

FOCUSED INVESTORS LLC
— INVESTMENT MANAGEMENT —

PORTFOLIO AND PERFORMANCE REVIEW
SECOND QUARTER 2010

<u>Performance*</u>	<u>Second Quarter</u>	<u>Year- To-Date</u>	<u>Since Inception**</u>
FI Concentrated Value Composite (gross of mgmt fees)	(8.1%)	(3.4%)	2.7%
FI Concentrated Value Composite (net of mgmt fees)	(8.2%)	(3.7%)	1.8%
Russell 1000 [®] Value Index	(11.2%)	(5.1%)	(5.5%)

* Important performance disclosures are at the end of this letter.

** Annualized. Inception Date: 8/1/06.

Last quarter's decline in stock prices more than offset the gains enjoyed by investors during the first quarter of the year, marking an abrupt end to a four-quarter winning streak of positive stock market returns. Multiple concerns including the effects of both the overseas debt crisis and the stubbornly high U.S. unemployment rate caused investors to question the current pace of the economic recovery. The equity market run-up that began in March 2009 was led largely by economically sensitive companies whose stock prices by April 2010 had reached levels that reflected the expectation of a strong rebound in revenues and earnings. Unfortunately, these valuations proved difficult to sustain as investors' faith in this rebound wavered. We expect market volatility to continue as investors struggle to predict the direction of the economy and the implications for corporate revenues and profits. We learned long ago that our ability to make such predictions was limited and, quite frankly, not necessary for making sound long-term investment decisions.

We also learned long ago not to be overly concerned with short-term weakness in stock prices. In fact, we welcome the opportunity to add new companies to our portfolio at attractive prices as a result of market declines. We did just that last quarter by buying new positions in IBM and Goldman Sachs. Our focus is on changes in the underlying profits of the companies we own. Based on that measure, our overall portfolio continues to perform well. As we have written in the past, if the companies in our portfolio increase their revenues, earnings and cash flow over time, their stock prices will eventually follow suit.

Our portfolio reflects our best 15-25 ideas with little consideration given to how the resulting mix of companies compares to our benchmark. However, such a comparison is useful in understanding our relative short-term performance. The following discussion compares our portfolio weightings to those of our benchmark, the Russell 1000[®] Value Index, a well-known and commonly accepted value index indicative of our investment style.

Given the broad-based nature of last quarter's market sell-off in which all ten of the benchmark's sectors declined, it was almost impossible to avoid reporting negative performance and we were no exception. However, we did manage to out-perform our benchmark. We achieved this in part due to the relatively strong performance of our *Consumer Discretionary* holdings and our significant underweighting in *Financials* and *Industrials* which were both

among the benchmark's weaker performing sectors. Detracting from our relative performance was our lack of exposure to the benchmark's two best-performing sectors: *Telecommunication Services* and *Utilities*. The following paragraphs discuss several of our portfolio holdings that detracted from last quarter's performance as well as our two new additions to the portfolio.

Microsoft was our worst performing stock last quarter. Investors are concerned with the growing proliferation of non-Windows based mobile computing devices, including smartphones and tablets which cannibalize sales of Windows based notebooks and computers. The increasing availability of web-based application software poses a threat to Microsoft's traditional computer installed software. For instance, Google provides free web-based versions of slimmed down application software similar to Word, Excel and PowerPoint, three of the most popular applications in Microsoft Office. Finally, consumers and businesses have been slow to upgrade to Microsoft's newest product versions.

While these concerns are legitimate, we believe investors are underestimating Microsoft's strengths. The company's Windows operating system and Windows Office applications dominate the market for business and personal computers, and we think this dominance will persist for some time. Microsoft is devoting substantial resources to develop products to compete in the mobile device market and, if successful, these products could provide a meaningful source of growth. The company is also developing web-based versions of its most popular products to compliment its traditional software products. Finally, as consumer and business spending recovers, we expect to see an increase in upgrade activity to Microsoft's newer product versions.

