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Value Investor INSIGHT

The Leading Authority on Value Investing

Less is More

While he casts a narrower net than most investors, Saturna Capital's Nicholas Kaiser has proven more than adept at bringing in a consistently winning catch.

Nearly 50 years after being dubbed "Nick the cynic" by high school classmates, Nicholas Kaiser continues to wear the appellation with a certain pride. "Investing isn't exactly a business for the gullible," he says.

Kaiser's skeptical nature has produced excellent results for investors. His Bellingham, Washington-based Saturna Capital now manages $3.1 billion, while his flagship Amana Growth mutual fund has earned a net annualized 10.2% since its 1994 inception, vs. 7.5% for the S&P 500.

Despite the market's recent new-found optimism, he's currently finding plenty of contrarian opportunities in such areas as semiconductors, health insurance, natural gas, leisure travel and non-residential real estate construction. See page 2

INVESTOR INSIGHT

Nicholas Kaiser
Saturna Capital

Investment Focus: Seeks companies whose stocks have fallen from previous heights for reasons he believes will be corrected sooner than the market expects.

Investor Insight: Nicholas Kaiser

Nicholas Kaiser of Saturna Capital describes what "quant" investing taught him about fundamental research, why he's so comfortable investing in cyclicals, the country with which he's particularly enamored as an investor, how he combats excessive skepticism, and why he sees mispriced value in Intel, UnitedHealth, Devon Energy and Emcor.

You've long been a fairly traditional value investor, but your earliest investing experience was as a bit of a "quant." How did that come about?

Nicholas Kaiser: My first job out of business school in 1968 was as a systems analyst in Indianapolis for the U.S. Army. I was quite interested in computers and took on a moonlighting project with a local businessman, Sam Moxley, who owned a chain of drugstores. He had an IBM 360 computer that was idle at night and he wanted to use it to uncover systems for beating any number of markets – our main focus was on equities, but we also did regressions on things like tea prices in India, horse races and precious metals. We ended up starting a company called Optimal Digital Decision Systems, which focused primarily on selling stock research to institutional investors. That's how I got into the business.

Do any insights from that time inform your strategy today?

NK: In many ways it affirmed the importance of fundamental research. We concluded fairly quickly that earnings were just about the only reliable input you could count on to move stock prices. Our screening today focuses primarily on the historical earnings record, with the added twist that we also put a lot of emphasis on earnings surprises. We then combine that with fundamental research focused on the company's competitive position and where its industry is going in order to identify the best opportunities.

Another insight from our early work was that having market and macro views matter, because so much of an individual stock price's variation over time can be explained by how the market and its industry are moving overall. We understand how difficult it can be to get those types of things right, but have never con-

sidered that a reason not to bother. I'm 64 and have been through enough cycles that I should be able to add at least some value by recognizing when a cycle is working for or against us.

Your screening process for ideas is complicated by the fact that your biggest funds are sharia-compliant, meaning they adhere to Islamic law. Does that narrow your opportunity set considerably?

NK: In some ways, yes. In our sharia-compliant funds we can't invest in businesses involved in tobacco, alcohol or gambling. We can't invest in conventional financial services or insurance companies, because of the centrality in these businesses of the receipt or payment of interest.

But many of the Islamic principles we follow are fully consistent with a long-term investment strategy focused on high-quality companies. We avoid companies with high leverage, requiring that total debt be no more than 33% of the market capitalization. Accounts receivable needs to be less than 45% of total assets. Overall, about 40% of the 5,500 largest U.S. stocks pass our quantitative screens.

More generally, our philosophy resists speculation or gambling on stories. We want to own companies that may be going through some sort of challenge, but that have over time proven their ability to compete and make money. We stayed away from Google, for example, in its early years of being public because so much of it was story, and we just don't buy story. Last year when the stock got below $350 and was trading for something like 16x trailing earnings, that caught our attention. Our intent is to buy companies like that well and then hold them for a long time. The five-year average turnover in our biggest fund, Amana Growth, has averaged 6%.

