January 9, 2012

Dear Investor,
This report covers my outlook and investment strategy for 2012.
Notes on Holdings

More than half of your account is invested in preferred stocks, real estate investment trusts (REITS) and fixed income securities. These are generating attractive yields and have less overall price volatility than broader stock indexes. The balance of your account is invested in stocks. I continue to view this portfolio mix as prudent given the uncertainty and substantial volatility in global stock markets. That said, my bias for new purchases is towards the stocks of good companies in non-cyclical industries.

Stocks in your portfolio that performed well this year include EDAC Technologies, a small Connecticut based aerospace manufacturer, Macquarie Infrastructure, a manager of oil terminals, and US Lime Corp, an owner and manager of limestone quarries. EDAC technologies had a particularly strong year, more than doubling, as the company began to demonstrate earnings momentum after several years of weak performance.

Companies whose stocks did not perform well were largely in the energy, materials, agricultural and financial sectors.

Weakness in energy, materials and agricultural stocks reflected concerns of slowing global demand. Specific holdings which lost money included Teck Resources (copper and metallurgical coal mining), Apache Corporation (oil/gas exploration) and NAL Energy (oil/gas exploration). In the agricultural space, Bunge, Potash Corp, and Mosaic all finished the year down.

I continue to like many of these holdings, and their valuations look more attractive with the stocks down. I view the agricultural and materials holdings as likely to benefit from demand growth from emerging markets. And among the energy names, NAL became notably inexpensive late last year, with its dividend yield rising into the teens, despite a high likelihood of payment (the stock has since recovered and now yields around 10%).

Financial stocks were pressured by worries about the economy and possible bank failures in Europe. Your portfolio exposure to this area is limited, but those financial stocks we do hold, including Bank of New York and the Singapore based DBS Bank, declined substantially this year. I like the longer term prospects for DBS Bank, which operates in one of the higher growth regions of the world and has avoided the credit blunders made by many other large banks.

In general, I have reduced somewhat the number of cyclical stocks in your portfolio, given the potential for recession in 2012.

2012 Outlook

Stock valuations in many cases look attractive, particularly relative to treasury bonds. Many of our holdings have generated substantial earnings in the last year, leaving them flush with cash. At the same time they are trading at relatively low multiples of current earnings. However, the attractive valuation and return potential of those investments comes in the midst of substantial political and economic uncertainty.

European nations face recessions, budget crises, and possibly currency crises. Earlier this year, plans to restructure Greece's sovereign debt challenged a widely held assumption that Europe's central bank (the ECB) would support debt issued by its member states. That led to elevated borrowing rates for weaker EU participants, including Portugal, Spain, and Italy, exacerbating already strained budgets. The EU has pushed its troubled member states towards spending cuts. However those cuts may prove counterproductive in an environment of recession and high unemployment.

One measure that could help reduce borrowing rates would be a commitment from the ECB to act as a lender of last resort, putting the full faith and credit of the entire EU behind member states. So far Germany and its Northern European neighbors have resisted this step, as it would increasingly link their stronger budgetary positions with that of their financially weaker neighbors.

Over time the inability of EU member states to manage their economies through a central bank may lead some of these states to leave the EU and abandon the Euro currency. Were the EU and its currency to founder there would follow a number of negative consequences for banks and markets. These include:

1) Losses on sovereign debt, if repaid in devalued post-Euro currencies
2) Solvency risk for Euro banks holding troubled sovereign debt
3) Potential losses for U.S. banks with loans or other exposures to Euro banks
4) Losses on cross border trade receivables, if repaid in devalued post-Euro currencies
5) More pronounced European recession, with follow on impact on multi-national corporations

On the other side of the world, China is dealing with a possible real estate bubble. Investment spending in China represents more than 40% of overall GDP, a larger percentage than other major economies (the U.S. is closer to 20%). That spending has been partly supported by rapidly rising real estate prices. Recent data published by China's National Bureau of Statistics suggested prices in cities are beginning to fall. If that trend continued, it would create less incentive for new building and investment.

Both politically and economically, China is better positioned than most major economies to stimulate further growth and manage a 'soft landing' for real estate markets. That said, if real estate price declines become pronounced, it could pressure the Chinese economy and in turn, global growth.

Although the US appears to be in the midst of a slow recovery, continued high unemployment and reductions in government spending, particularly on the state level, make our economy vulnerable to economic shocks from abroad.

Consensus Estimates and Price Scenarios for the S&P 500

Analysts now estimate composite 2012 earnings per share for companies in the S&P 500 of $107, a 10% increase over 2011. In a global recession that number could fall substantially. Excluding financial stocks, S&P earnings contracted more than 20% in 2009, following the financial crisis. (It is worth noting that earnings for several of the S&P stocks - health care, information technology, and consumer staples - actually grew in 2009. Investing in good non-cyclical stocks made a difference.).

