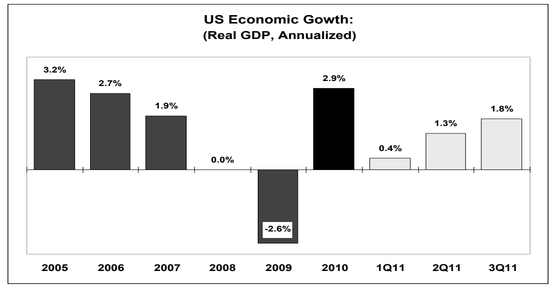
Investment Update
Year-End 2011

In our last two quarterly updates, we were optimistic that the US economy's first quarter soft patch would prove to be temporary. As the year passed, a naturally resilient economy has recovered from the first half's multiple shocks (a spike in oil prices, ripple effects from Japan's tsunami and nuclear disasters, an unusually bad tornado season). Real growth accelerated each quarter, and a string of encouraging recent economic news points to the final quarter of the year being the strongest.



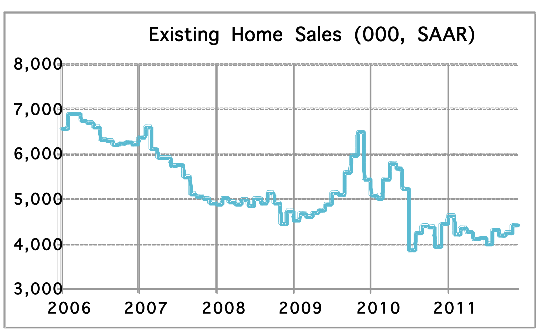
Let's review some recent domestic data that point in that direction:

_November data from the Institute for Supply Management indicated more growth in the manufacturing sector, marking 28 straight months of expansion. Notable was the strength in new orders, which bodes well for year end. Service sector ISM data from November were also solidly expansionary.

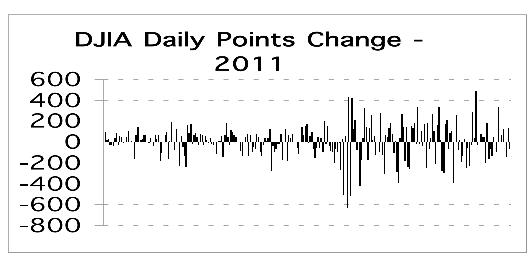
_November employment numbers: non-farm payrolls increased by 120,000. Over the past year, private payrolls have increased on average 157,000 per month. The unemployment rate continued its steady decline from a 10% peak to the current 8.6%. However, labor force participation is still too low, and the improving unemployment rate is not accounting for many unemployed workers who have stopped looking for work

_Total retail sales grew in November for the 15th time in the last 16 months, sales excluding autos increased for the 18th straight month. Core sales, which exclude autos, building materials and gasoline, have increased every month this year. Such consistent month-to-month growth is rare and encouraging.

_Housing starts in November increased more than 9% from October. Most of this increase was due to a big jump in multi-family construction, but single-family starts were also up. Housing starts have moved up quite consistently over the past six months. It should be noted that housing starts, which entail significant construction activity, are a much larger contributor to measures of GDP than are existing home sales.



_November existing home sales show a housing market that is bottoming. If not for the artificial 2009-10 increase in home sales caused by the temporary home buyers' tax credit, this bottoming process would be much more apparent. The inventory of existing homes for sale is at its lowest level since 2005. On the negative side, median sale prices have not shown any consistent improvement since early 2009 and continue to bump along 20-30% below the highs of 2005.