Give an example or two of stocks you own in your non-sharia funds that you can't own in your sharia-restricted Amana funds.

NK: Allegiant Travel [ALGT] is a good example. It's one of the few airlines that consistently makes money, with a business model – selling low-cost travel packages to popular destinations like Orlando and Las Vegas – that we believe has long-term legs. To keep costs down they fly from smaller airports, like their 14 flights per week from my hometown of Bellingham, Washington to Las Vegas. They have also been disciplined about adding or subtracting routes based on how full the planes are. One expansion initiative today is trying to get new 757s certified to fly to Hawaii from the west coast.

The issue when it comes to Islamic principles is that Allegiant makes a lot of money through partnerships with the Las Vegas casinos, which means we can't own them in our Amana funds.

Another example is Dr Pepper Snapple [DPS], which we liked as it was spun out of Cadbury in 2008 but which we couldn't own in the Amana funds because it had too much debt. After getting hit by the economic crisis and working the kinks out in its first 18 months as an independent entity, the company has put up some good numbers and the shares have performed quite well. We missed that part of the cycle in certain funds, but as they pay down debt and the risk profile changes, it may very well be something we can invest in soon across all our funds.

You're active in cyclical companies. Why?

NK: Part of it is the result of the Islamic screening process. Given fear over what might happen in the next downturn, companies with cyclical earnings generally aren't able to leverage themselves too highly, so a lot of them show up on our OK-to-buy list. Beyond that, we believe our understanding of business cycles and the fact that we take a very long-term view gives us somewhat of an edge in investing in cyclicals.

So we can't resist when something like Teck Resources [TCK], a big Canadian mining company, falls from $50 to $3 in less than six months as it did in 2008. Teck had made a large coal-company acquisition right before the financial crisis hit and the market was horrified by the risk, but our view was that the coal business would recover and their sale of a 17% stake to China Investment Corp. nicely stabilized the balance sheet and would open doors to future business. The stock is back to

Nicholas Kaiser

Higher Calling

As a white Episcopalian, Nicholas Kaiser didn't start out planning to build the go-to U.S. fund complex for investing according to Islamic principles. He was approached in the mid-1980s by a group of Muslim businessmen in Indianapolis who wanted to start a fund in which they would define the opportunity set and Unified Management, the investment firm he was then running, would provide the investing expertise. Thus was the inspiration for what are now three sharia-compliant Amana mutual funds managed by Saturna Capital, which Kaiser started in his hometown of Bellingham, Washington in 1989.

Defining what is and isn't a sharia-compliant business isn't an exact science, he says. The Koran forbids the payment or receipt of interest, for example, but his Islamic experts define that to mean for non-financial companies that debt should not exceed one-third of a company's total market cap. Companies that sell alcohol as a core business, such as grocery stores, are forbidden, while those in which it's outside the core business, such as airlines, are OK. "I like to think the restrictions on us make us know our businesses that much better," says Kaiser. "I'd also argue unlimited choice can be overrated."

around $45 and while we've trimmed the position somewhat, we still see great opportunity for them in Asia stemming from the CIC connection.

Canadian companies appear to be particular favorites of yours.

NK: We like Canada a lot. As countries go, it's well-run and its resource companies are asset-rich and well-positioned to benefit from developing-market growth. One way we're playing that is through Canadian National Railway [CNI], which benefits not only from the international resources trade, but also from rationalizing its network in the same way the big U.S. railroads are. To give one small example: The Fraser River canyon coming down into Vancouver is steep and narrow, with tracks on each side, one side owned by Canadian National and the other owned by Canadian Pacific Railway. That was a big bottleneck until the two companies made a deal to share the tracks and have one side for east-bound trains and the other for west-bound. That tripled the traffic going through the canyon, increasing profitability all around, and is the type of thing going on throughout the rail system in Canada.

