

Morgan Dempsey Small/Micro-Cap Value - Year End Commentary

**'Tis the Season 4 Treason**

Buried in the blizzard of global news and wrapped in the festivities of holiday feast and celebration, an ominous warning was reported in a Japanese newspaper, The Asahi Shimbun. Admiral Robert Willard, Commander of the U.S. Navy Pacific Fleet issued a lucid clarion call on Sunday December 19th, 2010; the "Carrier Killer" Dong Feng 21D anti-ship ballistic missile achieved operational deployment along the China coastline, which stretches for 11,260 miles. The missile technology, in part, was pirated from the U.S. under President Clinton and is designated to deny the U.S. 7th Fleet access to the Taiwan Strait. This is a pivotal security issue because this "disruptive technology" shifts the balance of power in the Far East. This new capability, to deny a theatre of battle to the 7th Fleet, seriously impedes the United States' ability to counter strike a Chinese attack or invasion of Taiwan. The Dong Feng 21D ballistic missile has an over-the-horizon radar capability to track U.S. carrier battle groups beyond 900 miles. It launches a warhead from artillery howitzers at a steep trajectory and re-enters the atmosphere at 7,000 to 10,000 miles per hour. America is a naval maritime power which projects that power around the globe using 10 Nimitz Class super carriers with 80-140 aircraft and staffed by 5,000+/- sailors. The ability to direct a warhead at a carrier battle group 900 miles away, sailing at 38 knots, requires a sophisticated network of technologies: gyroscope guidance, radar, satellite up-links, topographic cruise avionics, all networked with a secure encrypted communications system.

Premier Deng Xiaoping in the late 1980's cautioned his military establishment to "hide our capacities and bide our time" and to exercise patience--a characteristic of an ancient eastern civilization with 5,000 years of history. Those capacities and patience, coupled with the financial market crisis of 2007-2009 in the West, have given China an opportunity to emerge as military power to be reckoned with. China has developed lines of defense consisting of 3 concentric circles. Dubbed the "String Of Pearls", the outermost line encroaches Hawaii. They include these zones in their anti-access/ anti-denial zone or A2/AD policy. China has territorial disputes with Viet Nam, Burma, Brunei, Malaysia, Taiwan and the Philippines based upon the inner "circle of pearls" which the Chinese Navy defends as their territorial waters. China fosters the opinion that the South and East China Seas are territorial waters beyond the internationally recognized 12 mile limit. The western military and intelligence services were shocked at the January 18th public

**Strategy Highlights**

- Fundamental - Bottom up research
- Concentrated in best ideas
- Emphasis on "Fortress Balance Sheets" (Limited Debt - Strong Free Cash Flow)
- Founder/Owner/Operator run companies
- Low Turnover

**Team Information**

**Brian G. Rafn -Principal/Portfolio Manager**  
25 years of experience in securities analysis, trading and portfolio management focusing primarily on small/micro-cap stocks. Brian holds degrees in Finance, Accounting and Economics and previously served as a family office Director of Research.

**Terence V. Pavlic, CFA**  
24 years of experience including serving on the CFA Institute's Board of Governors, managing a \$600M mutual fund and past president of the Milwaukee Investment Analysts Society.

**Account Information**

Management Fee: 1.00%  
Minimum Investment: \$1,000,000  
No lockup period or redemption restrictions

