



Dear Clients & Friends,

The S&P 500 and Russell 2000 indices recovered in the 4th quarter, but still ended the year with disappointing returns of +2.1% and -4.2% respectively. Our value composite underperformed both of these indices as solid performance from high-quality U.S. stocks was not enough to overcome losses in U.S. financials, coal mining stocks, and a few particular special situation securities.

While the S&P 500 and Russell 2000 indices are undoubtedly our primary and most appropriate benchmarks, I believe their performance doesn't fully reflect the difficulty of the global financial markets in 2011. Of the 42 country stock markets listed in the Economist magazine, the U.S. Dow Jones (DJIA) was the best performing country index in the world with most suffering significant losses, including the Europe FTSE -19.4%, Japan Nikkei -14%, and Emerging Index (MSCI) -19.7%. Large losses were not limited to equity markets alone. The CRB Commodity Index declined 8.4% and the average of all hedge funds as measured by the HFRX index was down 8.9%. In other words, it was a tough year.

When we discuss our long-term performance record, we are often asked about the years in which we suffered short-term losses or underperformance. Often times the securities that caused short-term underperformance are the very issues that lead to future outperformance. We believe this will be the case with many of our current holdings including U.S. financial stocks. As outlined in the next section "The Case for Bank Stocks," I'll explain why we believe their strong franchises, improving fundamentals, and low valuations offer potential for good future returns.

Most of the investments we make are held for the long-term to take advantage of the earnings growth, dividends, multiple expansions, or other special situation workouts to occur. The key exception to this is our "Year-End Strategy," that I thoroughly outlined in our Q4 2008 quarterly letter which can be found on our website. This strategy entails buying stocks in mid-December that have suffered declines of 50% or more that meet our value investment criteria. Such companies are often oversold as investors sell these "losers" to offset their gains and minimize their tax bill. When January arrives and tax-loss selling abates, shares of such stocks often enjoy a quick pop up. While the month isn't over yet, our year-enders are off to a great start.

Value investing isn't always buying the stocks that have been pummeled the most. We see appreciation potential in some of the world's greatest blue chip companies. Their performance in 2011 could increase further as investors around the world look for the best way to preserve and grow their purchasing power in the event of rising inflation. In an environment of low global interest rates and huge pools of money looking for productive uses, we believe that companies with large international operations, strong brand names, high returns, and predictable growth should trade at much higher valuations than are quoted in the current market.

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Looking at the big picture, much of the bad news appears discounted into stock prices. Concerns over the Euro zone are on the front pages of every newspaper and policy makers are working vigorously for resolution. The “Arab Spring,” in which riots and uprisings are occurring throughout the Middle East, is creating near-term uncertainty in oil-rich and conflict-ridden areas. In the long term, however, secular shifts towards democracy in the region should promote peace and economic prosperity. While concerns over a hard landing in China loom, the slowdown of its inflation in food and real estate is exactly what its government is trying to orchestrate. In the face of this global turbulence, the U.S. economy recorded a modest 2% GDP growth. In short, the general consensus is that Europe is a mess, Middle East uncertain, China slowing down, and the U.S. is muddling through. That is the story everyone knows and a primary reason why investors have pulled out more than \$135 billion from U.S. equity funds in 2011.

The story many people don’t know is the extraordinary case for stocks over the long run. At a time when inflation risks are high due to massive government spending and quantitative easing (money printing) and interest rates at extreme lows, many stocks offer compelling values to own productive assets with growing earnings and dividend payout ratios above prevailing interest rates. In the current uncertain world, we think value-oriented equities are at the top of the asset class list, with the ability to achieve superior risk-adjusted investment returns going forward.

Our goal is to outperform the major stock indices and achieve double-digit compounded investment returns. We are disappointed that we did not accomplish this goal in 2011 and are committed to achieving much better results in 2012. We believe our portfolios have the right combination of securities to achieve our long-term goals. With the current market’s volatile trajectory, our flexible approach is also ready to take advantage of new opportunities.

If you have any questions, please don’t hesitate to give me a call.

Sincerely,

Tom Eidelman, CFA
Vice President

THE CASE FOR BANK STOCKS

BY TOM EIDELMAN

“Don’t Buy! Don’t Buy!” screamed TV pundit Jim Cramer on CNBC’s November 30th, 2011 episode of Mad Money as he did the entire show on why he wouldn’t buy a bank stock. After declining 17% in 2011, the financials sector seem to be universally detested today. Even our beloved office manager Jane Charbonneau was disgusted when I mentioned that banks were one area we are most excited about going into next year. Since it is the elephant in the room, I’m going to start this letter with the key concerns which are best articulated by Jim Cramer.

Cramer’s Bear Case: Europe mess, pitiful loan growth, government antipathy.

