SEPTEMBER 2012 INVESTMENT COMMENTARY

ADDING OIL, OVERHEATED DIVIDEND STOCKS, AND LESS TRAVELED PATHS

In last month's commentary, we analyzed the 2nd quarter earnings season of 2012, which at the time of publication was approximately 2/3 S&P 500 companies had reported. The second quarter earnings season is now completed, and less than 60% of companies beat earnings estimates, and even a smaller percentage of companies exceeded revenue estimates. This was the weakest level of sequential corporate performance improvement since the bull market began in March 2009; however, the markets, which had lowered the bar for earnings expectations, took the uninspiring earnings season in stride. For much of the month of August equity markets marked time, trading within a very narrow range before finishing 2.26% higher (S&P 500 index). A healthy portion of August's gain occurred on the last trading day of the month, with a 1.0% S&P 500 index advance fueled by comments made by Fed Chairman Bernanke in his Jackson Hole speech. Chairman Bernanke made it clear in that speech that "unconventional monetary policy is effective and that the US needs more of it". Message received... more Fed action is on the way. We believe additional stimulus from the Fed, absent cooperation from Congress, is like driving a poor performing car which is burning oil; you can continue to fill the engine with new oil every couple days and keep the engine from seizing up, but the car will remain in disrepair. What the car likely needs is a valve job, however in our analogy, the Fed can only keep the car running poorly and only Congress can make the necessary repairs.

Through the end of August, the S&P 500 index is up a rather solid 11.85% year-to-date, however, the advance warrants closer inspection. A disproportionate amount of the market advance year-to-date has been concentrated in higher yielding dividend stocks of utilities, telecom and consumer staples sectors which have been bid up by income-seeking investors who in more "normal" market environments would be happier in bonds. The historically low interest rate environment has nudged income investors out of bonds and other traditional income plays into dividend stocks, and the ease of gaining access to broad baskets of these sector plays through exchange-traded funds (ETFs) means that all stocks within the sector rather than the fundamentally best ones have all risen in price, many beyond realistic valuations.

AVOIDING CROWDED FROTHY TRADES AND SEEKING RARER DURABLE VALUES

Jacqueline Doherty of Baron's in her August 27, 2012 article titled, The Danger in Dividend Stocks, points out that "winning trades rarely stay winning indefinitely. So anyone heavily invested in stocks or bonds that throw off lots of cash—whether through interest income or dividends—should beware of the abundant signs of frothiness". We believe the leadership of utilities and telecom stocks is highly unlikely to continue, and in fact, the trend may be reversing as both sectors posted negative returns for August in the context of a rising market. According to Ms. Doherty, relative to how high quality/high yield stocks have historically been valued as compared to the broad market, "utilities and consumer staples sectors are now more expensive than they have been 90% of the time, and telecom shares are costlier than they have been at least 80% of the time in the past". It's worth repeating--winning trades rarely stay winning

indefinitely. So, for a trader, he or she could have jumped on the bandwagon early this year, rode the momentum in these stocks, collected a couple quarters of dividends and then sold out of them about now.

We are not traders and when we were searching for attractive investment opportunities earlier this year we already felt that traditional high yielding U.S. stocks, such as most utility and telecom stocks, were too fully valued to jump in at that point. We usually need to see compelling value when we choose to add a new investment to client portfolios. For example, we still own Verizon in many portfolios, with it having been purchased two years ago when it was trading in the high $20's, boasting a 6%+ dividend yield. Having purchased this high yield stock at a compelling valuation, many clients have benefited from the stock appreciating into the mid $40's, thus logging a 60% plus gain in share price, while collecting over a 6% annual dividend. We certainly would not be buying into Verizon stock at today's levels (forward P/E of 15 and a PEG ratio of 1.60), which we believe will lead to a decline in the stock price over the next year or more, at worst, or lead to a stagnate stock price for a longer period of time to allow earnings to grow into the current price level.