You own both mining giant BHP Billiton [BHP] and fertilizer company Potash [POT]. Can a deal there be good for shareholders of both?

NK: The price obviously matters, but we believe if BHP can buy Potash for $150-160 per share, it's going to get a good deal. [*Note*: The current BHP offer for Potash is $130 per share, while Potash shares closed recently around $143.] Potash owns the proverbial 1,000-year supply of raw fertilizer material that offers excellent payback for farmers looking to increase yields and supply what is going to be dramatic new consumer demand in emerging markets for better food. Potash knows this business inside and out and would be an extremely valuable asset for any owner. We're fairly confident a deal will get done, one big reason being the executives at Potash have some pretty fancy golden parachutes and are rooting for something to happen.

Does your low portfolio turnover combined with an emphasis on cyclicals cause you problems from time to time?

NK: Prices of resources can vary dramatically, so our obvious goal is to buy when the resource is cheap based on a long-term view of where its price is headed. We'll talk later about Devon Energy [DVN], one of our favorite energy plays in part because of its focus on natural gas, which today is priced at an all-time discount to oil on a BTU basis. We don't know exactly when that corrects, but we're confident it will and are therefore comfortable building up what is likely to be a multi-year position.

ON CANADA:

As countries go, it's well-run and its resource companies are well-positioned to benefit from emerging-market growth.

It can be harder for us to determine when a resource is too expensive rather than too cheap, so we don't always trim as much as we should when something gets ahead of itself. For example, we talked earlier this year about selling some of our position in Cree [CREE], a manufacturer of light-emitting diodes that are used in everything from flashlights to recessed lighting. We decided against it because we still believe the long-term growth potential is high as LED products find new applications and prove to be increasingly cost-efficient. But some short-term numbers have come in lower than expected, so the stock is now around $50, from $83 in April. We've used the recent weakness to add to our position.

All in all, the consistency of our returns would indicate we do a pretty job of both playing the cycles and of not being overexposed to any given industry sector. No one should count on timing cycles perfectly.

You spoke earlier about the importance of a top-down market view. How is that getting built into your portfolio today?

NK: We don't short, so our top-down view usually manifests itself in how much cash we're holding. It was fairly easy to foresee the last 1,000-point rise in the Dow, based on the fact we're coming up to an election and that the Fed and its counterparts around the world seem keen to print money. In the short-term at least, those two indicators are reliably positive for the market. We went into that period with 7-10% portfolio cash positions, which is pretty fully invested for us, and we expect to stay invested at that level through the end of the year.

Some time in the first half of 2011, however, we believe the chances of a market correction to the downside are high, as people realize the elections haven't delivered the promised nirvana and the artificial stimulus of easy money can't be sustained. We also expect the growth in aggregate earnings for the S&P 500 to slow down considerably over the next 12 months, to 5% or so, which won't be a positive for the market.

In analyzing specific stocks, how generally do you think about valuation?

NK: With valuation we tend to look back more than we look forward, wanting to see P/Es of 9-12x trailing earnings and an earnings growth level over the past year that is at or above the P/E – say something that grew earnings 10% over the past year trading at no more than a 10x multiple.

Our typical buy is a successful company that has gone through a rough period but has already turned the corner, with positive industry trends still as a tailwind. The dynamic is usually such that we don't need dramatic revenue growth to see the type of earnings rebound that will make the stock go up. That's a good thing these days, when big revenue growth is hard to come by.

Describe why you consider Intel [INTC] attractive now.

NK: The basic thesis is that while the market is treating Intel as if it's the most boring, no-growth company out there, there are many reasons to believe that's not the case. The most obvious is just to look at the results: in its latest quarter, the company's revenues were up 18% year-over-year to the highest level ever, driven by strong U.S. corporate IT spending and excellent demand for personal computers in emerging markets. Operating margins came in at nearly 40% and net margins were more than 25%.

