



January 1, 2012

Dear Fellow Investors,

The Great Recession is bottoming out, still a lot of work to do to get the economy starting down the long road of recovery.

When I was young I remember going to Disneyland and having a booklet of tickets to get on the rides. “A” tickets got you a ride on the “Main Street” vehicles, a “C” ticket would get you on the tea cups, and an “E” ticket would get you on the best most exciting rides. Everyone wanted to go on the “E” ticket rollercoaster type rides and feel the excitement of the sudden ups and downs. Well, 2011 offered you the financial markets equivalent of an “E” ticket ride – a rollercoaster ride up and down and returning to basically the same place we started at. Up almost 9% by May only to be down over 14% by October (with four days in a row during August that saw 400 point daily moves in the Dow Jones Industrial Average) and back to essentially unchanged by the end of the year.

When the day-to-day events of the world cause us to emotionally react and question the veracity of our common-sense financial disciplines we know there is fear in the marketplace. In 2011 we were challenged by a devastating earthquake and tsunami in Japan that caused the worst peacetime nuclear event in history. It resulted in a disruption to the supply chain that stalled the world economy for a period of time. We were treated to an up close and personal view of a dysfunctional US

Government in paralysis and unable to deal with our nations debt levels that resulted in a loss of the triple A rating by Standard and Poor's on our government debt. We were held hostage to the continuing game of kick the can in Europe where they are unable to come to solutions to their banking solvency and excess debt levels. Perhaps most importantly, a cart vendor in Tunisia set himself on fire in protest. This was the literal flashpoint to a protest movement around the globe where the populace no longer wanted to be the silent majority and started to voice their desire for change (In some cases toppling governments along the way). The Arab Spring, Occupy Movements, dissatisfaction with a return of Putin to the Russian presidency were all incorporated into Time magazine's "Man of the Year – The Protester". Amazingly, through it all corporations increased earnings, raised dividends, started hiring more people, improved their balance sheets and our base economy started looking a little bit better.

We are pleased to report during 2011 our diversified portfolios continued to generate the cash flow that our investors expect. This cash flow is utilized by many to fund their financial independence and by others to reinvest and compound. Either way, our objective of providing a consistent, growing cash flow from a portfolio that is diversified by asset class as well as securities, has been the calming influence that has allowed our investors to weather the ebbs and flows of short-term volatility and keep their focus on long-term investment fundamentals.

FORECASTS FOR 2012

This is the section of the annual letter that most readers turn to first – that foolish section where we actually make forecasts for the future! We remind everyone our portfolios are managed substantially from the bottom up – meaning, we look at individual investments themselves and the long-term value they represent. With this reminder out of the way lets review our forecasts from 2011's annual letter and make some new and bold (and perhaps foolish given our longer term perspective) forecasts for 2012.

U.S. ECONOMY:

- **Continued slow growth with economy accelerating towards latter part of 2012**

Everyone has declared the recession over. However, we differ from most economists on Wall Street that say we have been in a recovery. In

speaking with small to intermediate sized business owners, we hear many are struggling and limping along. They are running their businesses as lean as possible and are reticent to expand until there is more long-term clarity in regards to regulation, health care & taxes. In our opinion, this is not indicative of an economic recovery. Government statistics declare whether we are in a recession or not by monitoring Gross Domestic Product (GDP). The problem with the GDP measure is that it is not empirically based but rather a compilation of estimates and economist's inputs. We believe it is also fraught with an upward bias and constant readjustments. The following chart is illustrative of what GDP should look like if those biases and adjustments are removed. It shows the "real economy" still is not growing.