**Supplemental Information**

Top 10 holdings as of 12/31/10

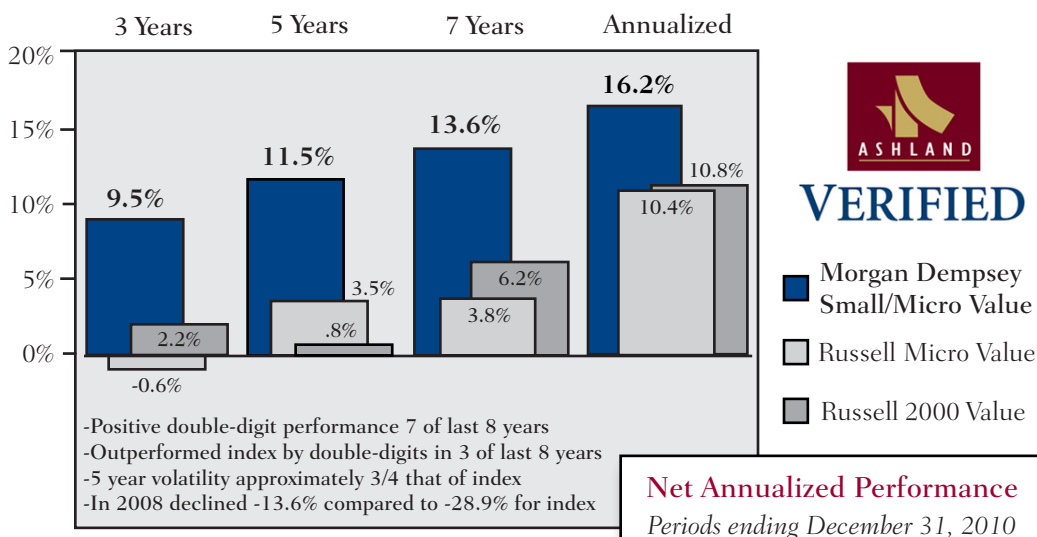
6.9% - Jos. A. Bank Clothiers, Inc.	JOSB
5.2% - National Presto Ind.	NPK
4.8% - J&J Snack Foods Corp.	JJSF
4.7% - Aptar Group, Inc.	ATR
4.4% - Gorman Rupp Co.	GRC
4.0% - Granite Construction, Inc.	GVA
3.3% - Lufkin Industries	LUFK
3.1% - Utah Medical Products, Inc.	UTMD
2.9% - L.B. Foster Company	FSTR
2.2% - Balchem Corp.	BCPC

Total Number of Holdings: 73  
1 year turnover: 15.9%  
Median Market-Cap: \$543 million  
Weighted Average Market-Cap: \$1.0 billion

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flight of the Chinese “Chendu J-20”, 5th generation stealth fighter. The twin engine stealth jet approaches 90,000 pounds which would suggest an intercontinental range capable of projecting Chinese power across the Pacific basin. Finally, China has demonstrated its capability to deploy kinetic satellite technology designed to disrupt military communications by destroying U.S. communication satellites in earth orbit.

The aforementioned military technology prowess of China is viewed through the lens of the U.S. as a single uni-polar superpower. From that perspective, also consider;

1. China operates a mercantile export trade policy with (E) exports amounting to 40% of GDP and (I) investment in infrastructure, real estate and machinery at 40%-50% of GDP, which are unsustainable levels, given that global economies must surrender to trade deficits on a structural, secular basis. China supports this economic model with national government ownership of business loan subsidies, piracy of intellectual property, WTO trade violations, and the manipulation of the Yuan to an artificially low exchange rate to the U.S. dollar.

2. China postures a divisive culture which creates confrontation between the autocratic communist central committee vs. the freelance, capitalist society or the educated/land-poor/urban middle class vs. the land rich/uneducated/rural poor, 130 Chinese dialects across the nation or 1 billion citizens in poverty, creating a dichotomy where a brittle, inflexible autocratic regime desire to force their will on its citizens as it has since 1947.

3. Piracy of intellectual property and technology cost foreigners \$230 billion through an active Chinese military sponsorship of cyber warfare and espionage of aerospace, computer software, oil and gas drilling, machine tool and metallurgy, pharmaceutical drugs, bio-technology and automotive OEM.

4. Forced transfer of western technology to allow access to Chinese domestic markets by foreign corporations, a 51% to 49% minimum majority in favor of the Chinese host company. An example was the 1998 sale of 47 super computers from IBM to the PLA Red Army which has fostered the development of the world's fastest super computer.

5. A \$2.89 trillion foreign currency reserve following decades of trade export surpluses lends credibility, however China has failed to develop “high value added” jobs and suffers from poor manufacturing quality controls, e.g., sulfur in drywall, poison infant formula, lead painted toys, radiated metal costume jewelry and less rigid corrosion resistant steels.

6. Poverty levels retarded 2010 growth when viewed as a per capita GDP comparison between the U.S. (\$45,934) and China (\$3,735) a 14:1 ratio which still represents a massive spread.

7. The evolution of an anti-access/access denial or A2/AD policy (discussed above), which fosters a diplomatic and military Monroe Doctrine but fails to consider the density of the population in the Far East or the proximity to other sovereign countries.

8. China has further tempted the fate of world stability by transferring atomic technology and military weapons to the regimes of North Korea, Libya, Iran, Venezuela and the Sudan.

