



## Market Comments

January 9, 2012

S&P 500 1281  
10 Year Treasury Yield 1.97%

### Review of 2011

U.S. equities finished 2011 virtually unchanged after a year that was notable for its extreme volatility. The S&P 500 started the year at 1257.64 and ended it at 1257.60, the smallest calendar year change in history.

The Index's modest change for the year belied a wild ride for investors. Stocks enjoyed a sharp rally during the first third of the year, reaching the year's high of 1370 on May 2, a gain of 9% which was driven by solid first quarter corporate earnings.

Stocks then traded sideways for several months, before plunging sharply in early August as concerns regarding the solvency of European sovereign debt intensified. Stocks fell from 1345 on July 22 to an intraday low of 1070 on October 3, a drop of 20%.

Equities stabilized and then moved 17% higher over the last three months of the year, rallying from 1070 to finish at 1257.60, essentially where they started the year.

The three risks we felt posed the biggest challenges for investors at the outset of 2011 included 1) European financial deterioration, 2) a sluggish U.S. economy, and 3) a rancorous political climate, and all three risks impacted stocks negatively at various times during the year, which was enough to offset 2011's most positive outcome: the continued strong performance of corporate earnings growth, which appears to be on track to result in earnings gains of about 17% over 2010, well ahead of the consensus' 10% growth expectation at the outset of 2011.

Fixed income investors generally fared better than equity investors in 2011. Treasury yields dropped sharply during the year as investors sought "safety" and chased yield, even though yields were very low relative to historic norms. The yield on the 10 year Treasury dropped from 3.30% to 1.89% during the year, driving large total returns for holders of intermediate and long dated Treasuries. Corporate bonds also did well; the Citigroup 7-10 year corporate bond index had a total return of 9.37%, although corporate spreads widened in the second half of the year coincident with rising European crisis concerns.

2011 was notable for the ostensibly insatiable appetite of investors for yield, both in the fixed income and equity markets. "Yield" oriented assets, already fairly full-priced entering 2011, reached higher valuation levels by year end 2011, in stark contrast to "growth" assets, which ended the year at historically low absolute and relative valuation levels.

Mutual fund flows in 2011 saw huge inflows into bond funds, and large net redemptions from equity funds over the course of the year, continuing a trend that has been in place since 2007.

## Outlook for 2012

We believe investors face many of the same risks at the outset of 2012 that they faced one year ago. Europe remains the largest obstacle for the equity market, which could remain mired in a trading range until it becomes apparent that meaningful progress is being made toward addressing and remedying the significant credit problems of some EU members.

With Europe in recession, it becomes more difficult for U.S. companies to maintain earnings growth rates both due to reduced demand from the Euro zone, and because the dollar could continue to strengthen versus other world currencies given the U.S.'s relative economic stability, making goods and services priced in dollars relatively more expensive in the global marketplace.

The U.S. economy's recovery remains below trend, unemployment remains high, and consumers continue to pay down debt loads incurred in the 2004-2007 time frame, reducing consumption (two thirds of the U.S economy is consumer-based).

Finally, the political climate remains highly charged and divisive, and some investors may opt to stay on the sidelines until the November elections afford more clarity about the future direction of the country and the relative roles of the private and public sectors in the domestic economy.

Notwithstanding the risks, we remain very constructive on the intermediate to longer term outlook for equities, and neutral to negative on the outlook for returns from fixed income assets.

Our valuation work is at the heart of these conclusions, and we believe the valuation metrics paint a compelling picture in favor of equities relative to bonds.

Bond yields are at historic lows, and offer virtually no margin for error against an eventual rise in inflation expectations and increases in interest rates. The 10 year Treasury at or below 2% implies a zero real return over the next decade, assuming an average annual inflation rate of 2%; real returns on Treasuries could easily become negative should inflation exceed 2% on average over the next ten years.

Corporate credits offer slightly better returns, as spreads have widened coincident European debt fears and recessionary conditions in the EU. Corporate bonds in the five to ten year maturity range offer yields of 3% (A rated credits) to 4% (BBB credits). Bond substitutes such as preferred stocks, REITs, and master limited partnerships, offer incrementally better yields, but valuations are stretched relative to historic norms and provide little margin of safety should interest rates rise at some point over the next few years.

High quality companies with solid equity dividends in many cases offer higher yields than their corporate debt issues. In the second half of 2011, investors chased dividend yield, and these companies saw their valuations move to high relative levels, although absolute valuations remain reasonable against long term averages. For example, Abbott Labs' stock yields 3.4% at present, versus a 2% yield for its 2017 maturity debt. Investors seem willing to exchange a yield pick-up with some upside appreciation potential for the interim price risk inherent in the equity relative to the debt.