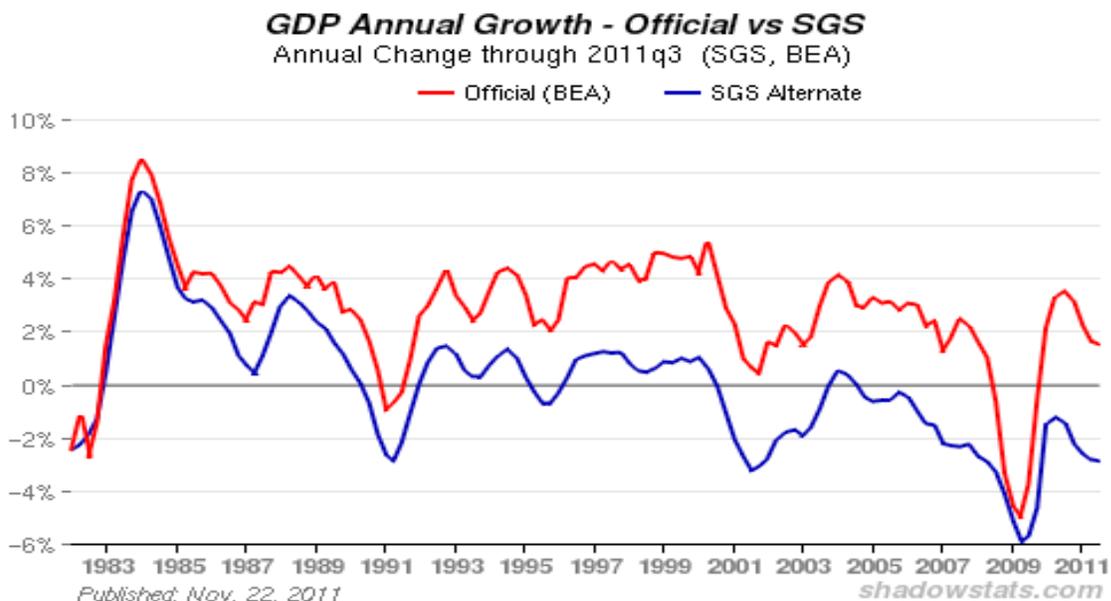


Chart #1 – Courtesy of ShadowStats.com

This should not be a surprise to our clients as last year we showed a chart of the U6 unemployment rate that was well over 15%. It still stands above 15% a year later. Until we get people back to work we will not declare this recession over.

U.S. Signals of Promise

Although times remain tough for most we do see long-term catalysts that should propel our economy forward:

- **The Return of Financial Sanity:** Can you believe lenders these days actually have the nerve to ask for proof of employment? We joke about this now, but these lax (or complete lack of) lending standards is what helped get us in the pre-Lehman Brothers over-

leveraged mess. Today, we are back to basics. Solid leverage ratios, credit history, employment & character will get you financing. Banks also stand armed with plenty of money waiting to be lent at low interest rates on an economically fundamental basis. Corporations have also followed suit and been able to tap the credit markets to refinance and issue new debt at historically low rates. All this adds up to a financially healthier household & corporation – both of which are essential for sustained economic progress.

- **Financial Strength of Corporate America:** Creating new jobs takes time – plain and simple. Research and development breeds new technologies which create or enhance entire industries. During the “Great Recession” schools never stopped teaching, students never stopped learning and companies never stopped investing in new technologies or improvements to old technologies. During 2010 the 500 companies in the S&P 500 Index spent \$164 Billion on Research & Development. As of the third quarter 2011, these same 500 companies held over \$1.2 trillion dollars in cash and short-term investments. Corporate America is healthy.
- **Change on the Horizon:** The challenge for our government going forward will be to lower the percentage of Gross Domestic Product they represent. While there is a desired and needed presence of government in society, due to the “Great Recession”, lower tax rates, a Middle East war financed with debt, and the deleveraging of private balance sheets, the size of government relative to the total economy is now unsustainably too large. There are only two acceptable ways to fix this – cut the size of government or grow the economy while keeping government at the same size. The government cannot shrink itself too fast otherwise it becomes an anchor on the employment of the country. In our opinion, the best solution is to slowly allow the size of government to shrink through sunseting projects and initiatives. This places the projects in the more efficient hands of the private sector and would allow the government to invest those dollars in areas where our country desperately needs improvement – infrastructure.

