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Quarterly Letter to Investors
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Executive Summary

The past year was a trying one for investors. After beginning the year with high hopes for an improving U.S. economy, stock prices peaked in early May as anxiety over Europe's debt crisis increased and investors worried that troubles in Greece could spread to the larger economies of Italy, Spain and perhaps even France. Then, political gridlock in the U.S. concerning the federal debt limit and subsequent credit rating downgrade by S&P set off months of turmoil in financial markets. For the full year, global equity markets were mostly lower with emerging markets especially weak, posting double-digit declines on average. Global bond markets saw extreme volatility, with the debt of a few select countries, notably the U.S., Germany, the U.K. and Canada exceptions to an otherwise dismal year for sovereign bonds. Most commodities prices were weaker, but gold prices rose for the eleventh consecutive year and the U.S dollar strengthened as investors sought safety in perceived low risk assets.

As we begin a new year, global financial markets remain fragile and subject to sharp moves based on the latest headlines. With Europe likely in recession, China laboring through the downside of a property bubble, and the U.S. heading towards a consequential election cycle, there will be no quick end to the uncertainty that has made investing a difficult endeavor.

A summary of our expectations for 2012 are listed below:

- Europe's debt crisis will continue to fester, with policymakers likely to do just enough on a gradual basis to avoid financial disaster.
- We expect recessionary conditions in much of Europe through at least the first half of the year and probably longer.
- The U.S. economy will continue growing anemically. However, as has occurred in each of the past two years, there will likely be recession scares that temporarily pull down equity prices.
- Political gridlock will continue within the U.S. with very few legislative initiatives accomplished until after the November elections. U.S. investors will become increasingly distracted by the election campaign as the year progresses.
- Emerging economies should continue to grow more quickly than developed markets, although the banking crisis in the Eurozone will hurt the prospects of Eastern Europe.
- China's slowing growth could depress growth rates elsewhere in Asia, but China will likely engineer a soft landing through monetary easing.
- Expect another year of easy monetary policy and extraordinarily low interest rates in the U.S. and a further shift toward easing by the European Central Bank to combat recession and lessen the impact of the sovereign debt crisis on the banking system.
- Even in the most likely scenario where the Eurozone remains intact, we believe the euro itself could come under substantial downward pressure.
- We expect inflation to remain mostly inactive for at least another year.
- Unpredictable, high-impact events (so-called black swans), along the lines of last year's Arab spring and Japanese earthquake/tsunami/nuclear meltdown, cannot be ruled out. Obvious candidates include an uncontrolled breakup of the Eurozone, intensifying political and military tensions with Iran over its expanding nuclear capabilities and a political and economic collapse of North Korea in the wake of ruler Kim Jong Il's death.
- In terms of asset allocation, we continue to favor high-yield fixed-income assets and alternative high yielding assets such as REITs, preferred stocks, Master Limited Partnerships (MLPs) and high-dividend-paying equities versus investment-grade and sovereign debt securities. Within equities, we prefer U.S. and emerging markets versus developed markets, and remain particularly cautious on Europe ex-U.K. and Japan. We also believe commodities may experience continued volatility until global growth expectations improve.

U.S. Economic Environment

After underperforming expectations for the first three quarters of 2011, U.S. economic growth is projected to have accelerated to the 3% range in the fourth quarter. Labor-market measures, such as payrolls and initial claims for state unemployment insurance, strongly hint at modest improvement despite an uncertain business environment. Industrial production and consumer spending have remained strong and recent housing market statistics indicate an uptick off of the bottom may have begun. Judging by the reactions of financial markets though, investors remain quite skeptical about the sustainability of the economic improvement. In fact, most economists expect GDP growth to decelerate again in the first half, given recessionary conditions in Europe and a slowdown in China and other emerging market economies. In addition, robust consumer spending in the U.S. may not continue as consumers have spent more than they've earned the past six months through reduced savings and increased borrowings. Bond yields in the U.S. are lower than they should be, given general economic conditions, presumably as a result of Federal Reserve Bank actions as well as investors having a greater-than-normal preference for safety and liquidity. If we were in a normal economic cycle, we think longer-term Treasury yields would be 3% or higher, reflecting the resilience of the U.S. economy and the fact that core inflation appears steady at around a 1.5% to 2% annual rate.