Going forward, the company has a diverse line of microprocessor and other related products that will benefit from any number of technology trends, whether its cloud computing and the infrastructure necessary to provide it, tablet computers, more ubiquitous and powerful smartphones, or selling personal computers in places like India and China. They are in an innovation business and have used huge R&D spending to constantly upgrade and expand their product lines while driving down manufacturing costs.

Growth is more challenging from such a high base and when the company has to lower prices on an annual basis in more commodity areas. But we believe there's no reason revenue can't grow at 5% or so going forward and EPS at a 10% annual rate, driven by operational efficiency and a more-profitable product mix. That revenue and profit growth would be in line with what they've achieved over the past five years in a difficult environment. We just don't believe that's worth a less than 11x earnings multiple.

What's your take on Intel's shelling out $7.7 billion for software firm McAfee?

NK: We think it makes a lot of sense. As more computing moves to the "cloud," security issues will become even more important. To the extent this helps Intel build enhanced security features directly into its hardware, we believe it will make its products more differentiated and valuable. The details will obviously matter, but the strategy is sound.

We don't think it's a bad thing if the company uses some of its cash to enhance its positions in important markets. Two weeks after the McAfee deal was announced, Intel said it was also buying the wireless-chip business of Germany's Infineon. They've admitted being a bit slow in smartphones, but it's still early enough in that market's lifecycle that playing catch-up with an acquisition can make sense.

From today's price of around $20.50, what upside do you see for Intel shares?

NK: Consensus earnings estimates for the year ending in December are $1.93 per share, so the stock trades at 10.6x earnings – less if you take out $3.70 per share in net cash on the balance sheet – which implies the company is doing no better than running in place. Since the overall market started going up in August, Intel shares have done little.

We typically look at where a currently beaten-up stock has traded in the past and then try to assess whether the business and its prospects warrant at least getting back to previous levels. In this case, Intel shares hit $28 at the end of both 2005 and 2007 and we're confident they

INVESTMENT SNAPSHOT

Intel
(Nasdaq: INTC)

Business: Global market leader in the design, manufacture and sales of microprocessors and integrated chipsets used primarily in the manufacture of computers.

Share Information (@10/28/10):

Price	**20.47**
52-Week Range	17.60 – 24.37
Dividend Yield	3.1%
Market Cap	$114.12 billion

Financials (TTM):

Revenue	$42.74 billion
Operating Profit Margin	39.2%
Net Profit Margin	24.7%

Valuation Metrics (@1028/10):

	INTC	Nasdaq
Trailing P/E	11.0	13.9
Forward P/E Est.	10.6	16.1

Largest Institutional Owners (@6/30/10):

Company	% Owned
Vanguard Group	3.6%
State Street	3.5%
BlackRock	2.6%
Capital Research	2.2%
Fidelity Mgmt & Research	1.8%

Short Interest (as of 10/15/10):

Shares Short/Float	1.0%

INTC PRICE HISTORY

THE BOTTOM LINE

"The market is treating Intel as if it's the most boring company out there," says Nicholas Kaiser, who believes broad-based microprocessor demand will propel 10% annual bottom-line growth for the company going forward. As earnings grow and market pessimism dissipates, he expects the shares within one to two years to reach $28.

Sources: Company reports, other publicly available information

should at least return to that level over the next year or two as earnings increase and they get some credit for modest growth.

In the meantime, the company continues to buy back shares and has increased its dividend at a 17% annual rate over the past five years. (The current yield is 3.1%.) That takes even more risk out of what we already believe is a low-risk opportunity.

Is the uncertainty a bit higher for your next pick, UnitedHealth [UNH]?

NK: The story here is that the market is behaving as if healthcare reform is going to badly damage the profitability of health insurers, and we don't believe that's true. There will be give and take, but we expect the primary ultimate effect of reform to be an increase in the demand for health insurance, which is a positive for UnitedHealth.

