

OCTOBER 12, 2010

*“The enemy of conventional wisdom is not ideas, but the march of events”*  
– John Kenneth Galbraith



***Dear Investor,***

Throughout the third quarter, public anger and discontent continued to simmer and boil. While it is a close race, there is yet no clear victor for the mantle of most despised; Congress, common stocks, and bedbugs are locked in a tough battle. Conventional wisdom is clearly pessimistic and glum.

We strongly believe that times of negative sentiment, like today, are generally precursors for periods of superior investment returns. Yet, today's fear is based on facts that we should not ignore. We remain focused on fundamental investing and biased towards wealth protection.

Notwithstanding the pessimism, by most measures the third quarter of 2010 was a positive period for the investment markets and certainly for our portfolio. Calendar second quarter earnings reports proved that our holdings are making progress by growing sales, increasing earnings, and improving balance sheets. While the pace of economic recovery remains painfully slow, the march of events continues to overcome each new fear of a return to crisis.

## **Equity Portfolio**

Our portfolio continues to build on the positive recovery of 2009, with several holdings experiencing sharp gains in the quarter; a strong reversal from a difficult second quarter.

As we discussed in recent letters, portfolio turnover was unusually high for us during the early part of the year as we repositioned our holdings following the robust gains of 2009 to reflect our forecast of moderate economic growth. This repositioning has generally benefitted recent portfolio performance. During the third quarter, we made only one new acquisition (Broadridge Financial) and no sales (with the exception of tax driven trades in certain portfolios). In keeping with our new format, we include an appendix that discusses the addition to the portfolio, plus important developments in some of our other holdings.

While we are able to allocate across the marketable security spectrum, we continue to find the most compelling risk/return potential in the equity slice of the investment pie. Using capital flows as an indicator of mass popularity, we are in the minority. Bond funds have reeled in \$225 billion this year (through August) while domestic stock funds have lost \$5 billion in assets. With a similar disgorgement of stocks at many institutions, it is a real testament to resilience that the broad equity indexes remain in positive territory for the year.



## Credit Markets

Our municipal debt, corporate debt, and hybrid securities continue to perform well. The broader bond indexes have clocked significant gains this year as economic growth slowed and expectations for additional Fed intervention increased. Traders continue to weigh the Fed's intentions to keep accommodative rates at all costs, with fears that once the monetary kindling is lit, the inflationary fire may quickly get out of control.

If you wanted to find one area of the investment market that is showing irrational exuberance, the bond market is our candidate. While we continue to selectively buy municipal and corporate credits that provide relative value and safety, we do so generally in bonds that we expect to hold to short maturity, with the intention of reinvesting at higher rates. We believe much of the retail public thinks that investing in bond exchange traded funds (ETFs) or bond mutual funds is an equivalent strategy. In most cases it is not. Many funds are rolling long duration vehicles that can, and will, suffer capital depreciation when rates move higher. We worry that investors are making decisions based on perceived riskless capital preservation, when their chosen investment (i.e., funds) is anything but.

While the short end of the interest rate curve perhaps accurately reflects the sluggish economy and lack of inflation, we do not believe the longer end is adequately discounting conservative assumptions.

As a case to consider, we submit to you a comparison of Microsoft stock (which we own) and the 30-year bonds issued by Microsoft. These AAA rated Microsoft bonds carry a fixed 4.5% coupon and are due in 2040 (and currently trade at a slight premium).

Microsoft stock is under pressure due to market concerns about declining competitiveness and technology obsolescence. Microsoft bonds trade at a low absolute yield (i.e., high price) due to the perceived longevity and consistency of the business. We submit that one, or both, of these assets is mispriced.

Let's start with the stock. Microsoft sells at roughly 11 times recent earnings. Cash flow equals or slightly exceeds earnings, so we think the stock price carries roughly a 10%+ free cash flow yield. Importantly, this cash flow is unlevered as net debt is basically zero. Microsoft still retains an awe-inspiring gross margin of 80% and net income margins of 30%. Revenue has grown by an annualized rate of 9% over the last five years and the current product cycle in desktop and server software should drive near term revenue growth higher.

It is valid to point out that this cash flow, when earned, does not yet belong to the shareholder – especially with Microsoft which has been reluctant to return cash. Management may be willing to use it in sub-optimal ways, for example a large acquisition. But, they have not been as stingy as often perceived. Microsoft began paying a dividend in 2003 and has increased the

payout by 11% annualized over the last five years – most recently raising it 23% concurrent with the recent debt issue.<sup>1</sup> The stock currently yields 2.6%. They also paid a special dividend of \$3 per share in 2004, and there is nothing that prevents them from doing this again. Additionally, Microsoft has repurchased net shares of \$50 billion over the last four years, significantly reducing the share count. Other than to service the debt interest and maturities, Microsoft is under no obligation to preserve their cash hoard, or protect their balance sheet for the benefit of the debt holder.