Observations and Implications of the 2012 Elections

Last year's experience proved that more than ever, consideration must be given to macroeconomic and political factors when allocating assets and selecting securities. The 2011 gridlock in Washington was a primary cause of the summer's market volatility, and it is a near-certainty that political considerations will remain a market-moving force in 2012.

The November 2012 elections promise to be one of the most important events of the year for the global markets. The early odds favor a Republican takeover in the Senate, where only 10 Republican seats will be contested versus 23 for the Democrats. Republicans will need to pick up only four seats to gain a majority in the Senate. In the House of Representatives, the results will likely be closer. In order to gain a statistical majority of 218, Democrats would need to pick up 26 seats. Of course, it is still way too early to make a truly informed judgment. At this point, it is merely enough to point out that Democrats appear to have an uphill battle in the Congressional contests. Of course, even a unified Congress can have difficulty getting laws passed that a sitting president opposes. Thus, the outcome of the presidential race will also be crucial, but it is also the hardest to call at this point. The odds of an Obama vs. Romney contest in November are increasing by the day with that matchup currently considered a toss-up. If the economy improves and the unemployment rate falls below 8%, President Obama would be difficult to defeat. On the other hand, if economic activity remains sluggish and employment gains stall, voters may very well favor the Republican candidate. Nonetheless, just as the Republicans in the Senate can stifle Democratic initiatives and presidential appointments with the threat of a filibuster in the current Congress, the Democrats will be able to play the same game if they lose control of the Senate and the presidency. A clear voter mandate would help, but a newfound willingness among politicians to compromise in order to get things done would be even more valuable to governing the nation.

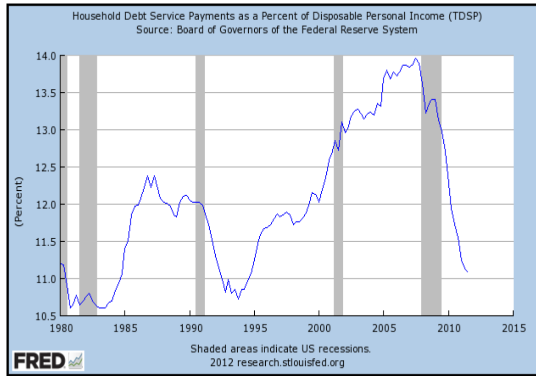
The economic problems facing the U.S. are much more easily solved than the European crisis if the political will and a respite from partisan politics can be mustered. The solution roadmap most favored is that of President Obama's bi-partisan Simpson-Bowles Commission, which presented its findings at the end of 2010. It detailed $4 trillion of proposed deficit reduction measures through 2020. The proposals, which included broadening the tax base while reducing tax rates, capping discretionary spending, shifting defense spending to reflect new priorities, and raising the retirement age to reflect longer life expectancies, are common sense reforms that would give everyone confidence that U.S. fiscal policy is moving in the right direction. The challenge is that every major political constituency will need to give something up to make it happen.

