

Fourth Quarter Commentary

Equity markets were plagued with uncertainty and high volatility in 2011. Concerns about contagion from the European Sovereign debt crisis, unrest in the Middle East, a tsunami in Japan, continued tightening in China and the downgrade of the U.S. credit rating were among the factors that drove equity markets lower throughout much of the year. However, a seemingly coordinated move to cut rates from multiple central banks and China's lowering of bank reserve requirements led markets to rally strongly into the end of the year, easing much of the previous period's losses. After having fallen as low as 12%, the S&P 500 Index finished 2011 up 2.1%.

We are optimistic about the U.S. equity outlook for 2012, as we believe it will follow a more positive U.S. economic outlook. U.S. growth turned out to be softer than many (including us) expected, but the past year ended on a much stronger note than most anticipated a few months ago. Among many useful coincident and leading indicators, the continued downward trend in weekly jobless claims is encouraging. The ISM manufacturing index and consumer confidence also look to have bottomed out over the past few months, with the latest readings showing a rebound. These positive signs suggest growth in the near future may turn out to be much better than expected. Your portfolio is economically sensitive, which accounted for its decline in the summer, followed by a sharp rebound (along with the equity market) in the fourth quarter, and an optimistic outlook for 2012.

Technology continues to be the most important sector in your portfolio. The explosive growth in the use of smartphones and the Internet has driven a large segment of the technology sector investment. Apple has seen extraordinary growth as it has benefited from sales of its iPhone and iPad. It is the largest position in the portfolio. Both Qualcomm and Sandisk supply technology to smartphones. Google, the second largest position, provides the search engine to the Internet. Priceline is a recent addition and is an online travel company whose most important business is booking hotels in Europe. Growth for Priceline is 35-40% and the company has a valuation of 17x earnings.

Energy continues to be the other important sector in the portfolio. Shales as both a source of oil and gas have been a dramatic technological innovation where the U.S. is the leader. We have invested in oil shales where companies are able to dramatically increase unit volumes while also benefiting from the high price of oil set by worldwide factors of supply and demand. Beneficiaries include E&P companies such as Continental Resources and Whiting Petroleum in the Bakken in North Dakota and Montana, and Anadarko Petroleum with exposure to the Niobrara in Colorado.

We remain optimistic about the outlook for the U.S. equity market. S&P operating earnings increased by double digits in 2011 while the S&P was up modestly. S&P announced last week dividend increases reached \$50.2 billion, 89% higher than in 2010. Dividend payout ratios are below 30% compared with a historical average of 52%. Currently, the yield of the S&P 500 is higher than the yield of 10-year Treasury bonds for the first time since 1955. Notwithstanding the attractiveness of

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equities versus fixed income, investors withdrew \$65.8 billion from U.S. stock mutual funds in last year's fourth quarter and invested \$52.5 billion in fixed income mutual funds. We expect corporations to continue to buy back shares, increase dividends, and engage in acquisitions at substantial premiums. We are confident that equities will be the asset class of choice.

We appreciate your continued support.



William D. Jones
January, 2012