The tension and heightened risks, which China exports to the globe, have been exasperated by a naïve, asymmetric policy toward China, initiated by President Richard Nixon and Secretary of State Henry Kissinger in 1972. Under the Clinton Administration, the level of Chinese espionage and political lobbying reached its zenith. President Clinton stated, while reflecting on his 8 years in the White House, that his greatest regret was the failure to develop any depth on a personal level with Chinese government senior officials. Clinton allowed his business pal Leon Schwartz of Loral Space and Communications, Inc. to transfer 200 pages of sensitive rocketry guidance technology to China, justified as a satellite commercial space venture. As a result, the China Great Wall Industry Company was able to refine the Dong Feng ICBM and most recently the Don Feng-21D. Clinton allowed Chinese liaisons to visit the White House from 1993-1996 over 200 times. These liaisons, John Huang, Charles Trie, Jonny Chung and James Rialy, funneled \$5.6 million in political contributions to the Democratic National Committee. At Clinton's request the U.S. Department of Energy Los Alamos National Laboratory relaxed security and allowed more tour visits. Within months a Chinese spy transferred the engineering architecture of the W-88 nuclear warhead to China in 1995. The MIRV (Multiple Independent Target Re-Entry Vehicle) warhead allows up to 10 warheads to be mounted (300-400 kilotons of TNT yield per warhead) on a single missile, technology China was years or decades from developing. Today, China deploys 23 intercontinental ballistic missiles with up to 10 MIRV warheads each.

We are witness to the hostile expansion of an emerging super power with 21% of the global population, controlled by an autocratic, totalitarian communist regime which under Mao murdered 60 million Chinese citizens from 1946-1966. A regime which wields piracy and espionage, as exhibited by the cyber warfare attacks on the pentagon and U.S. infrastructure, as policy tools. These developments should give Americans pause; we must take the opportunity now to re-evaluate current American foreign policy to China. A failure to do so, and admittedly the “worst case scenario,” could lead to the seizure of control of the Taiwan Straits and the invasion and annexation of the Taiwan Republic of China by the People's Republic of China in the next decade. The attempted invasion of Taiwan would lead to direct armed conflict with the United States and the potential loss of thousands of American lives



due to the technological advances acquired or stolen from the U.S. This will have enormous geopolitical and global economic consequences. Such a move by China will have as its genesis, the soft security policies toward China and the trading of U.S. technology for political contributions by the Clinton Administration.

The rising confrontation between communism and democracy (Cold War II) is upon us, with China representing a significantly more formidable foe than the Soviet Union, given its economic power and America's dependency on China as a large foreign creditor.

### Economics from 30,000 feet

The stock market for 2010 recorded another stellar year for small and micro cap issues with the Russell 2000 Small Cap Value Index +24.51%, the Russell 2000 Micro Cap Index +28.35% and the S&P 600 Small Cap Index +26.31%. The broader indices posted returns that were lower by about half with the DJIA 30 Index +14.06%, the S&P 500 Stock Index +15.06% and the Wilshire 5000 Index +17.16%. This is normal in the first half of economic recovery which favors the flexible, low debt, focused niche small company business franchises. The economy has posted 5 consecutive quarters of GDP growth since June 2009: +1.6%, +5.0%, +3.7%, +1.7% and +2.6% and the expansion is entering its 20th sequential month.

Several internal fundamental forces have converged to drive the reflation in economic commerce and at the same time inhibit the rate of reflation due to several structural impediments including:

1. Retarded levels of capital expenditures in 2008/2009 on property, plant and equipment (I) in factory plant, machinery, technology and the consumer/commercial housing stock (130,682,298 U.S. house stock) has exhibited an inflection change. On a NIPA (National Income & Products Accounts) basis, capital expenditure investment declined (-24.21% to \$1,589.2 billion in 2009 from \$2,096.7 billion in 2008. In the 4Q 2010, levels have rebounded +20% to a \$1,907.2 billion run rate and we expect to witness substantial growth in 2011-2012 as accelerated depreciation tax allowances at 100% (2011) and 50% (2012) will foster necessary capital formation. The 9.8% unemployment rate as we enter 2011, low capacity utilization 75.2% (72.8% manufacture) vs. 81.3% (79.6%) in 2006 and the loss of (-8,700,000) jobs since 2007 are directly related to the levels of capital formation and the aptitude or sentiment of capital investors.

2. The policy and regulatory incursions via rules, regulations, statutes, and codes, remain an impediment to growth with the Obama Administration believing that 35%-40% of GDP should come from government expenditures (G). The Tea

Party influence and the voter revolt in November 2010 have fostered a more centrist dialogue, however, the U.S. corporate tax rate at 35% remains at the high end of the OECD range of 11%-26%, with only Japan higher at 45%.