That's it, out of 2,000-plus pages of reform legislation?

NK: The government could have put companies like UnitedHealth out of business by going to a single-payer system, but it chose not to in part because of the enormous inefficiency of scrapping an entire system in place to at least try to reign in healthcare inflation. The biggest open question today concerns medical loss ratios, or the percentage of total premium dollars that will need to be spent on providing care. But the application of these rules is all about the definition of costs. Is it just what you pay in claims, or does it include the costs of maintaining a sales force? If companies spend money on wellness programs, are those allowable expenses that can be put against premiums? The more costs included in the calculation, the less onerous the MLRs will be.

Because reform didn't nationalize the regulation of the insurance companies, it's going to be very difficult for individual states to make the final MLR rules too painful for the insurance companies. All that does is make the companies withdraw from the state, and how does that serve the greater good?

What do you like in particular about UnitedHealth's business?

NK: We like the diversity of its business model, which generates around 25% of total revenues from less-regulated businesses such as administering Medicare and Medicaid programs for governments, IT consulting, and pharmacy benefits management. The plan is to eventually get 40% of sales from these non-health-plan businesses, which is a good, if optimistic, goal.

UnitedHealth currently serves more than 75 million customers and scale is obviously a big advantage in this business. That gives the company bargaining power with healthcare providers in negotiating reimbursement rates, pricing power with customers in passing on rising healthcare costs, and deters new entrants.

Since premiums are collected months before claims have to be paid, as long as underwriting is sound – and for the most part that has been the case for UnitedHealth – the company earns excellent free cash flow and high returns on capital.

INVESTMENT SNAPSHOT

UnitedHealth
(NYSE: UNH)

Business: Largest U.S. managed-health-care organization by revenue, with primary operations in insurance, pharmacy-benefit management and data services.

Share Information
(@10/28/10):

Price	**36.25**
52-Week Range	25.64 – 37.95
Dividend Yield	1.3%
Market Cap	$40.74 billion

Financials (TTM):

Revenue	$91.91 billion
Operating Profit Margin	8.3%
Net Profit Margin	4.9%

Valuation Metrics
(@10/28/10):

	UNH	S&P 500
Trailing P/E	9.1	17.3
Forward P/E Est.	10.1	14.0

Largest Institutional Owners
(@6/30/10):

Company	% Owned
Wellington Mgmt	6.7%
Fidelity Mgmt & Research	4.4%
Vanguard Group	3.7%
Capital World Inv	3.5%
State Street	3.5%

Short Interest (as of 10/15/10):

Shares Short/Float	1.9%

UNH PRICE HISTORY

THE BOTTOM LINE

Nicholas Kaiser expects the company's scale and diversified business model to allow it to thrive in a regulatory environment he believes won't be as onerous as the market anticipates. If he's right that revenue growth continues at 6-8% per year and margins are not compressed, he believes the stock will reach $60 within two to three years.

Sources: Company reports, other publicly available information

The stock is actually up more than 35% over the past year. How cheap do you consider it at a recent $36.25?

NK: Earnings have increased in each of the last six quarters and – in what we consider a very positive sign – earnings have exceeded expectations in each of those quarters. There's clearly uncertainty over earnings going forward, but the current share price is only 10x estimated 2011 EPS of around $3.60.

Revenue growth has been running 6-8% per year, which is a reasonable expectation going forward, and we've taken the position that margins are not going to be compressed. If we're right, we wouldn't expect the stock to reach full value over the next couple of years until it returned to the $60 level at which it traded in late 2007 and early 2008.

I didn't mention earlier that one finding of my early modeling work was the predictive value of increasing and, especially, reinstated dividends on share prices. There's a logic to it: Boards cut dividends in hard times and everyone gets mad at them, so they'll only bring the dividend rate back up when they're sure the business can support it. In UnitedHealth's case, in June it increased its annual per-share dividend from 3 cents to 50 cents. We believe that's a strong indication of the health of the business going forward.

