

Quarterly Report

October 31, 2009

Roumell Asset Management, LLC

Third Quarter Summary

Performance Summary	ANNUALIZED AS OF 9/30/09						TOTAL RETURN	
	3Q 2009	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR	SINCE INCEPTION	SINCE INCEPTION
Roumell Equity (Net)	16.73%	32.66%	9.10%	-1.32%	5.22%	10.70%	10.80%	201.23%
S&P 500	15.61%	19.27%	-6.90%	-5.43%	1.02%	-0.15%	0.34%	3.77%
Russell 2000	19.28%	22.44%	-9.54%	-4.57%	2.41%	4.88%	4.76%	64.88%
Russell 2000 Value	22.70%	16.35%	-12.61%	-6.65%	1.77%	8.05%	7.17%	110.42%
Roumell Balanced (Net)	14.06%	27.26%	9.70%	-1.10%	4.04%	7.74%	7.80%	124.20%
Thomson US Bal Index	11.85%	18.75%	1.81%	-1.32%	2.33%	2.32%	2.22%	26.62%
Roumell Fixed Income (Net)	10.60%	34.68%	N/A	N/A	N/A	N/A	N/A	34.68%
Barclays US Aggregate Bond	3.74%	5.72%	N/A	N/A	N/A	N/A	N/A	5.72%
Barclays US Corp Hi Yield	14.22%	48.98%	N/A	N/A	N/A	N/A	N/A	48.98%

Roumell Asset Management, LLC has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®). Ashland Partners & Co. LLP, our independent verifier, completed its examination of the composite performance returns for the period of 1999 (inception) through June 30, 2009. Please refer to the annual disclosure presentations at the end of this letter.

For the second quarter in a row we performed well, particularly in light of the fact that we continued to hold roughly *one third* of our assets in cash.

What Does Roumell Asset Management Do?

The past two years have been intellectually, emotionally, and financially challenging. Given investors' lingering concerns, we want our clients to understand what it is we do, how we do it, and what approximately are our objectives.

Which of the following phrases, do you think, best describes what we do?

- 1) Manage stock and bond portfolios
- 2) Opportunistically allocate capital

If you answered "opportunistically allocate capital," you're correct. What's the difference between the two? Stock and bond managers need to own stocks or bonds because that's what they do for a living—manage stock and bond portfolios. Over the years, it has become abundantly clear to us that the mainstream financial services industry sells stocks and bonds, day in and day out, rain or shine. This includes the vast majority of the mutual fund industry, Wall Street brokerage firms, and many others, including a plethora of cable shows with titles like *Mad Money* and *Fast Money*. In contrast, an opportunistic capital allocator—ideally—sits patiently until an investment situation is presented wherein the odds of success are highly favorable. In the absence of such situations, opportunistic capital allocators, or OCAs, ought to do nothing.

What about a "stocks for the long haul" approach? In other words, isn't it true that if you simply buy good companies and hold them for a long time, you'll do well? Not exactly. As indicated in our second quarter

2009 letter, there are some real drought periods: from 1966–1982 the market (as measured by the S&P 500) was flat; the ten-year annualized rate of return through September 30, 2009 is -0.15%. However, opportunistically allocating capital during these periods offered savvy investors superior returns. Hold it, you say: Warren Buffett is the smartest investor on the planet and he says just buy stocks and hold them. Not exactly. Buffett is indeed more of an OCA than a manager of a stock and bond portfolio. If his real belief was that one should simply buy stocks and hold, then why did he sit on \$40 billion in cash for several years? Buffett was, in fact, waiting. In the last twelve months, he spent about \$20 billion because he finally saw what he was looking for—high margin of safety investment opportunities. At present, Buffett still holds more than \$20 billion in cash. Moreover, Buffett has lamented that he did not take advantage of selling opportunities regarding his public securities holdings: “Furthermore,” he writes in Berkshire Hathaway’s 2008 annual report, “I made some errors of omission, sucking my thumb when new facts came in that should have caused me to re-examine my thinking and promptly take action.”

What about asset allocation? There certainly are positive attributes to asset allocation: it does provide diversification, it is easy to execute, and it is generally a superior strategy to being overweighted to one asset class. Benjamin Graham argued that investors normally ought to split their money evenly between stocks and bonds. He further recommended maximizing stocks to 75% at the most opportune times while never dropping equities below 25% of one’s allocation. Implicit in Graham’s advice is that there are periods when markets are overvalued or undervalued. Given “standard” asset allocation models currently in vogue, an investor ought to ask, “How much value can an approach that is widely marketed and easily duplicated offer?” Nonetheless, we would argue that most investors, by and large, are well served by a competently structured asset allocation plan. However, it’s not what we do.