3. Temporary staff labor, historically at 2% of the U.S. payroll costs, should in the 21st Century evolve as a fixture of flexibility and usage for a more normalized resource allocation which could change the mix of the 153,960,117 labor force. Flexible labor staffing yields a safety net albeit with lower salary and benefits to counter the unemployment levels above 9%.

4. The U.S. housing crisis which peaked in 2Q 2006 with a 69% home ownership vs. a norm of 63%-64% over 1945-2000 and the peak in home equity loans and cash withdrawals rising from \$43 billion in 1995 to \$862 billion in 2Q 2006 remains the largest impediment to growth. As reported by the Federal Reserve, the foreclosure rate was at 3.3% in October 2010. Even as the 60-90 day delinquency rate declines, it fails to reflect the vacancy of 18,770,000 single family homes which equals 948% of the 2006 peak new construction rate of 1,979,405. With construction spending at 14% of GDP, the surplus of vacant homes duplexes, condominiums and mobile homes/trailers was one reason that there were only 315,000 new construction starts in January 2010. Since then, new construction activity has posted a modest rebound with levels higher at 519,000-534,000 in October/November (26.22% 2006 levels) while the Case-Shiller Composite Index of home prices remains 18% below its January 2006 peak.

5. The debt leverage cycle and the disinflation in interest rates inaugurated in 1979 with Paul Volker's attack on inflation, culminated in the consumerism, LBO privatization restructures and government budget deficits of the 1980's-2000's. The speculative sentiment fueled by the Greenspan's monetary accommodation, has propelled domestic non-financial debt to \$35,859,322,000,000 or 243.19% of U.S. GDP. Consumer installment credit as of December 2010 amounted to \$2,403,077,000,000, 6.17% below its 2007/2008 peak while mortgage debt is stable, illustrating the retrenchment of consumption spending which peaked at 71% of GDP in 2007 and is now below 70%. The Federal Government debt as of February 3, 2011 amounted to 14.1 trillion, 95.63% of GDP vs. 37.55% in September 1979. The composition of the debt holders which own the U.S. Treasury debt obligation of bills, notes and bonds (30 days to 30 years) included the general public (67.17%) at \$9.47 trillion of which \$4.63 trillion or 32.83% represents U.S. intra-government holdings at the federal, state, county and municipal level.

6. The universal healthcare bill at 2,403 pages and 425,000+ words, was passed after dubious discussion and may be in violation of the U.S. Constitution. At a cost of \$2-3 trillion, it focused on the 15% of the 153 million labor force that is uninsured. This was followed by FINRA Restore American



Financial Stability Act 2010 under Senators Dodd and Frank, another over stretched regulatory incursion to cap fees on debt and credit cards, regulate lending and CRA policy and impair consolidation of the financial services industry. Milton Friedman argued that compliance with regulatory issues cost business more than the tax liability on income, dividend or capital gains. The unfunded liability of entitlements, social security, Medicare and Medicaid for the 77 million baby boomers (1946-1964) was projected by the Congressional Budget Office to exceed \$74 trillion. Already, by 2011, this costs the Federal Budget 18% of its budget vs. 2% in 1946. Radical changes in age qualification benefit levels, procedure allowances, on-budget status and private co-pay and investment contributions, is required to avoid a crisis.

7. Financial systemic stability, the support of confidence and growth sentiment, coupled with the Federal Reserve engaged in underwriting risk and injecting liquidity as necessary. The Federal Reserve System has expanded the balance sheet from \$824 billion to \$2,257 billion plus quantitative easing, all of which will have to be reversed in the future. Sheila Bahr at the FDIC estimates banking system liquidation costs of \$62-64 billion 2011-14 vs. \$279 billion lost in the 1985-1993 S&L crises. The “moral hazard” or “to large to fail” doctrine could change the future of further bank consolidation as the FDIC is promoting a regulator position of a suspension of further bank mergers (16,234 in 1981 vs. 5,934 in 2011).