We think Microsoft is undervalued at its current share price of roughly 11X forward earnings with roughly \$40 billion in cash and short-term investments (over \$4/share) on its balance sheet. The company generates substantial free cash flow, a meaningful portion of which we expect will be returned to shareholders through share repurchases and cash dividends.

In early June, Walgreen announced that it would no longer participate in any future pharmacy benefit management (PBM) plans offered by CVS Caremark, depressing the share prices for both companies. Walgreen appeared to be engaging in a very harsh negotiating tactic to force an increase in the PBM drug reimbursement rates paid to it by CVS Caremark. Walgreen most likely assumed that CVS Caremark would avoid a confrontation that might hamper its ability to effectively compete for new clients in its PBM business, especially since CVS Caremark had suffered several large PBM client losses at the end of 2009. Initially Walgreen's move looked cleverly designed to inflict immediate pain on CVS Caremark but spread its anticipated revenue loss over a multi-year period thereby easing the impact on its financial results.

However, CVS Caremark was just as clever in its response by announcing the immediate termination of its business relationship with Walgreen rather than allowing it to wind down over a multi-year period. This meant that Walgreen would be forced to absorb the anticipated revenue loss immediately rather than over several years. Not surprisingly, within days of CVS Caremark's announcement, the two companies resolved their differences and reversed their earlier decisions.

We were disappointed with Walgreen management's initial approach to resolving this disagreement with CVS Caremark and were equally disappointed with their failure to provide a persuasive explanation for the rationale supporting their decision. Walgreen was one of the least undervalued companies in our portfolio. When we decided to increase our positions in two of our other more undervalued companies, Walgreen was the logical position to sell to fund the purchases.

Earlier in the quarter we sold some UnitedHealth and NIKE to fund the initial purchases of our two new holdings. Since our portfolio is generally fully invested, we almost always need to reduce or sell a position in order to buy a new company or add to an existing position. Our goal is to constantly strive to have the highest quality, most undervalued portfolio possible by selling companies with higher price-to-value ratios and reinvesting in more undervalued companies.

Walmart's sales results in its U.S. discount store business remain sluggish reflecting both a weak retailing environment and management missteps in pricing and merchandising. In an attempt to improve customers' shopping experience, the company has been remodeling stores and reducing merchandise stock keeping units (SKUs), giving the stores a cleaner, less cluttered look. However, the remodeling efforts have been disruptive and customers have complained about the reduced assortment resulting from the eliminated SKUs. Furthermore, the company implemented price rollbacks in some categories in which it already held a dominant market share position. Thus the lower prices failed to generate incremental unit sales. In response to these missteps, Walmart recently announced several changes in its senior management. Walmart's deep management bench provides the company with the flexibility to make management changes as needed.

Despite the weak U.S. same store sales, Walmart reported low double digit EPS growth in its most recent quarter. These results were driven by strong international operations (a growing portion of the company), positive operating leverage and a reduced share count reflecting a substantial share repurchase program. As the company's growth opportunities decline so does its need to reinvest capital in the business, contributing to substantial free cash flow. Management has an outstanding track record of returning excess cash to shareholders. During the past three years, the company has repurchased \$18.5 billion of its own stock. Last quarter the Company's Board approved an additional \$15 billion share repurchase program which represents over 8% of its current shares outstanding. The company has increased its dividend every year since 1974. We believe Walmart will prove to be a very profitable long-term investment.

IBM was a new addition to our portfolio during the quarter. IBM has transformed itself over the past two decades into an information and technology services and software company. On the services side, IBM offers outsourcing (data centers), maintenance, consulting, and systems integration and application management. IBM's software applications allow companies to store, share and manage information more efficiently. In 2009, services and software represented 84% of pretax income, while hardware and related financing represented the remaining 16%.