The bondholder is buying a senior interest and will receive 4.5% per annum. No matter the level of inflation or general interest rates, or Microsoft profits, or if additional debt is added to the balance sheet, or a fall in Microsoft debt ratings occurs – a holder of this bond issue will receive 4.5% per year and, in 2040, will have their original investment returned provided Microsoft is solvent. During that time, the value of the bond will fluctuate, and we believe not mildly.

We can argue about inflation versus deflation in the short term, but we do not accept as a rational argument that rates will stay at an historic low for decades. If the 30 year Treasury bond (off of which the Microsoft is priced) moves from 3.65% to just 4.65% during the next year, the MSFT bond will depreciate roughly 20% in dollar price – a five percentage point move in the next year would cause the bond to lose half its value. An upward move anytime in the next few years of just one percentage point will mean significant negative annualized returns for the bondholder, and certainly for the mutual fund or ETF holder whose fund purchased the bond. This does not even consider the future challenges to MSFT's business on which equity investors remain focused.

Currently, our bond positions are generally short duration and will be held to maturity, so market price fluctuations don't matter as much, but a shareholder in a bond mutual fund does not have that luxury.

So, while we are sensitive to concerns regarding the stock, we believe the ultimate return to a shareholder will still be significant as the balance sheet and high margins will enable a significant cash return to an equity holder. Axiomatically, this means a poor risk adjusted relative return to a long bondholder. And while a 30 year bond is a specialized product, generally bought by life insurance companies and pension funds, it is equally hard to argue that Microsoft three-year debt at 0.875% represents a more attractive investment than the equity.

## **Firm Update**

Spears Abacus continues to thrive in a very difficult environment. The original firm, WG Spears and Company, was founded during the difficult market of the 1970's. It was not easy, but it persevered and ultimately earned strongly positive returns for clients.

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<sup>1</sup> Despite a large cash balance on the consolidated balance sheet, much of this cash is held outside the United States. Microsoft would need to repatriate this cash (and pay applicable taxes) to fund dividends and buy-backs. They have made the decision to issue debt in the U.S. to fund the increased dividends.

Today's environment is as tough as we have seen; an overhang of debt, the risk of policy mistakes in Washington, and a secular decline in U.S. competitiveness all seem to indicate low expected returns and challenges for years to come. Yet, we believe the firm is uniquely equipped for the challenge. The SA team is small but possesses a broad and varied skillset. Teamwork is strong and camaraderie is high. The burden of research and portfolio management is our shared effort. Our operations and support staff is second to none. We continue to increase and expand our co-ownership model; Frank Weil, Rob and Bill have expanded the partnership from the founders to include Jeb Breece, Paul Pfeiffer, and most recently Stephen Frank.

While the firm philosophy has not changed, our research and capabilities have expanded over the years. We no longer are confined to equity portfolios, with a few fixed income issues when appropriate. Many of our clients' circumstances warrant a more holistic approach to return and risk. Although our equity research is where we can distinguish ourselves and add the most value over time, we continue to tailor client portfolios along the total return spectrum using municipal, corporate and treasury bonds, as well as convertible issues, preferred stock, MLPs, and other securities that we identify through careful research, and that meet our quality and liquidity standards.

Our equity mutual fund, The BeeHive Fund, just passed its two-year anniversary. The fund's total assets are in excess of \$65 million and growing. Despite the interesting timing of our launch (two weeks before Lehman failed) performance has been net positive since inception and has exceeded the S&P 500 benchmark. The fund serves as a model for our equity accounts. More importantly, it is open to any new investor, even those with modest amounts to invest. You can find out more at [www.thebeehivefund.com](http://www.thebeehivefund.com).

We also are attuned to a heightened need for communication on a timely basis. While we believe short term investing is ultimately detrimental to returns, we are also aware that the frequency and volatility of economic news has increased over the last few years. Beginning this quarter, we intend to write and distribute occasional interim commentary. These comments might concern our portfolio, or the more general economic environment. We do not expect a fixed frequency, and at times our quarterly communication may be sufficient. As always, we appreciate any comments and welcome all debates on our thinking.

### **Concluding Thoughts**

Stock markets are up significantly during the last 18 months; the recession officially ended over a year ago; unemployment is lower, profits are higher. Shouldn't we all feel better?