The Hauser Law which was postulated by Stanford economist Kurt Hauser shows that the 65 year (1945-2010) relationship between revenue sourced collections of income taxes, customs duties, fees, royalties and capital gains taxes has ranged plus or minus 0.50% around 19.20% of GDP. Since the 1913 inauguration of the income tax, marginal rates have ranged from 15% to 90% with negligible changes in accelerating tax collections. Only the principle of lower tax liability stimulating productivity, technology innovation, risk assumption and capital formation investment, which expands the size and scope of economic commerce or the taxable base, drives higher tax revenue to the U.S. Treasury. Tax receipt growth is a direct function of the size and growth rate of the U.S. economy. Political intentions to expand the marginal rate only foster business changes in investment and tax strategy.

### Portfolio Highlights

Similar to 2009, the value strategy traded in tandem with the small and micro capitalization tranche of the stock market, however, in 2010 the strategy traded at a 300-600 bp premium to its indices. The Small Micro Cap Value strategy utilizes a Graham & Dodd deep value philosophy seeking founder/owner/operator managed business franchises exhibiting fortress balance sheets, ample organic internal free cash flow generation and high returns on invested capital.

In the 1st quarter, 18 of our companies posted record earnings that were above 2006 peaks. In the 2nd quarter, there were

23 such companies; 14 for the 3rd quarter and as we pen this letter the 4th quarter is reporting more mixed results as 12 month comparisons focus on higher anniversary levels of earnings power.

The stock derby for the year registered significant capital gains in L.B. Foster (37.34%), Aptar Group, Inc. (+33.10%), Buckle, Inc. (+28.99%), Carbo-Ceramics, Inc. (+51.88%), Synalloy Corporation (+56.93%) Dawson Geophysics Company (+51.69%). The corporate finance focus on deploying cash for mergers and acquisitions, given the \$2.708 billion cash reserves in business coffers, targeted 3 of our companies for merger: The Carlisle Group, Teledyne and Nabor Industries came courting for Hawk Corporation (\$42.00), Ladish Company Inc. (\$48.25) and Superior Wells Services (\$22.50). Weak performers in our portfolio included Knight Capital Group Inc., KBW, Inc. Sturm Ruger Company, Inc. and both of our commercial bank issues, First of Long Island Corporation and Bar Harbor Bankshares, Inc.

Amongst our Locomotive 7 holdings Utah Medical Products Inc. traded in a \$24-29 channel in 2010 which allowed Lufkin Industries Inc. to vault into the top seven tilt stocks based on capital gains. Lufkin Industries designs, fabricates, installs and services the rod reciprocating well pumps which dot the Texas and Oklahoma landscape; it is the land based drilling which is the only type of drilling that is not opposed by environmentalist. The global demand for crude oil crossed the 87-89 million daily barrel capacity of supply and pressure will continue to mount against the Obama Administration to promote more oil and gas drilling in the Gulf of Mexico and elsewhere.

Our founder/owner/operator holdings include 43 of 73 and 69% of the portfolio on a dollar basis. The sector weightings of the strategy include Industrials at 27.8%, Consumer Discretionary 20.2%, Consumer Staples 13.3%, Materials 11.2%, and Energy 11.2%. The contrarian hedge in Consumer Staples, at 13%, allocates to package foods and grocery supermarket chains which could face commodity wholesale inflation at the COGS line in 2011. Holdings in Bal Chem Corporation, J&J Snack foods Corporation, Flowers Foods, Inc., Sanderson Forms, Inc. and new investment Cal-Maine Foods, Inc. manufacture a broad line of breads, cakes, pretzels, chicken, eggs, frozen juice bars and ice beverages and nutrient supplements, all of which are generally priced below \$8.50 per unit of retail. The demand profiles of these products are high-frequency, repetitive usage, necessity vs. luxury, and consumed in a way that suggests secular stability across economic scenarios. The grocery store holdings of Ruddick Corporation and Weis Markets, Inc. operate supermarket grocers from South Carolina to Pennsylvania, which should yield heightened operation volumes as winter weather fosters pantry stock piles.

During the 4th quarter we purchased Apogee Enterprises,



Inc., Cal-Maine Foods, Inc., CPI Aero structures, Inc., SIFCO Industries, Inc., MFRI, Inc. and Lacrosse Footwear, Inc. Apogee Enterprises, Inc. adds some “picks and shovels” exposure to the portfolio as they produce architecture glass for skyscrapers and commercial buildings. The Aerospace Industry exposure lost in the Ladish Company, Inc. merger was replaced with CPI Aerostructures, Inc. and SIFCO Industries, Inc., both fabricators of fuselage and wing panels, struts and frame mounts.

