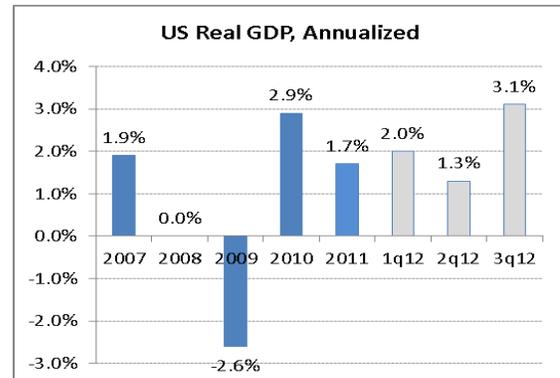


Investment Update Year-End 2012

At the beginning of the year, we outlined some key expectations for 2012. Here is a summary of what we thought back then; how the year actually turned out; and what we think about 2013.

US economic growth: We expected that growth would be higher in 2012 than 2011. Annualized real growth has been above 2% through the end of September. With Hurricane Sandy as a wildcard, growth in the last three months was probably sufficient to boost growth for the full year above 2011's 1.7%. During 2012, employment conditions continued to slowly improve although unemployment is still almost 8%; the housing market bottomed and is now looking much healthier; and consumer spending, especially on big-ticket items like vehicles, was good. Business conditions in the manufacturing and service sectors have been expansionary for most of the year, and capital spending has been good if not robust.



As the most disruptive tax and spending effects of the fiscal cliff have been at least temporarily averted, more of the same slow economic growth is likely in 2013. With the permanent extension of many existing tax measures, most of the very large tax increases that were scheduled to take effect on January 1 did not in fact occur. However, there have been some tax increases for almost everyone, from low- and middle-income workers via the higher payroll withholding tax, to high-bracket taxpayers who face significantly higher income and capital gains tax rates. Higher taxes will be a drag on the economy, but it could have been worse.

With regard to government spending, nothing much was decided during the fiscal cliff negotiations. Unfortunately this means that 2013 will be another year of high political uncertainty, as investors will again have to deal with a series of battles over the US debt limit and virtually every other aspect of budget policy. Just as high uncertainty was a drag on the economy in 2011 and 2012, we expect 2013's growth to be affected as well. There is plenty of anecdotal evidence that consumers held back during the 2012 holiday season, anticipating that tax rates would be going up.

Europe and the euro: We thought that Europe would continue to muddle along and be able to avoid the collapse of the euro. Quoting our friends at Bretton Woods Research, “His [ECB president Mario Draghi’s] pledge on July 26th to do everything necessary to preserve the euro was a game-changer for financial markets. In very quick fashion, Draghi effectively extinguished European currency risk and sovereign default risk plaguing markets since early 2010 when the Greek government first began to exhibit chances of a default. Draghi’s pledge made clear that European policymakers 1) would not allow any scenario in which an EU member would be allowed to exit the euro currency zone, and 2) they would do everything necessary to ensure that the central bank would essentially guarantee EU member sovereign debts.”

The large declines in Italian, Greek, Portuguese and Spanish bond yields since July 26 and the corresponding rallies in those countries’ equity markets indicate just how important this ECB step was. Although sovereign defaults are not a risk at present, Europe’s growth outlook has not improved in any fundamental way, nor will it as long as countries follow the path of higher taxes and austerity. For 2013 as in 2012, Europe will not implode but recession or at best very slow growth is what we expect.

Growth in the rest of the world: We expected that many of the emerging markets and particularly China would grow more slowly than in the recent past, but would avoid recession. Of the BRIC’s, Brazil’s growth was only slightly positive and India shrank slightly, while China and Russia had better growth that also improved as the year passed. Chinese growth has been perking up late in 2012, and 2013 should be as good or better.

Equity markets: For 2012, we thought that modest P/E expansion and growing corporate earnings would combine to produce U.S. equity market returns of about 10%. Happily the year turned out even better than that. Using consensus estimates, S&P 500 company earnings for the following twelve months increased from \$106 to \$114 during the year, and during the year the S&P 500’s forward P/E multiple expanded from 11.5X to 12.5X.

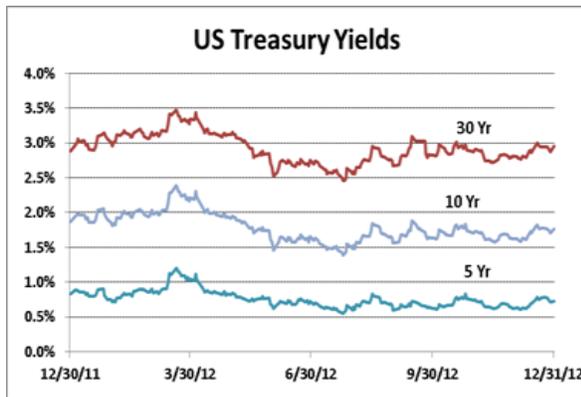
For 2013, we would not be surprised if earnings growth is lower than in 2012. Late in 2012, many companies reported somewhat disappointing revenues, which if the trend continues will make profit growth that much more difficult to achieve.

Then again, emerging markets might be more of a help to profits in 2013, and equity markets could easily have another good year. As usual, there is plenty to worry about, but not enough to keep us from continuing to invest in stocks for long-term appreciation.

Fed policy and interest rates: We expected that slow but continued US growth, i.e. the absence of a recession, would lead to a less-accommodative Fed and the beginning of rising interest rates. For several years we have been wrong on both accounts, but in

<u>2012 Equity Markets *</u>	
S&P 500	13.4%
Dow Jones Industrials	7.3%
NASDAQ	15.9%
Russell 2000	14.6%
MSCI EAFE	13.6%
MSCI Emerging Mkts	15.2%
<u>2012 US Equity Market Sectors *</u>	
Financials	26.6%
Consumer Discretionary	21.9%
Health Care	15.2%
Technology	13.2%
Industrials	12.5%
Telecommunications	12.5%
Materials	12.2%
Consumer Staples	7.5%
Energy	2.3%
Utilities	-2.9%
* Price change only	

2012 we were partially right. The Fed continued its dual policies of quantitative easing and extremely low short-term rates. However, longer-term interest rates began moving somewhat higher in the second half of the year.



In December, for the first time ever, the Fed directly linked future policy moves to specific levels of unemployment and inflation, and will maintain the current very low interest rate policies as long as unemployment is above 6.5% and inflation is below 2.5%. In this slow-growth economy, it has already taken three years for unemployment to drop from 10% to just below 8%. Unless the pace of job creation improves unexpectedly, low short-term rates look to be with us for a while longer.

2013 may be the year that longer-term interest rates finally start to consistently move higher, as it appears that the Fed is starting to contemplate the end of its quantitative easing program.

Stocks versus bonds: We expected stocks to outperform bonds in 2012, and we got this right. Most investment-grade bond investments earned low-single digit returns in 2012, although lower-quality high-yield bonds did produce much higher returns. For 2013, we think that stocks will again outpace investment-grade bonds. As in 2012, given the historically low yields on bonds, we do not expect them to produce much in the way of capital gains.