But somehow we don't . . .

Is it because we are all suffering from collective post-traumatic financial stress disorder? Or because we are a society that likes misery and self-loathing? Or one that accentuates the negative?

While we may believe conventional wisdom is exaggerating the clear and present danger, public anxiety is rooted in valid and rational concerns. Government is clearly in a dire state, our housing market is far from a healthy recovery, our ingenuity is in a lull, and our government's fiscal trajectory is no longer, in fact or perception, sustainable at current levels. All of this is true. But it is also true that massive populations around the world are entering the consumer class, new breakthroughs in alternative energies are on the verge of commercialization, excesses have been wrung out of the financial system over the last few years, the "bailouts" have worked and are returning capital and possibly a profit, and – most importantly – investment assets are well priced by pessimistic assumptions.

Chuck Jones, the creator of Bugs Bunny, Daffy Duck and many other great characters once said; "Human beings will line up for miles to buy a bucket of catastrophes. But don't try selling sunshine and light – you'll go broke." We completely empathize with Mr. Jones. The most popular (and forwarded) articles continue to be ones predicting doom. Gold is at an all-time nominal high, driven primarily by the fear trade. Glenn Beck commands huge crowds and support for views that are neither backed by reality nor facts. CNBC is practically auditioning commentators based on the boldest and most dire statements they can make. We are concerned broadly, but not to the point of paralysis. Through research and judgment we continue to find compelling investments at attractive prices.

Sincerely,



William G. Spears



Robert M. Raich



James E. Breece



Paul F. Pfeiffer



Stephen H. Frank

## **Broadridge Financial**

Broadridge, a spin-off from Automatic Data Processing in 2007, describes their business as one that provides the plumbing that connects 13,000+ securities issuers, 800+ banks and brokers and 100+ million investors. Sticking with this analogy, the main line in this plumbing system is Broadridge's proxy services business, which is used by all major broker-dealers and is responsible for processing over 70% of all shareholder votes. Branching off of this are strong market positions in interim and annual statement distribution, transaction reporting, pre- and post-trade fulfillment, and equity and fixed income processing. Customer relationships are generally covered by multi-year contracts, but ultimate revenue levels are dictated by the health of the capital markets and investor participation. Reflecting the financial market events of the past two years, revenue and earnings are somewhat depressed. Further depressing current earnings are three new business and system implementations that will move from dilutive to meaningfully accretive over the course of the next three years. In its own right, this would drive respectable earnings growth.

We believe that the return on our investment will be additionally enhanced by Broadridge's financial flexibility. The company generates significant free cash flow (7% FCF yield at purchase), has material excess cash on the balance sheet (\$350 million, 12% of market capitalization) and could easily support more debt while maintaining a solid investment-grade rating. We believe that Broadridge will continue to use this capacity to make small acquisitions, to increase the dividend (currently 2.6% yield), and to reduce the number of shares outstanding.

At our purchase price, we believe that the return profile is skewed nicely in our favor with limited risk to the downside in our reasonable worst case scenario and opportunity for meaningful appreciation as capital market activity and investor participation improve.

## **Hologic**

This quarter marked a major milestone for Hologic as the company finally presented their PMA application for approval of the Selenia tomosynthesis breast imaging platform. Tomosynthesis is differentiated from standard digital mammography in that 11-21 (typically 15) x-ray images are acquired along an arc and then reconstructed by computer software to create a 3-D image of the breast that a radiologist can page through like a CAT scan. We have long believed that this technology will eventually become the gold standard in mammography as it shows promise in detecting previously missed cancer (i.e. those obscured by layers of tissue) and, perhaps more importantly, in reducing false positives, which cause unnecessary stress to the patient and cost to the system. The FDA's Radiological Devices Advisory Panel agreed and unanimously voted to approve the technology, with one panelist remarking that "we need to provide the tools for the physicians to do their job." The official FDA approval decision is still a few weeks away, but we expect that the FDA will follow the panel recommendation.

To be clear, even with approval in hand we do not expect a sharp increase in sales. With no premium reimbursement in place and uncertainty over integration with existing hospital patient flow, initial demand will be limited to early adopters. However, we do believe the approval will have a measurable impact on replacement market activity, both in terms of jump starting replacement demand, which has been subdued by tight hospital budgets, and allowing Hologic to increase market share as they will be the only company on the market with a mammography machine whose software can be upgraded to tomosynthesis.