The MFRI, Inc. holding is additive to our infrastructure theme “Infrastructure Dreaming ZZZZ” which constitutes 26% of portfolio capital. MFRI, Inc. is the holding company for the legacy business Midwest Filter Resources, Inc. domiciled in Niles Illinois and founded in 1924. The business manufactures a diverse line of insulated/jacketed/coated pipes, ½”-42” which transport corrosive chemicals in elevated, sub-surface, sub-sea installations.

### Stock & Trade

This quarter we highlight a near-term holding purchased on the 13th of December 2010, MFRI, Inc. of Niles, Illinois. The company operates a legacy infrastructure business organized in 4 operation segments Perma-Pipe, Inc., Midwesco Filter Resources, Inc., Therma-Case, Inc., and Midwesco Mechanical & Energy, Inc. The legacy business dates to 1924, Midwesco Filter Resources which is an OEM manufacturer of 10,000+ industrial filters, cartridge collectors, electro-static precipitators and stack scrubbers that service various effluent vapor and exhaust emissions based in Winchester, Virginia (32%-36% sales). Perma-Pipe, Inc. located in Niles, Illinois launched in 1961, fabricates, installs and services insulated/jacketed/coated pipes, ½”-42” which transport corrosive oil & gas, petrol chemicals, waste & sewage or chemicals (-320 degrees F to +750 degrees F). Tubular pipes fabricated in 4’-60’ sections coated with fiberglass, urethane foam, steel mesh and fiberglass insulation which are installed above ground, underground or subsea to 15,000’ depths. The company also networks PAL-AT, Liquid Watch, and Fluid Watch leakage sensors in 64 probe x 16 relay segments to measure and detect leaks. Perma-Pipe is the domestic #1 leader in coated/jacketed/insulated tubular pipes in North America at a 34% share (\$128,000,000 sales). The Therma-Care, Inc. operation, located in Niles, IL (1956) fabricates and designs heat exchangers, refrigerated chillers, coolant towers and pump & reservoir systems 5-540 tons and ½-8000 hp engines which service petrochemical, madhir tool printing, metal smelters and oil/gas pipeline transport industries.

The company operates on a fortress balance sheet with cash reserves at 11% of assets and total debt at \$43,541,000 or \$30 million net of cash (27% tangible capital) balanced by \$83 million in tangible equity (Debt/Equity ratio 1:2.7). The fiscal year ends January 31st. Reported EBITDA gross cash

flow amounted to \$13,556,000 (\$1.99 per share) in 2010 and \$19,460,000 (\$2.86 per share) in 2009. Accounting earnings were \$0.68 and \$0.98 per share in 2010 and 2009 rebounding from the 2000-2003 losses of \$(-.08) to \$(-.22). Top line sales revenue, which was \$125,534,000 just after 9-11, has compounded at +8.67% to \$230,381,000 in 2010. Peak sales revenue (\$303,066,000) was achieved in the fiscal year ended January 31, 2009 with a 19.45% gross margin, 6.42% EBITDA gross cash flow margin, EBIT% 3.56%, NIBT% 2.66 and NIAT% 2.21%. As our infrastructure theme matures and the industrial cycle continues, the company believes the margin structure has material upside. Earnings power 2001-2003 posted losses \$(-.08-.22) with 2004-2010 EPS ranging \$.10 to \$.98 or 8 years of sequential positive earnings.

The stock price traded at \$1.20 in 2002 and peaked at \$31.59 in 2007 or a 27X compounding in 5 years indicating the cyclical leverage to construction and engineering and general building. The common stock is considered a micro-cap at \$68.34 million and pays zero in cash dividends. The operating free cash flow range since 2001 has been 15%-26% levels which meets our 20% threshold. We have accumulated shares in the \$9.20-12.60 range at approximate parity with tangible book value at \$11.38, at 10.0x-11.0x trailing EPS and at 3.1-4.3x gross EBITDA cash flow. As the U.S. embarks on the most expensive construction and engineering cycle since the 1930s, the 1,235 employees at MFRI will be called upon for their expertise and vast array of pipes, filters and refrigerator chillers.

We calculate a \$2.60-2.90 peak cycle earnings power in 2018-2019 and MFRI could trade into the \$50’s on a per share basis.