We assume regulatory uncertainty is still the primary risk.

NK: As always. Rising unemployment would also be a problem, as lower commercial enrollments would result in negative operating leverage.

It's a political game. It's going to be hard to fund a lot of the mandates in the reform bill, and that gets harder if Republicans get real traction in Congress, which we see as more probable than not. The expectation of that is probably behind much of the recent move in UnitedHealth's shares, but we think they could get another good-sized bump if the elections in a few days signal a real shift.

Tell us about one cyclical idea mentioned earlier, Devon Energy [DVN].

NK: The company is just wrapping up a rather significant strategic overhaul, selling its stakes in the deep-water Gulf of Mexico (prior to the BP spill), as well as its non-Canadian international operations. By year-end it should have taken in roughly $10 billion pre-tax from all that, which it is redeploying into paying down debt, a new gasification plant in Texas with Conoco, expanding oil production from its Jackfish oilsands project in Canada, and buying back some $3.5 billion in stock. The goals are to focus development spending on higher-return projects and to broaden the resource portfolio to include more oil and compressed gas, while at the same time significantly strengthening the balance sheet.

Even with all that, is the company still too dependent on natural gas?

NK: Gas today is obviously a tough business in the U.S., as huge increases in supply have far outpaced demand. But put us in the camp of those who see that eventually correcting as production spending is cut back and demand increases. Natural

INVESTMENT SNAPSHOT

Devon Energy
(NYSE: DVN)

Business: North American oil and gas exploration, production and transmission, with primary assets in shale natural gas and a large Canadian oilsands project.

Share Information
(@10/28/10):

Price	**64.73**
52-Week Range	58.58 – 76.79
Dividend Yield	1.0%
Market Cap	$28.16 billion

Financials (TTM):

Revenue	$8.86 billion
Operating Profit Margin	43.5%
Net Profit Margin	34.6%

Valuation Metrics
(@10/28/10):

	DVN	S&P 500
Trailing P/E	9.4	17.3
Forward P/E Est.	11.6	14.0

Largest Institutional Owners
(@6/30/10):

Company	% Owned
Davis Selected Adv	6.7%
State Street	3.8%
Capital Research	3.7%
Vanguard Group	3.6%
Axa	3.5%

Short Interest (as of 10/15/10):

Shares Short/Float	1.8%

THE BOTTOM LINE

With a strategic overhaul nearly complete that will leave the company more financially secure and focused on higher-return assets, Nicholas Kaiser expects its shares to generate a decent return even if natural gas prices remain at historically low levels. Should new demand ultimately drive gas prices higher, "the upside is fantastic," he says.

Sources: Company reports, other publicly available information

gas at even higher than today's prices is much preferable to oil for many uses, both economically and environmentally. It takes time, but in key areas like transportation and electricity generation we expect to see gas take significant market share from oil. In Vancouver, for example, heavy vehicles often run on compressed natural gas – the gas is readily available and its increased use has had a real positive impact on the atmospherics in the region.

How do you build expectations for natural gas prices into your analysis?

NK: For gas prices to really spike, we'd need the type of booming economy that we just don't believe is on the horizon in the U.S. for years. That said, we do expect demand growth for gas as it takes volume from oil. Devon has over the past several years increased its bottom line an average of 6% or so per year, which we'd expect at least to continue even with no increase in gas prices.

We look at it this way: At today's share price [of $64.75], you're paying less than 11x this year's estimated earnings. That's hardly aggressive, so if the multiple stays the same, earnings grow 6% per year and we get another 1% in dividends, we'll make 7% annually on our money. On the other hand, gas has never been cheaper on a million-BTU basis than it is today versus oil, so the odds are in our favor that that corrects over time in favor of gas and we get a bump in price from today's level. That's an option for which we're paying nothing, but which would have a significant impact on Devon's earnings and share price.

