

First Quarter 2011 Commentary Individual Investors

After starting the year strongly, stocks reversed at the end of February as investors were confronted with escalating violence in the Middle East, a devastating Tsunami in Japan, and renewed sovereign debt issues in Europe. We did not believe that these events, significant as they were, would derail the global economic expansion. Therefore, we maintained our positions and stocks rebounded in mid-March as the prospects for increased earnings outweighed macro concerns. In addition, the near zero interest rate policy that the Federal Reserve has pursued, along with the second round of quantitative easing, has reduced money market rates to a nominal level. Investors are beginning to realize that their fixed income returns are insufficient and will not keep pace with inflation. Over the last three years, investors have moved \$600 billion into bond funds and \$250 billion out of equity funds. This trend is starting to reverse. Global economic conditions are improving and demand for hard assets is accelerating. In this environment, we expect growth stocks to outperform. For the first quarter, the S&P 500 returned a positive 5.9%.

The current crisis in Japan has overshadowed news of escalating violence in Bahrain, a tiny island off the coast of Saudi Arabia. Bahrain is home to the U.S. Navy's Fifth Fleet which represents the largest naval presence in the Middle East. With the fissure between Shiite, proxies for Iran, and Sunni growing in Bahrain, the U.S. is pressuring the Sunni rulers to accelerate reforms and ease tensions with their largely Shiite population. However, the recent Saudi military deployment in Bahrain may further strain U.S. - Saudi relations and result in elevated oil prices. Saudi Arabia remains the world's only swing oil producer. If the present crisis worsens, the effect on the price of oil could be dramatic, especially when the rebuilding effort in Japan begins. While nuclear energy will not disappear, we expect new permits will be delayed and older reactors taken offline, further tightening the oil market. This presents a backdrop of the inherent risks in supplying the 20 million barrels of oil that the U.S. uses each day. (In addition, approximately 5 million of those barrels are supplied from either unstable or potentially unstable countries.)

We have focused our efforts on identifying and investing in domestic oil exploration and production companies. In particular, we have been early investors in the Bakken Shale, which lies 5,000 feet underneath North Dakota and Montana. As the oil recovery and extraction technology improves, the US Geological Survey (USGS) has increased their estimates for recoverable oil. Currently, they estimate that the middle Bakken and lower Three Forks shale could produce between 3 and 4.3 billion barrels of oil. New drilling and fracing technologies continue to allow production companies to extract more oil from the wells, and increase the number of drill locations per section. These wells, when drilled and completed properly, can obtain an internal rate of return (IRR) approaching 100%, or a one-year payback. Clearly these returns are generating increased enthusiasm for the stocks, and validating shales as producing the best shareholder returns. It is not only investors that are drawn to these returns but other oil companies. The cost of debt for the majors is low. Exxon's bonds trade with an average yield of only 5%. Their low overall cost of capital, combined with the future price of oil, allows the majors to pay a premium for public companies and still make the acquisition accretive to earnings.

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Rising oil prices and expectations for them to stay high is prompting oil and gas companies to increase their capital spending and the rig count continues to accelerate. The industry is in an early phase of a new equipment cycle. Demand for their products and services will continue, driven by drilling in US shale formations. While we continue to believe that the Bakken is part of the solution to the U.S.'s energy needs, we are constantly on the search for the next hydrocarbon shale formation. The Niobrara shale, which straddles the Eastern Colorado/Wyoming border, shows promise. We have begun to invest in companies that have secured acreage in this formation and are already testing wells. Time will tell if this is the next Bakken, but investing early has its advantages.

The 25 largest technology companies had \$528 billion in cash on their balance sheets at year end. As expected, nominal money market returns are forcing companies to better allocate their cash through mergers, share buybacks and special dividends. In the first quarter 2011, there were \$47.3 billion worth of technology merger and acquisitions announced, up 126% from the first quarter 2010. Most of these acquisition targets have been small to midsize companies that are on the vanguard of new technologies or services.

Mobile and cloud computing continue to be priorities for corporations since they allow great user mobility and lower corporate cost structures. Over the last decade, bandwidth and capacity have been added, which has allowed cloud and mobile computing to become a reality. The internet is constantly evolving. The user experience has developed from static images to streaming video, and the next full step is internet TV. While conflicts over pricing, content availability and terms of use continue, the shift to internet TV is past the point of no return. Clearly this will be negative for traditional broadcasting and video distribution companies.

If history is any guide, the acceleration and adoption rates will be rapid. Companies are positioning themselves for their share of this \$170 billion market. Apple, an industry leader, has redesigned its Apple TV box eliminating the imbedded local storage making the process dependent on the cloud. This redesign provides insight into Steve Jobs, Apple's CEO and visionary leader, thinks of cloud computing and the internet TV. We believe that the companies that distribute the video and enable the connectivity software will be the best positioned, which is reflected in your portfolio.

Stock valuations are low and bond returns are anemic. Reported 2010 S&P 500 earnings were above the recent high in 2007, but the market is trading at over a 14% discount to 2007 levels. A combination of the end of US quantitative easing, an overheating Chinese economy, tensions in the Middle East or European sovereign debt are possible reasons for the current market discount. However, the US economic data is improving, US consumer debt has declined and emerging market growth is accelerating. This is a good environment for growth stocks. We expect more merger and acquisitions. Companies are attempting to create shareholder value through stock buybacks, and dividend increases. We will continue to manage your portfolio consistent with our investment philosophy. We thank you for your continued trust and support.