### New Horizons

“History suggests that capitalism is a necessary condition for political freedom and liberty. What kind of society isn’t structured on greed? The problem of social organization is how to set up an arrangement under which greed will do the least harm: capitalism is that kind of system.” - Milton Friedman

As we have noted in previous letters, our US national debt level and our policy toward it is lunacy. As with President Clinton and Nixon, the U.S./China relationship could just as easily spiral toward war as it could toward peaceful trade. Their external political/military thrust onto the global stage to consume natural resources, jobs and leverage trade surpluses will require the West to accept lower standards of living, which historically has almost always led to hostility and confrontation, e.g., Japan in the 1930’s.

The ghost of deflation and the threat of a depression fade to the recess of investors’ consciousness as the equity markets levitate toward the 2007 highs. The growing rotation toward price level instability (inflation) is exhibited in the slope of the

U.S. Treasury yield curve, now at 445 basis points (0.15%-4.60%) and the inflation indexed Treasury TIPS spreads, which have expanded to 256 bps (30 year) and 236 bps (10 year) from their 2008 lows of 28 bps and 23 bps. The CRB index and TIPS spreads in February are beginning to signal the spiral of inflation and we believe there is zero chance that the Bernanke Federal Reserve will implement a QE3 in 2011. Once the draining of liquidity begins, it will be a head wind for the markets.

On an optimistic note, before readers put a tombstone on the U.S. vs. the rise of China we would remind the world of our unique global advantages:

1. U.S. international overseas holdings of business assets (foreign real estate, inventories, buildings) approximates \$4.312 trillion and dominates all other countries including Japan \$740.9 billion, China \$229.6 billion, Singapore \$213.1 billion and Taiwan \$181.6 billion.

2. Water is the “blue gold” of the 21st century and is a scarce commodity. On a global basis, U.S./ Canada control the greatest reserves of fresh water. The Great Lakes constitute 80% of the fresh potable water in the world.

3. The climate, soil conditions and topography of the Great Plains, stretching from Texas to Alberta, is the largest contiguous fertile farm land in the world.

4. Gold reserves at the United States Bullion Depository in Fort Knox, Kentucky, are 4,603 tons or 147.4 million troy ounces and the Federal Reserve Bank of New York in Manhattan holds in excess of 5,000 metric tons or a gross 9.176 metric tons when consolidated. The gold bar bullion stock equals 20,187,200 lbs or 323 million ounces. At \$1,434 per ounce, this means \$463.1 trillion in gold is deposited on U.S. soil.

5. Post high school education in colleges, universities and technical colleges in the U.S. is key to the U.S. maintaining its technology prowess. The early internet was largely a product of U.S. academic institutions developed with Robert McNamara and the Kennedy Administration.

6. At 279 vessels plus 232 in the National Defense Reserve, the U.S. Navy wields 10 Nimitz Class Super carriers and 10 Tarawa/Wasp Class plus cruisers, frigates, destroyers and lateral combat ships. This force can deliver conventional or nuclear payloads plus Marine expeditionary forces on land, sea and air anywhere on the globe. This force defines our global influence and control regardless of China, Russia or other sovereign interdictions.

The equity markets face the prospect of draining liquidity as Fed policy will shift toward monetary restriction in 2011.

1. Inflation in commodities, including oil/gas, metals, grain oils, fruits and vegetables, and beef/poultry/hogs, will impact cost of goods sold and therefore profit margins across most industries.

2. Higher wage/salary and benefits will follow as unemployment declines from 9.8% to the NAIRU level (non accelerating rate of inflation unemployment) of 4%-5%.

3. The significant increase in regulation under the Obama Administration as measured by the Federal Register of 82,154 pages will slow the economy unless healthcare and FINRA are challenged.

4. Confiscatory tax structure of 35% corporate levels vs. 11%-26% in most of the rest of the world is unsustainable and must be addressed in the context of the Hauser Law we discussed previously.

As we navigate through 2011, ignorance of inflation, fiscal austerity and global politics will exert influences on U.S. equity price levels that could have dire consequences if not dealt with. Our strategy of fortress balance sheets and durable business models which generate organic, internal free cash flow and high returns on invested capital is warranted in these uncertain geopolitical times. Events, both economic and political, will test the fabric and strength of our collective stock portfolios in 2011 and beyond. Our focus remains on investing in the vanguard of U.S. small and micro capitalization companies, world leaders in niche markets with boundless opportunity.

### **Final Thoughts:**

History as a frame of reference would offer the following encouragement and counter to American isolationism or the retreat of American power and influence.

- Thomas Payne: “It is not enough for Americans to expect to reap the blessings of freedom but to undergo the fatigues of supporting it.”