Roumell Asset Management’s approach can easily be compared to a children’s game of tag. When you played tag as a child, a big tree was typically designated as home base, where you were safe and could not be tagged. Playmates wanting to motivate you to move away from the tree would move from ten to twenty feet away, at which point the odds shifted decidedly in your favor to come off base without being tagged. Played perfectly, you could just wait, move away from the tree at the appropriate time, return safely, and then wait again. Ideally, that’s what we do. Our time away from the tree may be a month, a year, or several years, but the objective is the same, which is to get back to the tree, aka cash, in the absence of a margin of safety in our investments.

Earlier this year we came off the tree in a rather big way and selectively purchased high yield debt securities. The opportunity appeared significant, offering us unusually high current income streams and deep discounts to par value; that is, \$1,000 contracts. Moreover, the downside appeared limited given our emphasis on valuing hard assets that we believed in, managed by people we trusted, all the while possessing senior claims over equity stakeholders on those assets. Our continued belief in the attractiveness of these fixed income securities is exemplified by the fact that our three top purchases in the third quarter were bond issues. OCAs wait because they have the luxury of doing nothing in the absence of compelling ideas where the odds are squarely in their favor (unlike the vast majority of mutual fund managers, who must live with investment mandates). In our approach to opportunistic investing, we emphasize understandable businesses with safe capital structures, managed by honest and competent people and purchased at quantifiable discounts to our calculation of intrinsic value. Further, we are willing to leverage our deep value discipline to concentrate on our best ideas (again, unlike mutual funds, where a typical position is often 1%–2% of the portfolio). With our “go anywhere” approach, we have investments in, among others, several micro-cap cash rich companies, a mega-cap pharmaceutical company, a Canadian natural resources/agriculture firm, direct high yield debt, and discounted closed end bond funds. When will new opportunities arise? Sometimes when it rains it pours and other times it’s like watching paint dry.

Our first objective is to be prudent. In terms of anticipated rates of return, our current ten-year annualized rate of return for our Equity accounts (which now includes *two* peak to trough declines in the S&P 500 of 50%) is almost 11%, which seems reasonable enough over time. Moreover, our ten-year return is not the result of one or two fabulous years: we have exceeded the oft-quoted S&P 500 in ten of the past eleven years. However, we are not looking to mirror a particular index; such an approach can readily be found elsewhere. Rather, we are seeking to rigorously exercise our discipline and believe that over time we will generate a meaningful absolute rate of return. We certainly hope, and expect, that our next ten years will be superior to our first ten, having learned a few new things—in reality, too many to count. That said, we cannot guarantee a certain level of return.

There are drawbacks to opportunistic capital allocation. First, OCAs, in general, and deep value-oriented ones like us in particular, can often be quite picky about price and miss reasonable risk/reward investment opportunities while they wait for perfect pitches. Second, in periods of overall rising market levels (whether those rises are the result of speculative bubbles or the confirmation of underlying fundamentals), OCAs may not fully participate, while index funds will likely provide superior returns. Finally, OCAs may stay in cash for extended periods of time, earning very little interest on those balances. It is our belief that the opportunity cost of cash is more than offset by the ability to act boldly when high margin of safety situations are presented in some publicly traded market.

Currently, we believe the stock market offers few investment opportunities outside of a handful of special situations. In addition, with the high yield bond market rally, we have reset our going forward fixed income investment return target to a 7%–12% range. Clients should not expect the fixed income security returns of the last two quarters to be duplicated going forward. That said, in our minds, 7%–12% rates of return on select higher yielding bond investments that we deem to be “money good” instruments are superior to paltry cash returns or overpaying for equity investments. Of course, we continue to hunt for opportunistic equity investments and know that in time we will find appropriate investments.

Isn't the economy out of recession and essentially repaired? The worst of the financial crisis does seem to be behind us, thankfully, and a true collapse of the financial system was averted (we believe we came close to true catastrophe). However, we now know, in a way perhaps not previously appreciated, how fragile our current financial system is, dependent as it is on a myriad of very complex worldwide relationships. Had anyone really thought about a run on the country's money market accounts and the potential freezing of our commercial paper market? Further, isn't “too big to fail” a bigger problem now with *fewer* large institutions and our increased dependence on the remaining ones? Additionally, it is true that companies have cut costs and businesses are replenishing after what were mind-numbing inventory reductions that occurred in late 2008 and early 2009 in the face of widespread financial panic. But big inventory restocking of this magnitude is not a recurring event and cost cutting raises unemployment levels.