We view infrastructure projects that are 20th century based to be user paid for and privately funded and constructed – toll roads,

utilities replacing water pipes, rail systems, telephone companies dealing with wires, etc. Government can help with funding and loan guarantees during periods of high unemployment such as we have now. 21st century infrastructure would be the appropriate place for government partnership and investment. Research facilities, education, NASA, and Internet (cloud) build out are examples of the infrastructure of the future. Government Debt for true investment is okay, but to fund consumption it is not.

We see Government debt continuing to grow for the next three years – even with reform it will get worse before it gets better. That debt will become inflationary only if business becomes very optimistic and expands their balance sheets faster than the government (The Federal Reserve) can simultaneously contract theirs. If the broad measure of money supply starts to expand too rapidly, then inflation will not be far behind. After declining in 2009 and 2010, total money supply as measured by M3 has finally started to rise again at a very moderate pace. However, Bernanke is well positioned with the shape and size of the Federal Reserve's balance sheet to control money supply so that inflation does not become a problem. Slow growth of inflation equal to the growth of GDP is achievable and maintainable for the foreseeable future. The inflation mandate of the Fed seems to be firmly in hand. The dual mandate of employment growth is in reality something the Fed cannot control (and in our opinion should be removed from their consideration). The Fed can lead the horse to water and make sure there is plenty of water there, but if the horse does not want to drink there is nothing the Fed can do about it. The Fed can make all the cheap money available it wants, but if corporations won't hire there is nothing the Fed can do.

- **The Bottom Line:** We still like America – we are allowed to create, innovate, try and fail. We have capital that is willing to do that as well. We can be the engine for the world economies. Even if we just invent and then it is built elsewhere – but we still own it. We believe as long as America is fundamentally a meritocracy it will thrive as the best and brightest will always rise to the top – and yes get paid accordingly. In reality the 99% would all jump at the chance to be part of the 1% - and some will actually do the work to get there.

THE WORLD VIEW:

- **Europe comes to a resolution to deal with the Euro problems**

The Euro Zone is dealing with their difficulties by addressing the systemic issues of deficit creation as opposed to creating ever more Euros to paper over the real issues. While short term they will be forced to create some new Euros, we believe they will shore up the financial institutions that are the foundational building blocks of the Euro Zone. As the year rolls along it will become obvious the Euro will remain a viable currency and the fiscal union of the countries who utilize it will become tighter - even as they weather a dip into recession again to accomplish the prudent long-term policy objectives. The possible result could be less demand for an inflating reserve currency of the US Dollar and more confidence in the Euro as the developed worlds medium of exchange. Our startling prediction is that this time next year the talking heads on the financial news programs will be done with the Euro, done with the presidential election, and the negative story will be the potential of the dollar losing it's exclusive reserve status.

- **Afghanistan comes to a power sharing agreement with the Taliban**

It is no secret that the Obama administration wants to disengage from as many military commitments as possible around the world. The government of Afghanistan knows history is repeating itself and with patience, another foreign occupier will leave. Rather than be ousted from power after our departure, they will come to a "democratic" understanding with the Taliban and proactively "ask" the Western forces to leave their country.

- **North and South Korea sign a Peace accord**

In what is likely to be spun as a successful conclusion to the Armed Conflict on the Korean peninsula by both sides, a peace agreement will be signed that firmly solidifies the existence of two Koreas. The North will get recognition and autonomy with the talk of reconciliation being put to bed. The South will get a specter of invasion as a greatly reduced risk. And, the United States will reduce our sizable military presence in South Korea by at least half.

EQUITY MARKETS:

- **An Increase of double-digit returns**

For 2011 we foresaw the stock market up by single digits. Another forecast we got spot on. We even had it correct that earnings would outpace a contraction in Price to Earnings ratios and that dividends would increase. As the chart below shows, we are approaching valuation levels, as represented by the Price to Earnings level of the Standard & Poors 500, that in the past have represented very attractive long-term value.