- George Washington: “The most effective means of preserving peace is to prepare for war.”

- Ronald Reagan: “A truly successful army is one that because of strength, ability and dedication will not be called to fight, for no foreign power would dare provoke it.”

**SMALL/MICRO-CAP VALUE INSTITUTIONAL COMPOSITE - ANNUAL DISCLOSURE PRESENTATION**

Year End	Total Firm Assets (millions)	Composite Assets (USD) (millions)	Number of Accounts	% of Non-Fee-Paying	Annual Performance Results Composite		Russell 2000 Value Index	Composite Dispersion
					Gross	Net		
2010	213	49	10	0%	26.86%	25.68%	24.51%	.49%
2009	173	5	8	0%	21.96%	20.83%	20.58%	.33%
2008	141	3	5	0%	-12.75%	-13.62%	-28.92%	N.A.
2007	188	4	5	0%	11.74%	10.67%	-9.78%	N.A.
2006	190	3	4	0%	19.74%	18.61%	23.48%	N.A.
2005	69	3	4	0%	16.60%	15.50%	4.71%	N.A.
2004	73	2	4	0%	23.57%	22.40%	22.25%	N.A.
2003	137	.4	1	100%	32.98%	31.73%	46.03%	N.A.

N.A. -Information is not statistically meaningful due to an insufficient number of portfolios in the composite for the entire year.

Morgan Dempsey Capital Management, LLC (MDCM) has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®).

Small/Micro-Cap Value Institutional Composite contains fully discretionary Small/Micro-Cap Value commission based accounts and for comparison purposes is measured against the Russell 2000 Value Index. The minimum account size for this composite is \$100,000 at time of entry.

MDCM 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. Results for Q4 2002 and Calendar year 2003 were from one account managed and researched exclusively by Brian Rafn at a previous investment advisory firm. Beginning January 1, 2010, composite policy requires the creation of a temporary portfolio for a client initiated significant cash inflow of at least 10% of portfolio assets. The creation of such a temporary account occurs on the date in which the significant cash flow occurs and the temporary account is combined with the corresponding composite account at the month end after the cash flow is fully invested. Additional information regarding the treatment of significant cash flows is available upon request. Composite returns represent investors domiciled primarily in the United States. Past performance is not indicative of future results.

The U.S. Dollar is the currency used to express performance. Returns are presented gross and net of management fees and include the reinvestment of all income. Net of fee performance was calculated using MDCM's maximum Small/Micro-Cap Value annual management fee of 1%, equally applied on monthly basis. The annual composite dispersion presented is an asset-weighted standard deviation calculated for the accounts in the composite the entire year. Additional information regarding the policies for calculating and reporting returns is available upon request.

The investment management fee schedule for the composite is 1% on all assets. Actual investment advisory fees incurred by clients may vary.

The Small/Micro-Cap Value Institutional Composite was created June 30, 2010. MDCM's compliance with the GIPS standards has been verified for the period June 30, 2000 through December 31, 2010 by Ashland Partners & Company LLP.

A copy of the verification report is available upon request. In addition, a performance examination was conducted on the Small/Micro-Cap Value Institutional Composite beginning January 1, 2004. A copy of the verification report is available upon request.



**VERIFIED**

The information herein is for informational use only. Under no circumstances does this information represent a recommendation to buy or sell securities. Information contained herein should not be construed as a solicitation or offer of any services in a jurisdiction where Morgan Dempsey Capital Management, LLC is not registered to do business or does not qualify for an exemption or exclusion from registration requirements.

Small and Micro-Cap stocks may be subject to a higher degree of risk than more established company securities. Small and Micro-Cap stocks may be less liquid which can potentially increase trading costs. The composition and market volatility of the Russell 2000 Value, Russell 2000 and Russell Micro-cap Value, which are unmanaged market value-weighted indices, and the composition and volatility of the portfolios managed by MDCM are materially different.

Some information provided on MDCM's website or in company communications reflects opinions, and as such are not facts. These opinions are subject to change with changes in economic conditions and new information. Therefore, this information should not be used as a basis for an investment decision.

Manager ranking data was obtained from Money Manager Review, Nelson Information, Informa/Effron PSN, Morningstar, Evestment Alliance and other consultant databases. These rankings are independently prepared, and we believe them to be objective and statistically valid. Other similar manager rankings may produce different results.

Further detailed disclosure information is contained in our Form ADV Part II which is available upon request