## **Oracle**

Oracle shares rallied 8.4% after the company reported fiscal first quarter results that exceeded expectations in almost all categories. In contrast to many recent manic market reactions where share price gains or losses often grossly overstate the importance of a particular piece of news, we believe that Oracle's price performance was warranted and reflected that investors are beginning to appreciate the thesis we identified at the date of our purchase. This quarter's results highlighted the strength of Oracle's software product cycle, but more importantly demonstrated that the Sun Microsystems acquisition is unlikely to be a thorn in Oracle's side and may in fact be a rose.

Oracle is easily on track to meet the accretion goals that were laid out at the time of the Sun purchase due to rapid measures to address underperforming businesses. However, in our opinion, the real opportunity is the new products that the deal enabled. The first such product to emerge is a line of database machines, Exadata, that integrate Sun hardware with Oracle software and are tuned for performance and efficiency. The result is speed that far exceeds that available by bringing together the components individually, along with lower cost of ownership and simplified implementation and maintenance. On the quarterly conference call Oracle provided an example of a customer win where three Exadata machines replaced 60 racks of competitor servers and still provided a performance improvement. It is clear why customer interest is growing and investors are correctly beginning to realize that the strategic rationale for the Sun acquisition was far more than cost cutting.

*Spears Abacus BeeHive Fund Performance (Net)*

2009	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
The BeeHive Fund	-2.82%	-11.62%	7.51%	11.65%	4.43%	3.87%	5.17%	2.97%	2.00%	-1.31%	3.42%	4.37%	31.59%
S&P 500	-8.43%	-10.65%	8.76%	9.57%	5.59%	0.20%	7.56%	3.61%	3.73%	-1.86%	6.00%	1.93%	26.46%

2010	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
The BeeHive Fund	-2.87%	3.48%	4.59%	0.98%	-7.92%	-4.41%	5.38%	-3.75%	8.77%				3.08%
S&P 500	-3.60%	3.10%	6.03%	1.58%	-7.99%	-5.23%	7.00%	-4.51%	8.92%				3.89%

Annualized Since Inception (9/2/08)	
The BeeHive Fund	0.53%
S&P 500	-3.04%

*Spears Abacus Municipal Bond Performance (Net)*

2009	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
SA Bond Account	2.32%	0.90%	-0.40%	0.71%	0.71%	-0.11%	0.86%	0.53%	1.71%	-0.62%	-0.24%	0.23%	6.74%

2010	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
SA Bond Account	0.66%	0.60%	-0.09%	0.59%	0.41%	0.33%	0.85%	1.38%	-0.33%				4.48%

*Important Note About Spears Abacus Advisors LLC ("SA") Client Newsletters*

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*SA BeeHive Fund Performance Information*

The performance data quoted represents past performance. Past performance does not guarantee future results. The investment return and principal value of an investment in The BeeHive Fund will fluctuate so that the shares in The BeeHive Fund owned by an investor, when redeemed, may be worth more or less than their original cost. The current performance of The BeeHive Fund may be lower or higher than the performance data quoted. The gross expense ratio of the Fund is 1.64%. The adviser has contractually agreed to waive fees and expenses through at least 4-30-11 such that the net expenses of the Fund do not exceed 0.99%. Investors who would like to obtain performance data for The BeeHive Fund that is current to the most recent month-end should call 866-684-4915 (toll free).

The Fund performance information shown is for The BeeHive Fund, a series of Forum Funds, an investment company registered under the Investment Company Act of 1940 that is managed by SA. The BeeHive Fund seeks capital appreciation by investing in a concentrated portfolio of companies believed to have exceptional management practices and defensible business strategies. The BeeHive Fund invests primarily in equity securities. Performance information for The BeeHive Fund is presented for 2009 and 2010.

The performance information set forth indicates the corresponding return of the Standard & Poor's 500 Total Return index. The volatility of the S&P 500 Total Return index (as well as any other index used by SA from time to time) may be materially different from the volatility of the accounts upon which the performance information presented is based. In addition, the securities holdings in the accounts upon which the performance information presented is based differ significantly from the securities that are referenced in the index. The S&P 500 Total Return index has been selected not to represent an appropriate benchmark to compare results but rather to allow for comparison to the performance of a widely recognized index. SA is not responsible for the accuracy or completeness of any information contained here that was obtained from or compiled by third parties.

Investors should consider the investment objectives, risks, and charges and expenses of The BeeHive Fund carefully before investing. The prospectus and, if available, the summary prospectus of The BeeHive Fund, which may be obtained by telephoning 866-684-4915 (toll free), contain this and other information about The BeeHive Fund. Investors should read the prospectus and, if available, the summary prospectus carefully before investing.

### ***SA Municipal Bond Performance***

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