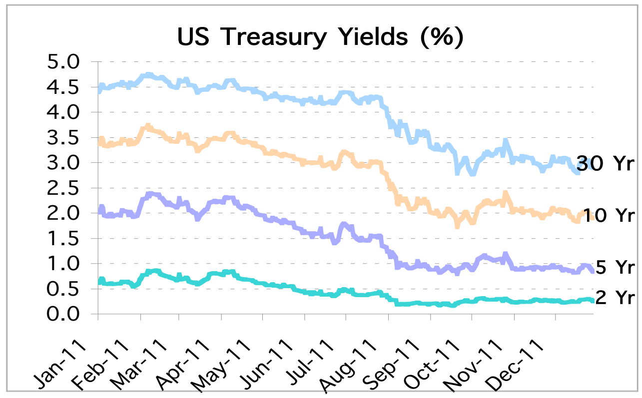


Although the domestic economy has rebounded as we expected, the direction of the global economy has frequently been called into question especially as Europe's sovereign debt problems continue to fester and China's growth has slowed. Equity investors have been on a rollercoaster this past year. At its high, the Dow

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

Jones Industrials average was up around 12% and at its low, down almost 10%, but ended the year up about 6%. The real story for equity investors in 2011 was volatility, with frequent large daily swings. Foreign markets were just as volatile as the US markets, but most finished the year far into negative territory.

Interest rates, especially at the long end of the maturity scale, again defied our expectations. Although we knew that the Fed was attempting to push longer rates lower via Operation Twist, we were surprised by how much those rates did fall during the second half. At the beginning of the year, rates were already at very low levels, particularly so given that the Fed's efforts to stimulate the economy have been widely seen to be sowing the seeds for higher inflation in the future. Nevertheless, rates except at the shortest end of the yield curve fell significantly over the year, meaning that bonds earned exceptional returns. The longer the bond, the higher the return: the longest Treasury bonds returned close to 30%, 10-year Treasuries earned close to 17%, while 0-3 year Treasuries earned less than 3%.



Our key expectations for 2012:

US economic growth continues, somewhat better than in 2011 but still below average and below potential. Unforeseen events could upset this picture, but absent major external shocks, we think that growth continues. Booming North American natural gas exploration and production from new shale sources is an ongoing source of growth. There is also the outside possibility that with a major election cycle in November, a positive policy surprise could improve the growth outlook. In terms of the surprises and how important they could be, Arthur Laffer, the father of supply-side economics (the one school of economics whose policy prescriptions have not yet been implemented to combat our slow growth), estimates that while reducing regulatory costs would likely be pro-growth, reducing marginal tax rates would be ten times as effective, and a sound and stable US dollar would be 100 times as effective.

Europe adopts measures that are sufficient to prevent the breakup of the monetary union and the euro does not collapse. The key will be Germany's political support for maintaining the union and its long-delayed acceptance of the issuance of Eurobonds or some other kind of joint funding mechanism for the weaker members, in exchange for greater fiscal and budgetary coordination within the union and discipline imposed upon the weaker members. In this scenario, the most disruptive short-term outcomes are avoided. Unfortunately, the resulting austerity measures and tax hikes will mean that Europe as a whole is likely to be doomed to a near-term recession and a long period of growth that is poor even in comparison to its lackluster recent past.

Although a recession in Europe will affect the rest of the world, we believe that growth outside Europe can continue regardless. The availability of trade finance, long dominated by European banks, is critical to this continued growth and while the Europeans are being forced to retrench in the face of more stringent capital requirements, Asian competitors are already stepping up to fill this financing void and keep trade flowing. At the end of the day, Europe has been a relatively small contributor to global growth for quite some time.

The emerging economies of Latin America and Asia reverse their recent slowdowns, and relatively high growth resumes. China, the most important emerging economy, does not return to 10% annual growth but is able to maintain growth in the high single digits and avoid recession. In these economies, authorities had intentionally engineered lower growth to better manage building inflation. Now that commodity inflation (which is especially problematic for these economies given the high proportion of per capita income that is spent on food and energy) has lessened, authorities now have room to reverse course and are doing so.

Some stabilization in Europe and the better economy in the US lead the Fed to become less accommodative as the year progresses, making 2012 the year in which interest rates finally begin to trend higher. It seems unlikely that bonds can continue to out-perform stocks.

No recessions outside Europe mean that 2012 is another year of healthy corporate profitability, and equity markets move higher on the back of higher earnings. As Europe stabilizes and fears of a hard landing in China are proven wrong, there is also room for some P/E expansion from today's very modest valuation levels, and average equity market returns for the year of around 10% would be a reasonable guess.

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