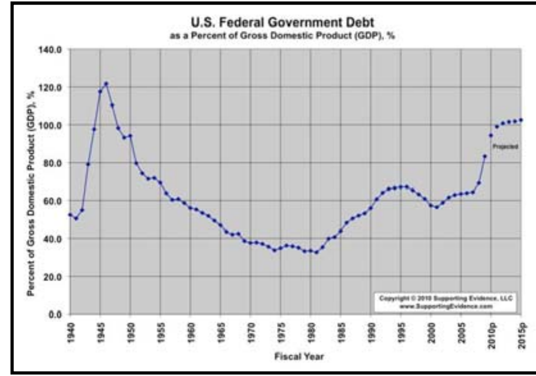
Europe's woes, China's slowdown, political dysfunction and upcoming general elections in 45% of the G-20 nations this year, including the United States, suggest that the financial market climate in 2012 is likely to be just as uncertain as the past several years. Our expectations are for Europe to continue to muddle along with bailouts, continued money printing and deferred actions rather than any significant restructuring. In China and other emerging markets in Asia and Latin America, we expect growth to slow, but to remain substantially higher than in the developed world. With political races in the U.S. and elsewhere likely to be tight until near the end, it is possible that equity markets will remain volatile, and that returns may be range-bound until some of the uncertainty begins to abate. When it becomes clearer to investors who the election winners will be, we are likely to experience a strong rally. Caution is in order however as there will inevitably be a great deal of anxiety amongst investors in the last six weeks of the year during the lame duck session of congress when many consequential issues will likely be decided including the scheduled expiration of the Bush tax cuts on income and capital.

Investment Strategy

U.S. equity markets are entering their thirteenth year of a broad consolidation period that began when the internet bubble burst in early 2000. Most valuation metrics have corrected substantially during this timeframe and stocks now appear to be

reasonably valued when measured against earnings, cash flow, book value and dividend yields. One of the significant factors hindering stock prices from breaking above the current trading range is the debt overhang in the household and government sectors. While households have been reducing debt since the financial crisis began in 2008, the federal government has dramatically increased its deficit spending and debt level. Political realities that began with the 2010 elections have now forced a debate on the size and scope of government. This will likely be one of the key issues upon which the 2012 general election will be fought. Regardless of the election outcome, it is fair to say that deficit reduction will be one of the top priorities for the next President and Congress. The only question will be how best to accomplish debt reduction, whether through spending cuts alone or through a combination of spending cuts and tax increases. In either case, a period of government fiscal austerity is a probable outcome and it is not at all clear that the private sector is poised for accelerating growth when all of the global economic headwinds are considered.





With this in mind, we are liable to be stuck in the trading range we've experienced since 2000 for at least another year or more. Until it becomes clear that conditions have changed to warrant a break above this range, we have determined that a slight modification in our U.S. equity strategy is advisable. We continue to recommend broad diversification across economic sectors, but, with increased volatility driven by the European debt crisis and political dysfunction in the United States and Europe, we believe it is appropriate for us to be more nimble in managing risk by strengthening our sell discipline. This will involve implementing statistical rules based upon the relative strength of the stocks we own that will trigger sell alerts to help us avoid substantial losses on individual stocks. While this approach may lead to somewhat higher portfolio turnover, we believe the trade-off will be worthwhile if losses can be mitigated. If you wish a fuller explanation about this technique, please ask us during one of our private discussions.

We thought it might be useful to reiterate our investment philosophy as we embark upon a new year. Our equity research process involves identifying companies with a dominant position in rapidly growing markets and predictable earnings growth, sound financial strength and quality management. In addition to strong fundamentals, we use technical analysis to assist with timing decisions. Our fixed-income investment philosophy adheres to a disciplined approach that emphasizes total returns and a steady income stream generated by what we believe to be high quality holdings. Our process is intended to provide more consistent returns while helping to reduce investment risks. This strategy emphasizes high credit quality, a focus on intermediate term securities, yield curve management through a laddered portfolio, and low portfolio turnover. In the current historically low interest rate environment, we have chosen to shorten the maturity horizon of our fixed income portfolios and have utilized alternative instruments such as bond ETFs, mutual funds, preferred stocks, REITs and MLPs to enhance income generation. Diversification amongst other asset classes including foreign stocks and commodities may be appropriate depending on clients' objectives and preferences.

We look forward to reviewing your individual objectives and circumstances with you in light of our view of economic and market trends to affirm or modify your investment strategy. Please accept our best wishes for a safe, healthy and prosperous 2012.