In contrast to Verizon, as well as many other large-cap high yield U.S. equities that we do not own, two of our utility holdings, Companhia de Saneamento Basico do Estado de Sao Paulo (SBS) and PPL are much more attractively valued and held up well in August. Spotlighting SBS for a moment, the Sao Paulo, Brazil sewer and water utility is up more than 50% YTD, and trading at about 9 times next year's projected earnings (forward P/E of 9 and a PEG ratio of 0.90), still appears quite inexpensive, in spite of logging a 170%+ gain since we originally purchased it several years ago. Unfortunately there are very few stocks like SBS, but that does not deter us from continually seeking to uncover investments which can achieve similar growth.

As we have written in the past, our equity process seeks to identify easy to understand companies. Our process requires objective research that results in a high level of conviction in our portfolio stocks and valuation targets. In most cases, we have a clear vision of the catalysts that will drive the share prices to those valuation levels; however, at times knowing the exact time frame for those targets to be realized is rarely known. One of the stocks we featured last month, United Online (UNTD,) a very new holding for us, is a great example. In UNTD we identified a company that had evolved into a relatively uncorrelated collection of online businesses offering a very high dividend yield that was supported by a comfortable level of free cash flow. We believed the yield and strong cash flow position offered good downside market protection, and although we recognized that UNTD did not generate strong revenue growth that could drive sustained price appreciation, we believed that the high yield and adequate cash flow represented good value that should eventually gather wider investor attention or more likely takeover interest by a private equity firm.

Within just a few weeks after our initial purchase, the company announced its plan to split the company into two independent publically traded firms resulting in a near 30% move overnight. While we recognized the potential catalyst, the time period was uncertain. Sometimes it takes a few years and other times, like in the case of UNTD, it just takes a few weeks to unlock value. The ultimate corporate restructure will not occur for United Online until early next year and we anticipate further gains in the stock as that event gets closer.

EMERGING MARKETS OFFER GOOD LONGER-TERM OPPORTUNITY

Well-traveled paths sometimes become less-traveled when sentiment changes because investors who are convinced that certain growth trends can go on indefinitely and then all the sudden the trends slow down. This has happened over the last year and a half with the emerging markets, particularly with China and Brazil. We believe that this shift in sentiment offers longer-term opportunities in both equities and debt in many of these markets. In terms of fixed income, yields and interest rates in developed countries are at or near historic lows, while yields in many of the emerging markets countries are considerably higher by comparison and are being driven lower as these former red hot economies slow to more sustainable levels. Not only do we find the relative yield advantage of emerging market debt compared to debt of developed markets to be attractive, we also believe that interest rates will continue to move lower, driving bond prices higher, creating a very

attractive total return opportunity that does not exist in other fixed income investments.

In terms equities, economic growth in emerging market is expected to outpace growth in developed economies and loose monetary policies in developed countries is creating excess global liquidity that is finding its way to all corners of financial markets. As author John Mauldin writes in his 2011 book, Endgame, "Emerging economies account for 43.7% of global output and, according to the IMF, will account for 70% of the world's growth going forward, yet they represent only 10.9% of the global stock market capitalization." I had to read that twice to make sure that I grasp what he was saying. He further states that "Emerging markets will be the big winners of the loose monetary policies around the world. Just as the Fed's loose monetary policy after the internet bubble burst created the housing bubble, the Fed's money printing will inflate emerging markets." Just like many other investments that we make, we can agree with Mauldin's premise, but the timing is much less certain.

We rationalize Mauldin's premise because economic reality dictates that excess liquidity (central bank stimulus) seeks investment; the law of supply and demand makes it highly likely that this liquidity will drive up stocks in the emerging markets. The old axiom is "don't fight the Fed" and this comes from the fact that monetary policy designed to stimulate the economy always succeeds in encouraging risk-taking, with the risk of overshooting leading to unintended bubbles. It is always important to remember that monetary authorities cannot direct where that risk taking will manifest itself. The case for a possible emerging market equity bubble can be made because by creating significant demand for "growth" investments, it is a high probability that such risk-taking will be directed toward areas demonstrating superior growth fundamentals, thus the emerging markets stand out. When that liquidity begins to rush into the emerging stock markets, the limited supply of emerging market publically traded securities will cause stock prices to inflate rapidly. Once we see that happen, at that point we will likely be looking elsewhere, but until then the opportunity is compelling.

