

October 3, 2011

To the friends and clients of the Harvey Investment Company:

Like the mythological Hydra, the overleveraged world we described in our last letter has a myriad of horrid faces. As we are learning, no Hercules can save the day with some valiant thrust. Some examples. The debt crisis in Europe has no palatable solution because the obligations of the profligate nations are heavily owned by the thrifty nations' banks. So much so, in fact, that writing down the debts to true worth could threaten their solvency. In the U.S., fraud claims from the subprime mortgage debacle are creating legal nightmares for our largest financial institutions that will stretch out for years. And growth in our economy has stalled because overall demand for goods and services is tepid, a result of tight public and private finances. The struggle between the President and Congress on raising the Federal debt ceiling, an ugly spectacle that needn't ever have happened, revealed discouraging acrimony between the political parties. This is profoundly so given our country's fiscal challenges which cry out for excellent decision-making. These are among the predictable and, likely ongoing, travails we face as a consequence of the years of expansive borrowing that drove growth in the United States and Europe. Where will such a fragile financial structure lead? The possibilities are so broad that the traditional relationships between asset classes are cockeyed. In the third quarter of 2011, the ten year Treasury interest rate dropped below 2%, strongly suggesting a depressed and deflationary period ahead. During the quarter the price of gold moved in manic lurches, at times soaring due to fears of global monetary chaos and, in turn, plunging when disaster appeared avoidable or deflationary conditions seemed more likely. Foreign currencies are also swinging widely in relation to one another, particularly the euro, the pound, and the U.S. dollar. Meanwhile, countries like Switzerland with stronger currencies desperately seek ways to cool the rise in their monetary units lest their products be priced out of the market. Fortunately, in America, most people continue to go about their work in productive and innovative ways in spite of the seemingly endless negative headlines. This national propensity is our best hope to weather these troubling times.

The S&P 500 stock index dropped 13.87% for the third quarter, a very painful, but not too surprising result in light of the aforementioned realities. Particularly unsettling was the astonishing volatility that characterized trading in this period. For example, in five of the six market days from August 4 through August 11, 2011, the Dow Jones Industrial Average experienced a change of greater than 400 points, moves of 4% or greater. On three days changes were greater than 500 points. Such moves were symptomatic of violent ups and downs throughout the period. The new, stunning volatility derives from the poisonous combination of daily traders hoping to profit from short-term market swings and New Age investment products designed to fully utilize today's amazing computer capabilities. We have been interested in the evolution of one product in particular---Exchange Traded Funds (ETFs). ETFs arrived inauspiciously on the scene in 1989 in Canada and first appeared in the United States in 1993. To

say that ETFs have won a following on Wall Street in the ensuing years is a gross understatement. In fact, it is estimated that today 40% or more of trading volume each market day is in ETFs. The ETF has become a product perfectly suited to the convergence of individual investors' irrepressible urge for short-term trading profits, hedge funds' high frequency trading strategies, modern computing power, and Wall Street investment banks' talent for financial engineering. We also believe the ETFs are a big contributor to today's volatility.

The development of the ETF over the past decade is a case study in how simple ideas on Wall Street morph into complex and potentially wealth destructive devices for individual investors. The first ETFs were designed to allow investors to invest in securities that replicated a stock index such as the S&P 500. Index mutual funds had long been widely used when ETFs came along, but the ETF had important tax advantages. Also, crucially, ETF shares could trade freely in the market place, providing greater liquidity than mutual funds where purchase or liquidation is restricted until after the close of the market each day. An important feature of ETFs was a mechanism designed to assure that trading in the market place would occur at very close to the value of the underlying assets backing the ETF. This function fell to certain large institutions (brokers, asset managers, etc) whose job it is to purchase or sell the ETF units as needed to keep prices close to asset values. Though the mechanics of this procedure are somewhat arcane, the gist of it is that these institutions, called *authorized participants*, either create new ETF units or destroy old ones, as the market day passes. In time, ETFs were designed for gold investors, for traders who wanted semiconductor stocks, for stocks in India, and ultimately for any asset group that had significant enough trading interest to justify creation. Why did this proliferation of new ETFs and daily trading in them explode on the scene? First, ETFs were uniquely appealing to individual investors, investment advisors, hedge funds employing complex strategies, and high frequency traders. Second, ETFs are enormously profitable for the Wall Street ETF sponsors and the *authorized participants*, and, once established, there is no end to their cash contribution. It is the gift that keeps on giving.

As frequently happens with financial products, ETFs, which began life as an elegant and useful new tool, have evolved into what appears little more than a gambling device. Today there are synthetic ETFs in which the underlying assets are never purchased; instead, derivatives designed to replicate the performance of the asset class are bought. There are ETFs using derivatives made to produce market changes two and three times that of the asset group. And there are now reverse ETFs, which are constructed for the investor wishing to bet against an asset class. Moreover, we believe, the very mechanism in place to assure ETFs trade at their asset value, under extreme conditions, reinforces and magnifies moves in one direction or another. Daily market swings that might be 100 to 200 points in the Dow Jones Industrials become changes of 300 and 400 points. It is clear that today's long-term investor today faces not one, but two Hydras. In addition to the monster of leverage, he trades in a market dominated by those with short-term motives far removed his own. They are employing strategies, techniques, and products that also have many ugly faces.

Our own strategy is guided by our belief that if we buy into a company where the earnings per share double over six or seven years, and our initial purchase price was conservatively calculated, we will double our money over that time frame. On the surface, it might seem that we should be unaffected by wild market moves such as those experienced in the quarter which just ended. We believe, however, there are two costs and one benefit. In terms of costs, the manic and outsized ups and downs of the market require the sensible investor to keep more in liquid assets for unexpected needs lest he be caught short in the midst of severe downturn. With money market rates at zero, this is expensive. Also, we believe that publicly traded companies are being capitalized at lower rates to reflect the greater risks inherent in a market with drastically increased

volatility. It is natural that a level of disillusionment, or even abandonment by some, has infected the individual investor. On the plus side, the wide swings provide greater opportunity for the alert investor to buy into outstanding companies at bargain levels. If the twin Hydras have

affected our mindset, it has been to focus us even more on our primary task of locating and buying into companies with really innovative management teams intent on building a great business. To us, this is the best hope to escape the negative pull of a sluggish economy and to avoid the wasteful distraction of markets swinging wildly, most often for no good reason. Our optimism that our approach can help you build your wealth in a safe way is undiminished.

Having started this letter with a mythological Greek reference, we will finish with a translation from the *Aeneid*. It is the epigram introducing Benjamin Graham's classic **The Intelligent Investor**. "Through chances various, through all vicissitudes, we make our way...."

Sincerely,

Samuel C. Harvey

In compliance with Rule 204-3 of the Securities and Exchange Commission, we are pleased to offer you upon request and without charge a copy of Part II of our Form ADV. This disclosure document contains information about the business practices and procedures of Harvey Investment Company, LLC. Please call us at (502) 339-8270, if you would like a copy