970 bestselling book by Richard Bach. The book tells a story about Jonathan, a seagull frustrated by the daily routine of the flock that cares more about finding food above all else. For Jonathan, it was not eating that mattered, but flight. Jonathan loved to fly and would spend all his time practicing, experimenting, and learning.

During one of his practice sessions, by experimenting with shortening his wing after observing a falcon, he is able to reach terminal velocity while maintaining control. He is wild with joy at the thought of sharing this enlightenment with the flock and exclaims "instead of our drab slogging forth and back to the fishing boats, there's a reason to life! We can lift ourselves out of ignorance, we can find ourselves as creatures of excellence and intelligence and skill. We can be free! We can learn to fly!"

When Jonathan returns to the flock he realizes that the elders do not tolerate his unwillingness to conform, resulting in his expulsion. An outcast, he continues to practice and realizes that his streamlined high-speed dive can bring him more food than he could have imagined as he can now reach the fish that schooled ten feet below the surface. He learned to glide on the thermals inland and dine on the delicate insects that get caught in the up drafts. "What he had hoped for the flock he now gained for himself alone; he learned to fly, and was not sorry for the price he had paid."

One day, Jonathan is met by two gulls who take him to a higher plane of existence where upon he meets others gulls who love to fly. He realizes he still has so much to learn about flight but there was a difference as here were gulls that thought like him. "For each of them, the most important thing in living was to reach out and touch perfection in that which they most loved to do, and that was to fly. They were magnificent birds, all of them, and they spent hour after hour every day practicing flight, testing advanced aeronautics."

"For a long time Jonathan forgot about the world he had come from, that place where the flock lived with its eyes tightly shut to the joy of flight, using its wings as means to the end of finding and fighting for food." Jonathan befriends the wisest gull, Chiang, who instead of being enfeebled by age, he is empowered by it; he could out fly any gull in the flock, and he possessed skills that the others were only gradually coming to know. Chiang takes Jonathan well beyond his previous learning and teaches him to think beyond limits. Ultimately Jonathan returns home to help and teach others that have been outcast for not conforming.

The elder Chiang reminded Jonathan: "It's strange. The gulls who scorn perfection for the sake of travel go nowhere, slowly. Those who put aside travel for the sake of perfection go anywhere, instantly."

This is the book I most often share with others. The principles are timeless and the target audience ageless as it is appropriate for those young people finding their path and for those whose path is evolving. I believe Bach touches on the essence of life and that is to find that which you love to do and attempt to touch perfection through a life-long commitment to learning, experimenting, and practicing. It is imperative to understand, though, perfection is not a finite goal, as perfection does not have limits; it is an ideal toward a life-long objective of infinite refinement. My life's work will be to create the most intelligent investment process we are capable of.

Our primary investment management objective at East Coast is to compound capital at superior rates net of fees and taxes over the long-term. Toward this mission, our investment process endeavors to be a learning machine so that we can fly, and ultimately soar. When we fall short of perfect flight, we will have arrived that much further ahead than if we had more modest goals like how to get from shore to food and back again.

“What do you think Fletch? Are we ahead of our time?” A long silence.

“Well, this kind of flying has always been here to be learned by anybody who wanted to discover it; that's got nothing to do with time. We're ahead of fashion, maybe. Ahead of the way that most gulls fly.”

“That's something,” Jonathan said, rolling to glide inverted for a while. “That's not half as bad as being ahead of our time.”

Jonathan Livingston Seagull