Finally, where would our economy be in the absence of massive government intervention, including both monetary and fiscal initiatives? (That goes for the rest of the world, too.) After the “cash for clunkers” program ended in late August, auto sales dropped dramatically in September: GM's sales were off 45%, Chrysler's were down 42%, Honda's sales fell 20%, Toyota's sales fell 12%, and Ford's were off 5%. Currently, the government is involved in roughly 90% of mortgage originations (Fannie Mae, Freddie Mac, and Federal Housing Administration). Effectively, there is no real private mortgage market apart from the government right now. Yes, things are better and government interventions on the whole have proved effective at averting real crisis, stabilizing markets, and injecting risk-taking (aka Keynes' “animal spirits”) back into a market where it was absent. That said, the important questions for investors to ask are: at what cost and what now? The investment question for us is always the same: price versus value. We just do not currently see many dollar bills priced at a discount given the market's dramatic response to favorable data.

What Worries Us Now?

- History. The astute, macro-oriented investor Mohamed El-Erian from PIMCO provided a wonderful analogy of recent worldwide economic activity in suggesting that the global economy was like a huge airplane driven to high altitudes and high speeds by one big engine—the U.S. consumer. El-Erian reasons further that the transition to a multi-engine global economy will take place over the next twenty to thirty years, meaning that, for now, the U.S. consumer is still very important.
- The “one big engine”—the U.S. consumer—fueled the global economy by taking on substantial debt such that household debt stands at roughly 1x GDP, a 100% increase from recent historic norms. How much more consuming can reasonably be strapped onto the backs of American consumers at this point? Household liabilities as a percentage of disposable income coming out of the 1990–91 recession were under 90%, grew to 100% in 2000, reached 136% at the credit peak in 2007, and now stand at a still near historic high of 129%. Shouldn't we go back to living within our means and, if so, what does that mean for the economy?
- What are the consequences of unprecedented federal debt levels? Roughly 40% of what our government is now spending must be borrowed. We simply put this into the “this can't be good” bucket, necessary as it undoubtedly is, as argued by many leading mainstream economists.
- Our rising debt needs are occurring while the Chinese are sending signals that their appetite is waning for our debt. Larry Summers, Director of the National Economic Council and past Treasury Secretary, calls it the “balance of financial terror.” Refinancing risk is ever present.
- Implications of prolonged unemployment. One third of today's jobless have been unemployed for more than six months, a post–World War II high.
- Overall market valuation. The Wilshire 5000 Index now trades at about 80% of GDP. The average and median levels since 1970 are 71% and 64%, respectively. Why should the market be priced at a premium to the economy now? In the third quarter, the insider selling ratio was 18 to 1 versus an historic average of 7 to 1. Where is the margin of safety?

Who Do You Believe?

Roumell Asset Management is not at its best musing about the overall market or macroeconomic trends. We are at our best digging deeply into specific securities (bonds or stocks), assessing underlying value, and remaining highly disciplined about what we are willing to pay—that is, price. However, if we can do our bottom-up work with a well-informed top-down picture, we should be better served. What's your top-down picture? Here are a few offerings:

“It will be a long slog—a matter of years—with the risk of some relapses along the way” before the economy returns to full capacity. —Paul Volcker, one of the most highly regarded former Federal Reserve chairmen, who has no need to sell you anything

“The U.S. will be very slow in recovery due to basically bankrupt financial companies and indebted consumers.” —George Soros, a top OCA investor of the past fifty years with no need to sell you anything

Or:

“Business overshoot. They'll snap back (in hiring); that will fuel consumer spending.” —Investment strategist from a major Wall Street brokerage firm that makes its money from selling stocks and bonds

“Despite the fact that markets have risen well off their lows, I think we're in a bull market I expect to go on. It's a multiyear bull market. I don't think it's over yet.” —President of investments at a major money management company whose firm makes money managing stock and bond funds

There are those with nothing to sell who do, in fact, believe the recovery is well on its way. Michael Mussa, Senior Fellow of the Peterson Institute for International Economics, stated, “The great global recession of 2008 and early 2009 is over, and worldwide economic recovery is now under way.” He may be right.

Here’s what the *Wall Street Journal* reported on September 12, 1930: “Brokers, businessman, and even the general public are more optimistic; over 75% of brokerage houses now advise buying stocks.” By the end of 1931, the market had proceeded to drop 62%. We are not suggesting a repeat of such an event but simply wish to point out that headlines should always be viewed with some suspicion.

Here are our suggestions: Consider the source of advice, find competent people whom you can trust, who exercise a discipline that makes sense, and stick with them. Further, invest with those who eat their own cooking. We have always invested and always will continue to invest alongside our clients. Senior personnel have 100% of their investable assets at Roumell Asset Management. As described in our firm’s ADV brochure, which is filed with the Securities and Exchange Commission (SEC), not only do we buy what we buy for our clients, but also we preclude ourselves from buying securities we are not buying for our clients.