Conversely, growth-oriented companies appear to be extremely undervalued for investors with a longer term time horizon. The S&P 500 currently trades at about 12x estimated 2012 earnings of \$105 (up from an estimated \$98 per share of earnings for 2011), versus a long term average P/E of 15-16x (the 12x P/E seems especially cheap in a 2-3% interest rate environment). The S&P 500's 2012 earnings yield is 8.2% (\$105 earnings in 2012 divided by the current 1280 Index price), the highest earnings yield since 1988. The implied risk premium is 6%+ (earnings yield of 8.2% minus 10 year Treasury yield of 2%); this metric is also high relative to a historic average of around 4-5%, and many high quality growth companies have implied risk premiums of 8-10%.

We believe fair value for the S&P 500 in 2012 is between 1550-1600, assuming 14-15x estimated earnings of \$105-108 implying upside of 20-25% just to reach fair value. The long

term average P/E for the S&P 500 is about 15-16x, and we could make the case that if interest rates remain in a range of 2-4%, the P/E for equities could be even higher than 15-16x.

## **Portfolio**

We believe high quality companies that are able to generate good growth in revenues, earnings, and free cash flow are very attractive at present.

Many of our companies appear to be significantly undervalued, and have shown strong growth in business value over the past several years despite extremely challenging business conditions.

We continue to emphasize companies that fit three broad themes.

First, for investors interested in both growth and income, high quality companies with solid and growing earnings and dividend streams seem attractive, and priced to provide high single digit to low double digit total returns over the next several years. Examples include Abbott Labs, Accenture, Blackrock, Chevron, General Electric, J. P. Morgan, McDonalds, Microsoft, PepsiCo, Philip Morris International, and UPS. These companies have dividend yields well above the S&P 500's 2% yield, solid earnings growth prospects, and histories of increasing their dividend payments roughly in line with their earnings over time. While their valuations are not as compelling on a relative basis given their strong second half 2011 performance, they are still reasonable on an absolute basis.

Second, there are a number of strong business franchise companies with 10%+ annual earnings growth prospects that trade at very low absolute and relative valuations. These companies include Apple, Disney, EMC, Express Scripts, Google, MasterCard, Priceline, and Qualcomm. Many of these companies appear to trade at levels that imply appreciation potential of 25-50% over the next several years, based on their demonstrated ability to grow earnings at well above average rates, and the potential for their valuations to expand to levels that are more reasonable (and closer to their historic average valuation metrics) given their longer term earnings and business value growth prospects.

Third, we believe many strong companies with relatively higher sensitivity to aggregate economic growth trade at very attractive valuations. This is the riskiest group of companies, because in a slow growth environment, their earnings growth is less assured; however, they appear to trade at very low valuations relative to normalized earnings growth over the economic cycle. Companies in this group include Apache, BHP Billiton, Capital One, Caterpillar, Chicago Bridge and Iron, Eaton, FedEx, Roper, and Union Pacific.

Finally, small and midcap companies, and emerging markets equities, which showed outstanding price appreciation in 2010, struggled in 2011, and now appear to offer solid return prospects over the next several years.

We do not know what the catalyst will be to result in improved valuations for U.S. equities, but history strongly argues that valuations eventually return toward long term averages.

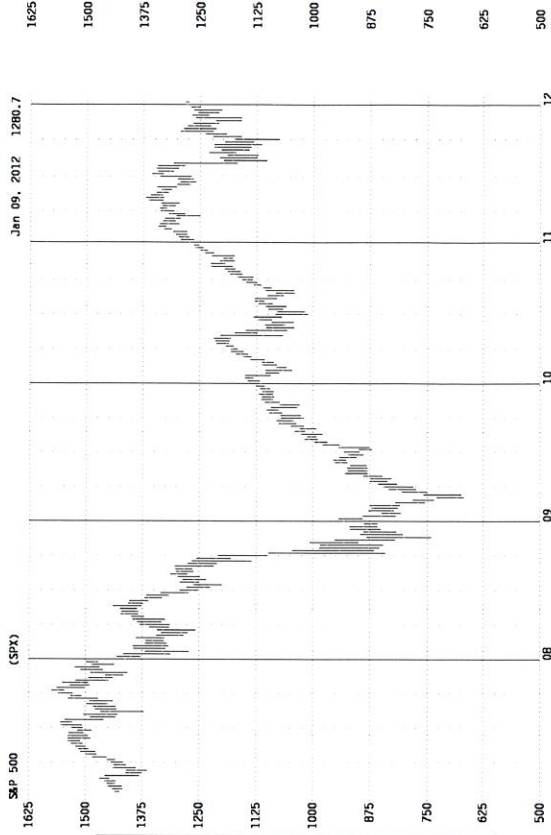
We will continue to focus on identifying and owning companies with strong balance sheets, demonstrated records of growing business value in difficult economic conditions, reasonable prospects for above average future growth, and attractive absolute and relative valuation metrics.

