

Fourth Quarter Commentary

Stock markets ended a volatile year little changed. The S&P 500 Total Return posted a positive 2.1% for the year belying the extreme volatility which saw the Dow Jones move an average of 269 points a day between August and November. Equities posted anemic returns in 2011, especially when compared to fixed income, but not because of earnings, which were up 17%. Multiples contracted because of the rise in the equity risk premium which rose to 6.9%, a 60-year high, well above the 50-year average of 2.6% and 10-year average of 3.9%. It was higher than it was during any financial crisis since the Great Depression. In short, investors are more adverse to equities than they have ever been. A mere stabilization on the risk premium will allow equities to track corporate growth in earnings, and a decline would allow for multiple expansion.

Facts, figures, and logic can be arranged to seem sound, but rarely do events transpire according to a scripted plan. Only months ago the headlines suggested an imminent US recession. Now the evidence points to a self-sustaining US expansion. We remain focused on finding those companies that will grow their earnings per share.

Our adherence to fundamentals and not macro economic issues served our clients well at the end of September. Markets experienced unrelenting selling pressure for the last two weeks of September and into October. Many investors reacted to fear, headlines, and volatility by liquidating positions and moving into money market or bond funds. We did not sell. We used the opportunity to add to current positions or buy new positions in companies that were fundamentally sound and presented an attractive opportunity. We only invest in companies when we understand the fundamentals and the business model. This helps us weather market turmoil.

Technology continues to be a significant weight in the portfolio. While employment is improving, we believe that corporate managements will bolster margins through increased use of hardware, software and by outsourcing their information technology needs. Smartphones and tablet sales are increasing, not just in the US but globally. The proliferation of internet and wireless devices is evident in the switch from IP version 4 (IPv4) to IP version 6. The Internet Protocol (IP) address is a numerical address assigned to connected devices. IPv4 allows for 4 billion addresses. This capacity is now exhausted. IPv6 will allow for 2^{128} addresses. Put another way, this number is a trillion times greater than the current estimate of stars in the known universe. Smartphones will likely account for 40% of mobile telephone shipments in 2012, up from 32% in 2011. At the same time, sales of non-smartphones will fall significantly. As this smartphone revolution unfolds, it is allowing for the next generation of technologies and services; laser projection keyboards, ewallets, and voice recognition to name a few. A company's ability to innovate and stay ahead of the technological curve will be paramount to its success. Apple continues to be a core holding and has consistently demonstrated its ability to lead in this ever-changing sector.

Energy is the other major weight in the portfolio. The most recent geopolitical issues in Nigeria and Iran have contributed to the increase in the price of benchmark oil. The supply risks are real and as a result we have focused on Continental Resources, Whiting Petroleum and Brigham Exploration (acquired by Statoil ASA during the quarter) which are domestic exploration and production (E&P) companies that are able to significantly increase their production and add reserves.

In the long-term, prices are driven by supply and demand. The creation of the US road system and migration to suburban centers made the US the driver of global oil prices over the last 50 years. However, US demand has

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plateaued and since 2008, US consumption has remained constant at approximately 19 million barrels a day. During the same time, China has taken the mantle of global driver of energy prices and accounted for 76% of the world energy demand increase. In comparison, the average American consumes five times as much energy annually as does the average Chinese. China, with three times the US population, is transitioning from a rural to an urban society. As China develops over the next few decades, their demand for energy will surpass that of the US. Already GM sells more cars in China than the US. China's leadership has set a GDP growth target of 7.5% for 2012. We expect energy consumption per capita will continue to expand significantly. Other emerging markets are increasingly demanding more energy to fuel their GDP growth.

Recent E&P announcements concerning capital budgets for 2012 suggest an improving environment for service companies. Global E&P spending in 2012 is expected to increase 10% to \$598 billion, versus \$544 billion in 2011. The service companies have underperformed due to global growth concerns and worries of a reduction in the North America rig count. As investors gain greater comfort that the rig count will not decline and that the international recovery is gaining momentum, we expect the service companies to perform well. We continue to hold Schlumberger and Seadrill. National Oilwell Varco remains a core holding since it supplies both onshore and offshore oil companies.

We remain optimistic about the outlook for positive stock returns. Standard & Poor's (S&P) operating earnings were up for the year while S&P performance was flat. S&P announced last week that dividend increases reached \$50.2 billion, 89% higher than in 2010. Dividend payout ratios averaged 52% historically. At this time, they are still near their lows, under 30%. Currently, the yield of the S&P is higher than the yield of the 10-year Treasury bond for the first time since 1955. While these facts are intriguing and should motivate investors to buy equities, we are, as noted, still seeing investors withdraw money from equity accounts. Stocks are modestly valued compared to either junk bonds or US Treasuries. The spread between Treasuries and dividend yields is extremely low by historical standards, and Federal Funds will remain at zero for the foreseeable future. Corporate cash has surged 47% from the recession low and is a record as a percent of GDP and in absolute terms. This should fuel share buybacks, dividend increases, and acquisitions. Eventually, this mosaic will induce investors to seek higher returns to counter the near zero return of money market funds and low-yielding bonds. We are confident that over time, equities will be the asset class of choice.

We thank you for your continued support.

Kind regards,



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