Chart #2 – Source Prof. Robert Shiller <http://www.tradersnarative.com/sp-500-price-earnings-ratio-long-term-chart-2330.html>

Certainly we could get to even more attractive valuations before we see an expansion of valuations. But this does not have to occur from a tremendous price decline in equity securities. Rather, we believe corporate profits will continue to grow and any further contraction in the PE ratio of the market will be offset by the dividend yield so that the total return investors receive from the equity markets in 2012 will roughly equal the pace of earnings growth.

In addition to the discussion of the economy previously mentioned in this letter, we feel the following influences will provide support to equity prices going forward.

- The strong balance sheets of corporate America are now awash with greater amounts of underperforming cash than at anytime before. Where the economics justify it, there will be investment in projects that offer higher rates of return. Otherwise, we will continue to see cash finding its way back to shareholders via higher dividends and share repurchases.
- The reality of the world is that the greatest opportunities for growth lie where the greatest number of people have a desire to improve their standard of living. The emerging markets and developing economies of the world will continue to provide the greatest rates of growth. Hence, we will continue to focus our attention on those US corporations that will participate in the emerging market's growth. This international contribution to earnings is a significant reason that dominant US corporations can have earnings growth greater than the rate of growth of the US economy.

While it might be a little technical for some of our readers, we think a couple of valuation models help support our belief the stock market is undervalued and can achieve our double-digit return forecast (if you're not studying for your CFA Charter feel free to skip the next 2 paragraphs!):

- **Grinold-Kroner Model:** this model states that the expected return on a stock or market index is composed of the expected dividend yield (Div_1/P_0), expected inflation rate (i), real growth rate in earnings (g), change in shares outstanding (chg Shares) & change in the price to earnings ratio (chg P/E). Visually, it looks like this:

$$\text{Expected Return} = Div_1/P_0 + i + g - \text{chg Shares} + \text{chg P/E}$$

Our input forecasts for 2012 are as follows:

$Div_1/P_0 = 2\%$, $i = 3\%$, $g = 7\%$, $\text{chg Shares} = -1\%$, $\text{chg P/E} = 0\%$
 (We are forecasting a 2% dividend yield, 3% rate of inflation, 7% real growth rate in corporate earnings, companies buying back stock reducing share count by 1% & no change in P/E multiples)

Running our input forecasts through the Grinold-Kroner Model gives us a 13% expected return on what we view as very reasonable input assumptions.

- **Fed Model:** this model divides the earnings yield of the stock market by the yield on 10-year Treasury bonds. (The earnings yield of the stock market is calculated as the operating earnings of the S&P 500 divided by the index level of the S&P 500 and is also equivalent to the inverse of the P/E ratio.) When the Fed Model gives a reading greater than 1 this means stocks are undervalued relative to bonds. When the model gives a reading less than 1 this means stocks are overvalued relative to bonds. Presently, we are at a reading of 3.9 which is one of the highest readings we have witnessed in decades. In our opinion, the earnings yield of the market needs to decline, which means higher equity prices or higher bond yields. Assuming current operating earnings, an increase of 10% on the S&P 500 coupled with an increase in 10-year Treasury yields to 3% still puts the Fed Model at a reading of 2.5 – still well over a reading of 1 which signals a buy for stocks. The Fed Model is a great segue into our Fixed Income forecasts because it shows just how overvalued we believe bonds to be.

FIXED INCOME:

- **Short-term rates near 0%, Long-term rates increase by at least 50%**

For the last two years we have forecasted the start of a new upward trend in interest rates. This has not happened – yet. We feel the artificially low Federal Reserve interest rates have already served their purpose. The panic stricken capital markets of late 2008 and early 2009 received the stabilizing liquidity they needed. The banking system has been allowed to rebuild its reserves with historically significant spreads between their cost of capital and lending rates. The monumental Federal deficits of the last three years have been financed through the expansion of the Federal Reserve's balance sheet at next to no cost to the government. The management of the Fed's balance sheet will become one of the most critical variables in controlling inflation in the years to come. The following chart gives perspective on just how large and varied it has become.