Our Three Top Purchases

Comstock Resources, Inc. 6.875% 3/12/2012 Notes. We purchased a sizable position in Comstock Resources notes in the third quarter at a negligible premium to par, \$1,000/bond. We view this investment as a higher return alternative to cash, given our confidence in the company’s assets and the people managing those assets. Comstock is an extremely well capitalized natural gas exploration and production company; the company’s net debt to enterprise value (net debt divided by the sum of stock market capitalization and net debt) is a very modest 8%. We believe Comstock’s asset value far exceeds its liabilities and are comfortable accepting a 6.75% yield-to-maturity (YTM) for two and a half years.

James River Coal Co. 9.375% 6/1/2012 Notes. James River Coal predominantly owns and operates coal mines located in central and northern Appalachia. We believe James River Coal bonds were an attractive investment given roughly an 11% YTM for notes that mature in less than three years and a net debt to enterprise value of about 25% at the time of purchase. Our valuation of the company’s assets included utilizing both a 2009 comparable private market transaction and analyzing expected cash flow generation. Our conclusion was that the company’s coal reserves meaningfully exceeded its financial liabilities.

Belo Corp. 7.75% 6/1/2027 Notes. Belo Corp. owns and operates twenty-three local broadcast television stations; fourteen are affiliates of the Big Four television networks. We acquired the Belo notes at a 12% YTM, of which more than 11% of that yield is in the form of current yield (the annual interest payment received divided by the cost of the notes). The implied net debt (using the market price that we paid for the bonds) to enterprise value is roughly 70% and is our most levered fixed income investment. We purchased the Belo notes at an attractive implied debt enterprise value to EBITDA multiple of 4.5x-5x. In reaction to a significant decline in television ad sales in 2009 that more than likely will not be recaptured due to secular local and broadcast television challenges, Belo has right-sized its cost structure and has remained profitable.

Enclosed you will find an article from *Kiplinger’s Personal Finance*, titled “My New Take on Bonds,” by James Glassman, who interviewed Jim Roumell for this story.

Pertinent securities laws require us to make available to you every year the latest version of our ADV brochure (filed with the SEC), which has been prepared in accordance with current regulations. If you would like to receive a copy, please contact us via email or letter.

Disclosure: The specific securities identified and described do not represent all of the securities purchased, sold, or recommended for advisory clients, and the reader should not assume that investments in the securities identified and discussed were or will be profitable. The top three securities purchased in the quarter are based on the largest absolute dollar purchases made in the quarter.

Roumell Asset Management, LLC

Fixed Income Composite

Annual Disclosure Presentation

Fixed Income Composite contains fully discretionary fixed income accounts (consisting of closed-end bond funds, individual bonds, and open-end bond funds) and for comparison purposes is measured against the Barclays Capital US Aggregate Index and Barclays Capital US Corporate High Yield Index.

Roumell Asset Management, LLC has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®).

Roumell Asset Management, LLC is an independent registered investment adviser. The firm maintains a complete list and description of composites, which is available upon request.

Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Past performance is not indicative of future results.

The U.S. dollar is the currency used to express performance. Returns are presented net of management fees and include the reinvestment of all income. Net of fee performance was calculated using actual management fees. For certain of these accounts, net returns have been reduced by a performance-based fee of 20% of profits, paid annually in the first quarter. Net returns are reduced by all fees and transaction costs incurred. Returns include the effect of foreign currency exchange rates. Exchange rate source utilized by the portfolios within the composite may vary. Composite performance is presented net of foreign withholding taxes. Withholding taxes may vary according to the investor's domicile.

The annual composite dispersion presented is an asset-weighted standard deviation calculated for the accounts in the composite for the entire year. Dispersion calculations are greater as a result of managing accounts on a client relationship basis. Securities are bought based on the combined value of all portfolios of a client relationship and then allocated to one account within a client relationship. Therefore, accounts within a client relationship will hold different securities. The result is greater dispersion amongst accounts. Additional information regarding the policies for calculating and reporting returns is available upon request.

The investment management fee schedule for the composite is as follows: for Direct Portfolio Management Services: 1.50% on the first \$500,000 and 1.00% on assets over \$500,000; for Sub-Adviser Services: determined by adviser. Actual investment advisory fees incurred by clients may vary.

The Fixed Income Composite was created and incepted January 1, 2009. Roumell Asset Management, LLC's compliance with the GIPS® standards has been verified for the period January 1, 1999 through June 30, 2009 by Ashland Partners & Company LLP. A copy of the verification report is available upon request.