If dislocations in Europe led to a financial crisis of the same magnitude as the burst of the housing bubble in 2008 and a similar reduction in corporate earnings in 2012 as in 2009, it would imply a reduction in 2012 S&P earnings to around $80, down 20% from 2011 levels, with earnings contraction most likely concentrated in the cyclical financial, industrial, energy and materials sectors. If the market multiple corrected relative to those earnings to an 11x PE, comparable to the multi-year low in March of 2009, it would imply downside on the S&P 500 to around $880, a 30% decline from current levels. While this is not a likely scenario, it is possible and is a factor in my bias towards non-cyclical industries.

The upside for US markets depends on our avoidance of recession. If the US avoids recession in 2012, S&P earnings could rise to around $107. Combine that with a slightly higher multiple for each dollar of earnings in a more stable environment, and the index could trade to 1500, 20% above current levels.

Managing Risk in Your Account

In 2011, your account's daily moves, both up and down, were roughly half that of the broader market. To the extent that correlation held in 2012, it would imply about half the downside of the market (slightly less after taking into account about a 5% full year dividend yield). I am actively looking for investments which would further reduce risk while providing good potential returns. These include:

1) High quality municipal bonds for taxable accounts
2) High quality stocks with strong balance sheets and relatively non-cyclical businesses. Note that earnings for health care and consumer staples held up well in the 2008/2009 recession.
3) High yielding stocks, bonds, and MLPs where yields are likely to remain attractive under stress scenarios.
4) For authorized accounts, short positions (i.e., bets that purchase prices will fall) in low quality, highly indebted or grossly overvalued stocks.
5) For authorized accounts, protective puts when volatility premiums are low.

I am particularly partial at this time to category 2, high quality, defensive stocks. An example is Becton Dickinson. Becton Dickinson manufactures relatively low cost, high volume items used by hospitals, including needles, syringes, catheters, and blood storage casings. It also produces reagents and antibodies used for medical research.

Becton’s stock has fallen over the last year reflecting concerns about sales growth and costs. Hospital utilization has fallen alongside employment, hurting the sales outlook, and plastic and other raw material prices are up. That said, Becton has substantial manufacturing scale and resultant cost advantages over recent entrants and smaller firms. In addition, product sales to hospitals undergo lengthy review by purchasing committees, making them more difficult to displace once accepted.

I believe that Becton's relatively low unit cost products are less likely to face ongoing price pressure than higher ticket medical devices, and sales should benefit from increasing health care utilization as the baby boomer cohort ages. Becton has had remarkable earnings consistency, having grown earnings in sixteen of the last seventeen years. This includes the recessionary 2008 and 2009 period, when Becton's earnings were up more than 10% in each year. The business is highly cash generative, and Becton maintains a conservative balance sheet. And the stock currently trades at one of its lowest multiples of earnings of the last fifteen years.

There are other large companies that share Becton's characteristics: well-managed, high barriers to entry, moderate cyclicality, good long term earnings outlooks, strong balance sheets, and reasonable valuations. I am on the watch for companies that fit that description and adding opportunistically when I find them.

At the same time, there continue to be interesting opportunities among smaller companies. Here are two.

MFC Industrial: MFC Industrial provides material procurement and trade financing for small manufacturers, typically financing raw materials at a fraction of their liquidation value and taking a lien on those materials as collateral. The company specializes in the procurement and financing of iron ore used in steel production and PVC plastic, used in vinyl siding for housing and a range of industrial applications. MFC also owns an interest in a Newfoundland iron ore mine. MFC current trades just above the value of its net cash on hand, despite generating consistent profit and cash flow. Management intends to use that cash to acquire assets cheaply from European banks in the midst of deleveraging. MFC also plans to pay a special one-time dividend next year which could be as much as $2 per share, 30% of the current stock price.

Span-America: Span-America manufactures air and foam mattresses and accessories for medical facilities. The company's stock hasn't moved much over the last few years, but the company continues to improve its products and customer mix. Over the last several years Span has increased its presence in the hospital market. Those sales tend to be more difficult to displace than sales to nursing homes, Span's traditional customers. In addition, after accumulating a substantial amount of cash over the last few years, Span recently announced the acquisition of a medical bed frame manufacturer, which should add to near term earnings. Span still has very little debt and earns attractive returns on its existing assets. I think it's only a matter of time before the stock begins to more accurately reflect the company's substantial earnings power.

As always, feel free to contact me with any thoughts or questions. Best wishes for the New Year,

Note: This information is intended as a discussion of past account performance and investment strategy. It is not a recommendation to purchase any specific security or type of security. An investment in securities involves the risk of loss.