This is the type of commodity play that we like today: the downside is minimal, it's defensive against inflation and the dollar falling apart, and the upside could be fantastic.

From one unloved business to another, describe your interest in Emcor [EME].

NK: About 70% of Emcor's revenue comes from providing mechanical and electrical services for new and renovation construction projects. They have built the business over time through buying local HVAC or mechanical-construction firms, centralizing administration to some extent but leaving the local operation mostly intact. The remaining 30% of the business is in facilities services, which does things like wire your building for Internet services, replace incandescent lighting with LEDs, or install fire and security alarms.

The downturn in commercial real estate has clearly had an effect on the company's business, with earnings per share off 12% in 2009 and expected to fall another 25% this year, to around $1.80. But absent another sharp leg down in the economy, we believe the business is on the cusp of turning back up, driven by modest improvement in the real estate outlook and by new spending on energy efficiency and other conservation efforts in government buildings and stimulus spending on modernizing transportation systems. We're encouraged that while earnings over the past several quarters have fallen, they've always stayed positive and have consistently beaten market expectations along the way. We consider that a testament to management's conservatism and operational acumen.

INVESTMENT SNAPSHOT

Emcor Group
(NYSE: EME)

Business: Design, installation and maintenance of electrical and mechanical systems for commercial, industrial, and government construction projects.

Share Information
(@10/28/10):

Price	**25.79**
52-Week Range	22.06 – 29.80
Dividend Yield	0.0%
Market Cap	$1.71 billion

Financials (TTM):

Revenue	$5.22 billion
Operating Profit Margin	4.5%
Net Profit Margin	2.5%

Valuation Metrics
(@10/28/10):

	EME	S&P 500
Trailing P/E	13.6	17.3
Forward P/E Est.	12.4	14.0

Largest Institutional Owners
(@6/30/10):

Company	% Owned
Vanguard Group	6.4%
LSV Asset Mgmt	5.0%
BlackRock	4.5%
Artisan Partners	4.3%
Ameriprise Financial	4.0%

Short Interest (as of 10/15/10):

Shares Short/Float	6.0%

EME PRICE HISTORY

THE BOTTOM LINE

Mired in a cyclical downturn, the company should eventually return to solid growth through a secular rise in non-residential construction spending, acquisitions, and the increased outsourcing of facilities management, says Nicholas Kaiser. He expects over the next year or two for the shares to return to their pre-crisis high of $38.

Sources: Company reports, other publicly available information

Do you see any secular growth in the business?

NK: The company has increased revenues over several years at a 7-8% annual rate, which we expect to continue. That has and will continue to come from acquisitions, long-term secular growth in U.S. non-residential construction spending, and the increased outsourcing of facilities management by corporations and government landlords.

With the shares at a recent $25.80, how are you looking at valuation?

NK: This one is optically a bit pricey for us, trading at 14.5x 2010 earnings estimates. But we're comfortable with that type of P/E in a cyclical business near what we consider the bottom of the cycle. If we're right about growth picking back up and if management continues to execute as they have over time, we'd expect over the next year or two for earnings to drive the share price back at least to its high of $38 in mid-2007.

The risk here is that the weak construction environment persists longer than we expect, but that just means growth won't really be there, not that the business is in any real danger. Since we don't consider the shares priced to expect any growth, that scenario shouldn't hurt us much.

You last year launched the Amana Developing World Fund. Has it been tough executing your strategy in emerging markets?

NK: We have had to take it slow in building the portfolio, partly because it's harder to find companies in emerging markets that have the balance sheets and historical profit records we require. Another issue is that many markets, particularly in Asia, strike us as more than fully priced.

The stock has been on a bit of a tear the last few months, but the fund's largest holding – which we still very much like – is LAN Airlines [LFL], Chile's largest airline. After its recently announced merger with TAM of Brazil, it's actually becoming Latin America's largest airline. It may take a while for them to work out the integration details, but LAN over the years has made good use of growth opportunities while enhancing shareholder value. We expect further consolidation in the industry worldwide, and believe LAN would ultimately make an attractive addition to a larger global player.