Equity returns over the past decade have been far below long term norms. We believe that the next decade will provide patient investors solid equity returns as premier companies continue to show good business value growth, and as valuations eventually move toward levels that more accurately discount true underlying shareholder value given reasonable growth rates and normal interest rate levels.



## Capital Markets Expectations

Current Levels: (12/31/11) S&P 500 1258 Ten Year Treasury 1.88% Inflation: 2.20%



### Long Term Total Return Expectations:

Asset Class	Current	Historic Range
Cash	0-1%	2-4%
Treasuries	0-2%	4-6%
Investment Grd Corporates	2-4%	5-7%
Preferred Stocks	5-6%	7-8%
U.S. Equities	7-10%	9-11%
U.S. Small-Midcap Equities	8-10%	9-12%
EAFE Equities	6-10%	9-11%
Emerging Market Equities	8-12%	9-12%

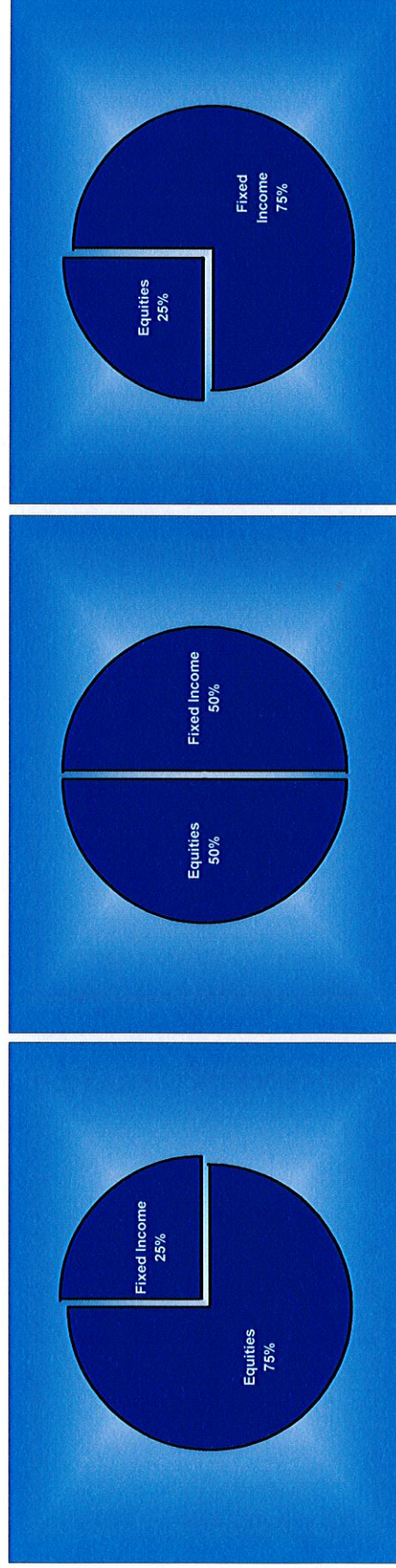
### Long Term Capital Markets Characteristics

	Current	Historic Range
U.S. Investment Grade Credit Spread	75-125 bps	50-100 bps
U.S. Equity Risk Premium	6-9%	4-6%
U.S. Equity Dividend Yield	1.5-2.0%	1.5-3.0%
S&P 500 Long Term Earnings Growth	5-8%	7-8%
Current P/E 2012 (S&P 500)	12.2x	
Current P/E 2013 (S&P 500)	10.9x	
Fair Value P/E	14x-15x	15-16x

## Capital Markets Forecasts

S&P 500 (2012)	Earnings	\$102-107	Year End Target	1475-1550
S&P 500 (2013)	Earnings	\$113-119	Year End Target	1600-1750
Ten Year Treasury	Range	1.5-3.5%	Year End Target	2.75%

## Long Term Expected Returns by Asset Allocation



7.75% (2.5% yld, 5.25% appreciation)

6.5% (3.0% yld, 3.5% appreciation)

5.25% (3.5% yld, 1.75% appreciation)

Return assumptions for charts: Equities 7.0% appreciation, 2.0% yld; Fixed Income: 4.0% yld

## Key Assumptions:

- \* U.S. Economy shows modest growth in 2012 around 2.5-3.0% annual rate.
- \* Inflation expectations remain muted in 2012, keeping bond yields near historically low levels
- \* Corporate profit growth remains good in 2012 although comparisons become more difficult over the course of the year.
- \* Fixed Income remains less attractive than Equities given low yields and risk of rising inflation and interest rate environment
- \* Large cap, growth and high quality equities are most attractive U.S. sectors given historically cheap absolute and relative valuations
- \* Small and mid-cap remain attractive despite outperformance over past several years