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Investment Counsel since 1961

Conservative Growth - Second Quarter Commentary 2011

This past quarter was rough. Investors had to grapple with massive disruption from the earthquake and tsunami in Japan, the end of the second round of quantitative easing, and fears over a default in Greece. Unemployment crept higher. Real consumer spending dropped in April and May. However, recent data suggest some momentum as the second quarter ended.

We continue to remain optimistic about the outlook for positive stock returns. The reason is the lack of interest for riskier investments and the behavioral trauma among individual investors who are focusing on principal protection and capital preservation. This aversion to stocks and risk creates opportunity for above average returns in the stock market.

Further support of this risk aversion trade is supported by mutual fund money flows. While \$18 billion flowed into U.S. stock funds in the first four months, \$26 billion then flowed right out the door in the eight weeks ending June 22. We believe this risk aversion is creating an opportunity for the equity market.

The second quarter was a very volatile quarter, affected by U.S. growth concerns, European sovereign-debt fears, and gyrating commodities. The sharp sell-off that began in May and continued into June was accompanied by a shift into more defensive sectors, including health care, consumer staples, and utilities. The aversion to risk and defensive posturing by the market led to our underperformance in Q2 as we have been positioned in more aggressive and cyclical sectors such as technology and energy. We continue to believe there is terrific opportunity in the stock market and that the technology and energy sectors will lead the way.

There are many additional reasons to be optimistic. Corporate balance sheets in the U.S. and abroad are healthy, valuations remain attractive and yields on many dividend-paying stocks are higher than what investors can get from bonds. Earnings and gross domestic product have recovered or surpassed their former highs, yet stocks still trade below their peaks. The global economy is expected to grow at 4% in 2011 and near 5% in 2012. Investors are underinvested in stocks relative to bonds.

We continue to find oil an attractive investment opportunity. Increasing demand from China, India, Saudi Arabia, Brazil, and other emerging markets has created a global market that is more inelastic than in past years. China alone imports almost a million barrels a day more than a year ago. The price of oil is high and will remain so. We have invested in oil exploration and production companies that are able to grow their production. These companies include Continental Resources and Whiting Petroleum in the Bakken Shale. As the oil recovery and extraction technologies improve, the estimates for additional oil continue to increase. The latest U.S. Geological Survey for the Bakken reports reserves as high as 4.3 billion barrels, 25 times their 1995 report. The CEO of Continental Resources believes the number could be as high as 24 billion barrels of oil. Energy companies are rapidly expanding their capital spending to

develop the oil and gas shale formations. We have added Halliburton, Complete Production Services, and Carbo Ceramics to the portfolio. These companies supply products and services that are consumed by the E&P companies as they develop the energy shale formations.

Recently, technology stocks have been mixed as the sector struggled from seasonality and Japanese supply chain disruptions. While IBM performed well in the quarter, Google disappointed. The long-term trends of mobile computing and cloud computing are still well in place. U.S. corporate balance sheets are at record levels and margin improvement through increased technology spending is a priority since it allows companies to replace labor with technology. Forester Research projects that spending on the "cloud" will grow from \$40 billion to \$240 billion in the global IT market over the next ten years. Cloud computing provides a platform on which corporations can increase margins by lowering fixed costs. While adoption rates are increasing, penetration is still low. Apple, Google, IBM and Netlogic are all beneficiaries of the cloud, smartphones, and mobile telephony. We thought the Rimm smartphone would also do well. It did not and we eliminated the position. We continue to search for additional beneficiaries that are attractively valued.

We appreciate your continued support.

A handwritten signature in black ink, appearing to read "Bill".

Bill Jones