Investment Update
Third Quarter, 2011

For equity and commodity investors, the last three months have been particularly rocky. The global economy is still in something of a soft patch that might have begun with, but in any case was exacerbated by, Japan's earthquake-related disasters. On its own, this weaker economic growth would have been enough to make many investors nervous. Unfortunately, policymakers here and abroad have given investors even more to worry about. The combination of soft economic data and policy-driven events such as Augusts' debt ceiling debacle, the downgrading of US sovereign debt, the ongoing European debt crisis, and China's slowing growth have raised recession fears, and stocks and commodities have corrected substantially.

After dropping sharply in August and more severely in September, most stock markets are now 15-25% below their 2011 highs and are slightly negative so far this year. At the same time, day-to-day volatility has spiked, and daily 200+ point moves in the Dow Jones Industrial Average are common. Much of this new volatility is blamed on high-frequency trading, which involves very rapid computerized trading of millions of stock and option positions per day. Many of the large market moves seem far larger than is warranted by the daily flow of news.

If any investors are smiling, they are probably investors in longer-maturity bonds. While short-term rates continue to be anchored close to zero by the Fed's commitment to maintain a fed funds rate target of essentially zero into 2013, the recently announced Fed Operation Twist has pushed longer-term rates down significantly. Bond prices have rallied on these lower interest rates and as funds have flowed into bonds from stocks and commodities.

In our last Update we were optimistic that global growth would bounce back because we thought that the economic soft patch was mainly due to transitory influences like Japan's disaster. Since then, the worsening euro debt situation has raised the odds that Europe's banking system will need to be bailed out and that the region's economies will dip back into recession, but we are still cautiously optimistic that growth in the rest of the world will continue.

Reasons to think so:

While the global banking system is highly interconnected and problems in Europe's banking system will impact the entire system, even if Europe's banks deteriorate further and need to be recapitalized, the global banking system is far less likely to freeze up as it did during 2008 and 2009. A reason for this optimism is that European banks hold most of the suspect loans made to Greece, Portugal, Spain, and Italy. This is quite different from 2008, when mortgage-linked securities were held throughout the world's banking system, and as a result, the bursting of the housing bubble caused the entire system to lock up.

88 Broad Street • Boston, Massachusetts 02110
Tel (617) 624-0800 • (800) 900-4401 • Fax (617) 624-0801 • E-mail bfo@bosfam.com

In the US, banks are in far better shape than in 2007 and 2008. They are flush with cash and capital and have been proactive in reducing their exposures to Europe. Our banking system will be affected by whatever happens in Europe, but is positioned to withstand European headwinds.

Current indicators are not signaling an imminent recession in the US. Employment is not robust, but new unemployment claims are at their lowest level in six months. Although zero net new jobs were created in August, that statistic was distorted by the number of striking Verizon workers, and September's number is likely to be better.

Outside of Europe, the global Purchasing Managers Indexes have not deteriorated significantly, and in September the manufacturing sector PMI's for the US and China actually perked up to levels signifying expansion. Rail car loadings are not showing any hint of a recession.

Spending on durable goods is holding up well, and despite poor consumer sentiment, total consumer spending is well above the levels we saw before the 2008-2009 recession. The pace of growth in Federal income tax receipts from individuals is steady, and total receipts are only 10% lower than the last pre-recession peak.

Finally, lower commodity prices make it less likely that the developing economies will need to tighten monetary policy to contain inflation, potentially hurting growth. China's pragmatic approach to currency management, which is allowing the yuan to gradually appreciate, reduces inflationary pressures in China. Combined with China's stated willingness to tolerate somewhat higher inflation, the risks of a dramatic slowdown in this most important developing economy seem fairly low.

Stock markets have fallen far enough that we think that they are discounting a much worse economic scenario than is likely. The S&P 500 has dropped about 16% from its July high, but we don't expect anything like a 16% drop in earnings next year for the companies that are our core holdings. Many stocks look quite undervalued now.

We believe that the kinds of companies that we invest in will not see operating results fall off a cliff next year. With very few exceptions, our companies continued to be profitable right through the last recession, most showed only modest declines in earnings, and a sizable minority continued to grow earnings. As portfolio managers, strong balance sheets are also something that we look for, as these are the companies that are most likely to survive periods of economic stress. If anything, the average corporate balance sheet is in better shape now than before the last recession.

When the markets are going through extremely volatile periods like the last few months, it is helpful to keep in mind that the stocks we invest in are pieces of real, productive enterprises. The values of these enterprises don't fluctuate as wildly as their stock prices have. Well-managed companies whose products fulfill a need will survive and prosper over time, even if we are wrong about the near-term direction of the US economy.

The information contained in this report has been taken from trade publications, statistical services and other sources, which we deem reliable. We do not represent that it is accurate or complete, and it should not be relied upon as such. Any opinions expressed herein reflect our judgment at this date and are subject to change.

88 Broad Street • Boston, Massachusetts 02110
Tel (617) 624-0800 • (800) 900-4401 • Fax (617) 624-0801 • E-mail bfo@bosfam.com