Cramer stated that Wall Street analysts are focusing too much on the fundamentals of the specific banks and not enough time on the “big picture macro disaster waiting to happen in Europe.” In addition to the fear of importing Europe’s crisis, he believes stagnant loan growth and government antipathy towards the sector is why it has been “beaten to a pulp.”

Cramer does agree that bank fundamentals are improving and certain stocks such as Citigroup are “spectacularly cheap at these levels,” but with all the negatives surrounding the banks, “the reasons to stay away are so powerful it’s not even worth considering why the banks may be worth buying.”

I want to address these concerns directly because we respectfully disagree with all three of his arguments:

1) We believe the risk of the European financial crisis permanently impairing U.S. financial is very low. While temporary fears could cause volatility in bank stocks, small and regional banks have no direct exposure to Europe. Our large money center bank holding, Citigroup (Ticker: C), has diligently outlined its \$7B net exposure to Europe “PIIGS” countries with which we are comfortable given its \$144B common tangible equity.

2) While loan growth remains a challenge, banks can use the extra capital for acquisitions to buy other undervalued banks, increase dividends, or buy back their own shares.

3) Since increased government regulations are burdensome and costly on all banks, banks are likely to pass on these cost increases over time.

In our view, the above risks to bank stocks are far outweighed by their positives. U.S. banks have valuable global franchises, improving fundamentals, and very attractive valuations which could lead to very high future returns on investment.

The Bull Case: Valuable franchises, improving fundamentals, economic recovery, bottoming housing market, increasing dividends & buy-backs, and compelling valuations.

Banks play a vital role in the global economy. They’re the funnel in the capital formation process and the engine that keeps the car humming. Without banks, corporations would struggle to scrounge up money to expand, and consumers would find it difficult to buy a home or profitably save and invest. In the long term, banks are likely to grow in line with the world’s total output, no matter which sector generates the greatest need for capital.

The United States banks in particular have some of the best capitalized and strongest franchises in the world. This is partially due to the pain already incurred during the credit crisis of 2008, where investors funded mortgage losses with fresh money, creating well funded and reserved portfolios of loans and healthier loan portfolios due to stricter lending standards.

In the following letter, I’ll detail how improving fundamentals, recovering economy, investor pessimism, and low valuations make U.S. bank stocks a compelling investment opportunity today. I’ll start by highlighting the value of their global franchises.

Strong Franchises

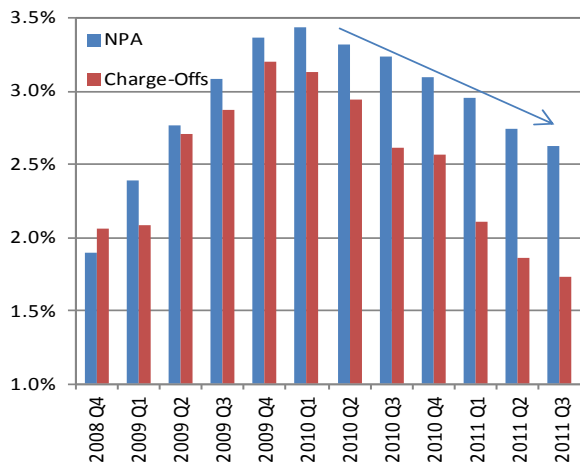
The major U.S. money center banks have tremendous franchises. Their numerous offerings (credit cards, mortgages, consumer lending, investments, etc.), ubiquitous reach, and low cost products motivate customers to bank with them. For example, Citigroup (Ticker: C) has a global franchise consisting of 16,000 offices in over 100 countries. Citi is the largest issuer of credit cards in the world and serves 96% of the Fortune 500 multinational companies needing to pay their employees all over the world in different currencies.

Given the concerns over stagnant loan growth in the U.S., we love that Citigroup earns more than 50% of its income from faster growing emerging markets in Latin America and Asia. Citigroup, along with the other big U.S. money center banks, provides value for their customers and society.

Improving Bank Fundamentals

Banking industry fundamentals have improved every quarter in nearly every category since the credit crisis of 2008. While I could show hundreds of different charts indicating improvements of percentage of loans that are 90 days past due or charged off among all business lines including credit cards, consumer credit, and mortgages, I'll show one chart that sums it all up. Chart A below shows that the percentage of non-performing assets (NPA) and charge-offs has declined every single month since the recession.