As IBM has changed its business mix towards more predictable and profitable services and software, the company has also focused on becoming a leaner, more efficient organization with a constant focus on reducing expenses while maintaining and improving service quality. For the past seven years during which Sam Palmisano has served as Chairman and CEO, the company has reported consecutive double-digit earnings per share growth. This EPS growth has been driven by a strategy of consistent organic revenue growth, margin expansion, share repurchases, and selected acquisitions.

Management recently laid out its plan for achieving 2015 EPS of at least \$20 using the same strategy that has worked so successfully during the past seven years. While we think management's goal is optimistic, we also believe that it is achievable. However, we have used more conservative assumptions in our IBM valuation than those incorporated by management in their 2015 EPS goal. Based on our valuation, IBM is selling well below our estimate of its

intrinsic value. If management is successful in achieving its more optimistic goals, then the company is even more substantially undervalued.

Our other new position last quarter was Goldman Sachs. Goldman's stock price dropped sharply in April after the SEC filed a lawsuit against the company. The stock weakened even further as investors became increasingly concerned that financial reform would severely restrict Goldman's business activities and depress its future profitability. In its lawsuit against Goldman, the SEC alleged that the firm failed to disclose material information to investors about Abacus 2007-AC1 ("Abacus"), a collateralized debt obligation (CDO) sold to them by Goldman. Specifically, the SEC alleged that Paulson & Co. (a now well-known hedge fund that profited handsomely from the meltdown in residential real estate prices) was involved in selecting mortgage backed securities that were used to construct the CDO sold by Goldman. Furthermore, the SEC alleged that Goldman hid Paulson's involvement in selecting securities for this CDO and misled investors into believing that Paulson was going to be an investor in Abacus when in fact, Paulson was betting that Abacus would fall in value.

There was significant public debate about the merits, motivation and timing of this lawsuit. Regardless, once the lawsuit had been filed we believed it was in Goldman's best long-term interest to reach a quick settlement with the SEC. Battling the SEC in court would have exposed Goldman to the risk of permanent reputational damage, client defections and a possible (although we believed unlikely) negative verdict. We also concluded that the SEC would favor a settlement which it could then publicly proclaim as a victory while avoiding the possible embarrassment of a loss in court. In fact, a few days after quarter-end Goldman announced a \$550 million after tax (roughly \$1 per share) settlement with the SEC which was greeted enthusiastically by investors and was far less than what we had assumed in our analysis.

Although the SEC lawsuit against Goldman received the most press, financial reform had the potential for the most profound impact on the company's intrinsic value. Financial reform was aimed mainly at preventing banks from engaging in overly risky activities that might lead to taxpayer funded bailouts. Goldman is subject to bank related rules and regulations because of its decision to become a bank holding company during the height of the recent financial crisis. As the quarter progressed, it seemed likely to us that financial reform would be enacted and would require higher capital requirements and impose new restrictions on derivatives trading activities and place limits on proprietary trading (the so called "Volcker Rule"). The effects of financial reform were clear: to reduce the future profitability of the companies affected.

We bought Goldman when its share price dropped to 1.2x tangible book value, a level which we believed discounted both a large settlement with the SEC and a substantial reduction in future profitability. While it will take years to determine the final impact of financial reform, we believe it is highly unlikely to depress Goldman's profitability to levels low enough to justify the current share price. If Goldman is successful in structuring its business to mitigate the effects of financial reform (possibly by abandoning its bank charter) or if the final rules are watered down, Goldman may very well be one of the cheapest stocks in our portfolio.

Health Care stocks declined last quarter as investors continued to grapple with the long-term implications of the health care reform legislation enacted last March. "The devil is in the details" aptly describes both health care reform and the just passed financial reform. While these new laws enact broad-based changes and requirements, the actual implementation details are still being hammered out. It will take months and in some cases years before their ultimate impact is known. We feel comfortable that the current valuations of our health care and financial holdings provide significant enough margins of safety to protect against the ultimate consequences of these new laws.