LACK OF PROGRESS IN EUROPE AND FISCAL CLIFF RESTRAIN GROWTH

In substance, the challenges in Europe have not changed that much over the last couple of months, although rhetoric has bolstered hope. Most recently, tensions are growing between the European Central Bank (ECB), which is working on the details of a plan to buy short-term bonds issued by troubled nations like Italy and Spain to keep those country's interest rates at sustainable levels, while Germany's Central Bank is resisting such bond purchases.

As markets remain frustrated with the lack of progress in Europe, stateside, the prospect of the year end "fiscal cliff" is increasingly being cited as a drag on economic growth. Although we believe that Congress will ultimately skirt the potentially abrupt effects of the expiring tax cuts and spending cuts, the continued discussion of such a potential fiscal shock certainly will have some damping effect on our economy in the interim. Additionally, the likelihood that some, but not all, adverse effects associated with year-end tax policy expirations and automatic spending cuts will not be averted is likely to have a dampening effect on economic growth in 2013. As the election season heats up with the Republican National Convention at the end of August, and the Democratic National Convention in early September, the focus of campaign debate has moved more squarely on the economy. At no time in recent history have the two main parties been so polarized. No matter who wins the White House in November, the actions necessary to address the country's long-term fiscal challenges will be addressed because they have to. The President that we inaugurate in January will make a difference by determining the spirit of the compromise that the two polarized parties in Congress must reach sooner than later.

2013 should not disappoint those of us who have been waiting for bold legislation that will begin to tackle tax reform, infrastructure investment and long-term entitlement programs regardless of who wins in November. We view this as ultimately very constructive for the markets; however the outcome of the election will certainly dictate how we approach this long-term optimistic view tactically in the short-term. We will flush this out more as we approach year-end.

MARKET SAGE JEREMY GRANTHAM ON FORESTRY AND FARMS

When we talk about long-term optimism and looking into

the future as it pertains to components of our investment strategy, we typically bifurcate the time horizon into near-term, the next 12 to 18 months, intermediate term, the next 18 to 60 months, which typically corresponds to lengths of time roughly representative of shorter-term cyclical trends and longer-term slices of a typical business cycle, and long-term. Our longer-term outlook is influenced by trends in demographics, commodity scarcity, and innovation in technology. Not dissimilar to an individual's retirement plan, long-term outlooks when it comes to the world of investments should not change to any significant degree unless something large and unexpected occurs that will alter long-term trends. We believe that on occasion, indulging a longer, multi-decade look into the future can be of value in shaping our long-term strategic outlook. One of the most profound thinkers in the investment world when it comes to long-term macro trends is Jeremy Grantham (Co-founder and Chief Investment Strategist of Grantham Mayo Van Otterloo, (GMO), a Boston-based asset management firm. In his most recent quarterly newsletter, he lays out a number of serious challenges that he predicts will evolve over the next several decades. These challenges include accelerating global food shortages and ever higher resource prices; this outlook leads Mr. Grantham to an asset allocation recommendation for long-term investors that includes up to a 30% allocation to natural resource plays, dominated by agriculture and forestry sectors. We are currently not recommending such a large allocation to such investments, as it is very possible that economic growth challenges, in the short to intermediate time horizon, will produce deflationary pressures that could temporarily offset the supply/demand led price increases that Mr. Grantham foresees.

In some of our recent commentaries, we've written about our allocation to timber, through Plum Creek Timber (PCL) and Rayonier (RYN), as a strategic allocation that combines relatively high current dividend yields with capital appreciation potential tied to an improvement in the housing market. If Grantham's vision unfolds, this strategic allocation could well be a core holding for us for quite a long stretch. The objective of our monthly commentaries is not to tell our readers what happened last month in the market, but instead to lay out our tactical and strategic thinking so that clients can better understand their portfolios. We always hope that these monthly commentaries will stimulate discussion around these subjects and that such discussion will help us better understand our clients.

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