Chart A: Bad Loans & Charge-offs Declining



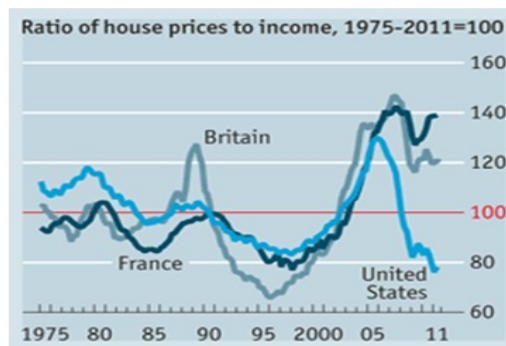
Source: Bankregdata.com

Any need to raise additional capital or take loan loss reserves for upcoming bad loans? Not likely. As a group, banks have the highest levels of tangible capital and loan-loss reserves since before the crisis of 2008. To top it off, the FDIC reported that for only the second time in 39 years, no new bank charters were added in the 3rd quarter of 2011. We believe that an environment of reduced competition should lead to higher profitability in the future.

Real Estate Bottoming

The real estate market also plays an important role for banks. U.S. residential real estate prices may have bottomed out and could start to rise. According to the Economist magazine, U.S. house prices relative to incomes are more than 20% below their 35-year historical averages. Low housing prices should spur housing demand. As demand and prices rise, construction and mortgage lending should pick up and recovery rates on foreclosed properties would rise. An improving real estate market would certainly bode well for bank profitability.

Chart B: US Housing Undervalued



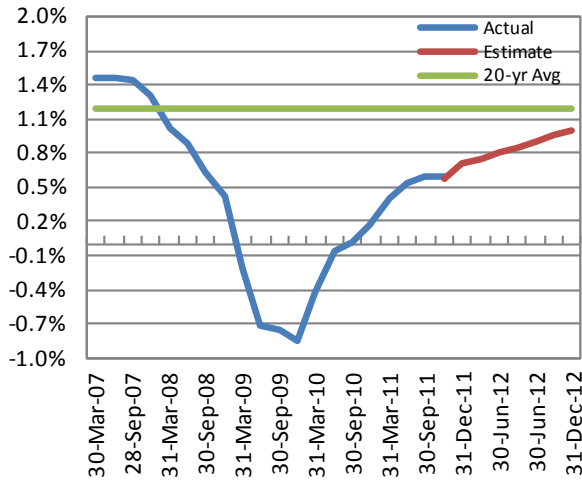
Source: The Economist

Improving Profitability

It all comes down to earnings. Banks reported a 49% increase in net income in third quarter 2011 compared to 2010. This is the highest level of industry profits since the second quarter of 2007. Earnings have improved year-over-year for nine quarters in a row.

Bank profitability (as measured by return on assets) is reverting back towards historical levels (See Chart C on next page). This is the key reason why many banks, including Citigroup, have committed to increasing their dividends and share buybacks in 2012.

Chart C: Large Cap Bank Return on Assets

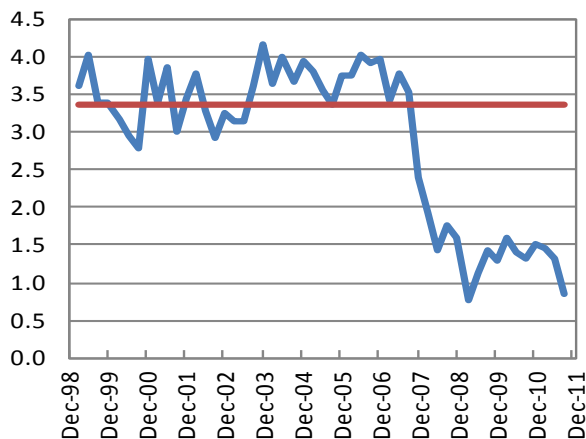


Source: Factset. Data is median of BAC, BBT, C, CMA, FHN, FITB, HBAN, JPM, KEY, MI, MTB, PNC, RF, STI, TCB, USB, WFC, ZN.

Investor Pessimism & Cheap Valuations

Stocks often hit their lows when the prevailing opinion is pessimistic and rise as investor sentiment swings back toward optimism. With the European financial crisis on the front pages, government antipathy towards the sector, and the 2008 crisis in the back of investor’s minds, banks stocks are cheap and unloved. According to a Morgan Stanley report, 43% of investors are currently “underweight” the financials. Because of such pessimism, large banks are trading at record low valuations compared to their tangible book values (See Chart D below). Low valuations are key to high future investment returns.

Chart D: Low Bank Valuations



Source: Factset. Data is median of BAC, BBT, C, CMA, FHN, FITB, HBAN, JPM, KEY, MI, MTB, PNC, RF, STI, TCB, USB, WFC, ZN.

Conclusion

We understand the pervasive concerns surrounding financial stocks including the Europe mess, low loan growth, and government antipathy. However, it is precisely for these reasons that the banks present such a value opportunity. Strong franchises, improving fundamentals, recovering U.S. economy, bottoming housing market, and low valuations make U.S. bank stocks compelling investment opportunities today. After being the worst performing sector in 2011, we think bank shares are poised for a big rebound in 2012.

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