In previous letters, we have pointed out that U.S. dollar weakness provides a foreign currency benefit in reported earnings for companies with sizeable international operations such as McDonald's. This obviously works in reverse as well. Due to the U.S. dollar's recent strength relative to the Euro, these companies will experience a foreign currency headwind instead. We view these currency swings as largely noise and tend to ignore them in our analysis of underlying revenue and earnings trends. However, exchange rates do impact the value of future cash flows so we use the most current rates in our valuation models. The most recent changes are not material to the valuations of the companies we own.

As always, our commitment to our clients is unchanged: we will remain rational, disciplined investors as we search for opportunities to preserve and compound the capital that has been entrusted to us.

Thank you for your continued interest in Focused Investors.

Bruce G. Veaco
Partner and
Portfolio Manager

Nugroho (Dédé) Soeharto
Partner and
Portfolio Manager

Performance Disclosures

Focused Investors (“FI”) Concentrated Value Composite contains all fully discretionary, fee-paying accounts that are managed according to FI’s concentrated value strategy. Performance is calculated on a total return basis, which includes reinvestment of all income, plus realized and unrealized capital gains and/or losses, as applicable. Individual account performance will vary depending upon, among other things, the account’s cash flows and market conditions prevailing at the time of investment.

Gross of management fees performance is presented before management and custodial fees but after trading expenses. Prior to January 1, 2010, the model fee is one-twelfth of the highest annual management fee borne by any account in the composite (1%) and is deducted from the monthly gross composite return to arrive at the net of fee composite return. Subsequently, net of management fees performance returns are calculated by applying the standard management fee schedule for separately managed accounts, including tiers, to all accounts in the composite. Actual fees vary. FI’s management fees are more fully described in Form ADV Part II which is available upon request.

FI seeks to achieve long-term capital appreciation through a concentrated value-oriented investment strategy. FI’s concentrated value strategy invests client assets primarily in common stocks of companies that are trading at prices significantly below FI’s estimate of their intrinsic values at the time of initial purchase. FI believes that it generally takes several years for the gap between the price of an undervalued security and FI’s estimate of its intrinsic value to close, if at all. In this regard, FI’s concentrated value strategy is best suited for investors with a long-term investment horizon (i.e., no less than five years). Because FI’s portfolios are relatively concentrated, the performance of each holding will have a greater impact on an account’s total return and may make the return more volatile than a more diversified portfolio. As with any investment vehicle, there is always the potential for gain as well as the possibility of loss.

The Russell 1000 Value[®] Index (the “Index”) measures the performance of the large-cap value segment of the U.S. equity universe. The Index includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values. The Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The Index is completely reconstituted annually to ensure that the represented companies continue to reflect value characteristics. Performance returns for the Index do not reflect transaction costs, management fees, or other expenses that would be incurred in managing an account. While FI’s objective is to outperform the Index, this does not imply that FI’s portfolio strategy will share or track the same or similar characteristics as the Index. In addition, there is no guarantee that FI will achieve its objective.

Forward-Looking Statements

As investment managers, one of our responsibilities is to communicate with our investors in an open and direct manner. In so far as some of our opinions and comments in our letters are based on current management expectations, they are considered “forward-looking statements” which may or may not be accurate over the long-term. While we believe we have a reasonable basis for our comments and we have confidence in our opinions, actual results may differ materially from those we anticipate. You can identify forward-looking statements by words such as “believe,” “expect,” “may,” “anticipate,” and other similar expressions when discussing prospects for particular portfolio holdings and/or the markets, generally. We cannot, however, assure future results and disclaim any obligation to update or alter any forward-looking statements, whether as a result of new information, future events, or otherwise. Further, information provided in this letter should not be considered a recommendation to purchase or sell any particular security.

Form ADV

Our most recent Form ADV (Parts I and II) is available at <http://www.adviserinfo.sec.gov>. If you would like to receive a printed copy of either, please contact us.