After more than 40 years in the business, have the last few years prompted any changes in how you invest?

NK: I wouldn't tie it directly to the crisis, but one of the best things I've done is turn over the day-to-day running of the business to my daughter, which lets me focus much more on research and investing. I recently filled out a form that required a list of the number of countries I'd been to in the past five years and it came to 23. There's nothing like boots on the ground to fill out your knowledge base, and given the complexity of the investment environment today that's more important than ever.

I also think I'm doing a better job of incorporating other smart people into our investment process. I'm a dyed-in-the-wool skeptic, and while that's served me well as an investor, taken to an extreme you end up not doing anything. Having smart young people bringing you ideas and challenging you is a good way to help compensate for that.

Performance Summary (as of December 31, 2010):

Average Annual Returns (before any taxes)	1 year	3 years	5 years	10 years	Expense Ratio[1]
Amana Income Fund	12.21%	1.98%	7.97%	6.66%	1.26%
Amana Growth Fund	15.92%	2.58%	6.94%	5.86%	1.21%
Amana Developing World Fund	5.63%	n/a	n/a	n/a	1.59%

Morningstar™ Ratings[2]	Overall	1 year	3 years	5 years	10 years
Amana Income Fund - "Large Value" category					
Morningstar Rating™	★★★★★	n/a	★★★★★	★★★★★	★★★★★
% Rank in category	n/a	68	3	1	2
Funds in category	1,120	1,240	1,120	956	502
Amana Growth Fund - "Large Growth" category					
Morningstar Rating™	★★★★★	n/a	★★★★★	★★★★★	★★★★★
% Rank in category	n/a	45	6	4	1
Funds in category	1,504	1,718	1,504	1,286	787

Performance data quoted herein represents past performance, is before any taxes payable by shareowners, and is no guarantee of future results. *Current performance may be higher or lower than that stated herein. Performance current to the most recent month-end can be obtained by calling toll-free 888-73/AMANA or by visiting www.amanafunds.com. Total returns are historical and include change in share value and reinvestment of dividends and capital gains, if any, and do not include the potential deduction of a 2% redemption fee on shares held less than 90 days. Share price, yield, and return will vary, and you may have a gain or loss when you sell your shares.*

The Amana Funds limit the securities they purchase to those consistent with Islamic principles which limits opportunities and may increase risk.

Please consider an investment's objective, risks, charges and expenses carefully before investing. To obtain a free prospectus that contains this and other important information on the Amana Funds, please call toll-free 888-73/AMANA or visit www.amanafunds.com. Please read the prospectus carefully before investing.

The Amana Developing World Fund commenced operations on September 28, 2009 and is not yet rated by Morningstar

[1] *By regulation, expense ratios shown in this table are as of the Funds' most recent prospectus which is dated Sep. 3, 2010 and incorporates results for the fiscal year ending May 31, 2010. Average annual total returns include changes in principal value, reinvested dividends and capital gain distributions, if any.*

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[2] ***Source: Morningstar Dec. 31, 2010.*** *For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating™ based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance (including the effects of sales charges, loads, and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% in each category receive 5 stars, the next 22.5% 4 stars, the next 35% 3 stars, the next 22.5% 2 stars and the bottom 10% receive 1 star. The Overall Morningstar Rating for a fund is derived from a weighted average of performance figures associated with its 3-, 5- and 10-year (if applicable) Morningstar Rating metrics. A high rating does not necessarily mean a fund had a positive return.*

% Rank in Category: This is the fund's total return percentile rank for the specified time period relative to all funds that have the same Morningstar category. The highest (or most favorable) percentile rank is 1 and the lowest (or least favorable) percentile rank is 100. The top-performing fund in a category will always receive a rank of 1. Percentile ranks within categories are most useful in those categories that have a large number of funds.

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