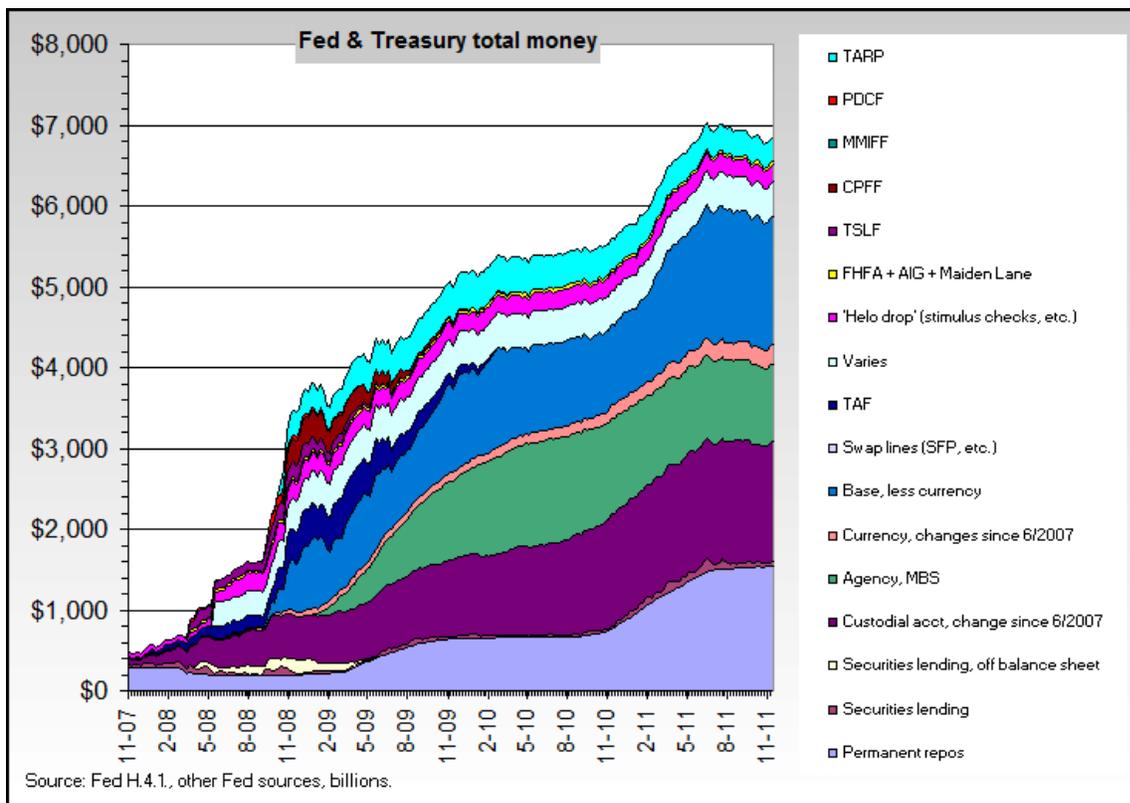


Chart #3 - http://www.nowandfutures.com/key_stats.html

The Fed has signaled its intention to keep short term borrowing rates at close to zero until sometime in 2013. At the same time, they are already extending the maturities in their portfolio. The stated purpose is an attempt to reduce longer-term interest rates to help the economy. We are not surprised it also means the cost of the monumental government debt is being financed longer term at the historically low rates we have presently. But even first year economics students learn about supply and demand. And if the supply of bonds (government borrowing to fund deficits) continues to grow, then at some point there will not be enough demand to buy them all. To attract buyers, rates would then have to increase.

Currently, the big buyers of our supply of bonds are the Federal Reserve and our foreign trading partners who are taking our debt in payment for the trade deficit we are running with the rest of the world. We are of the opinion the Federal Reserve cannot expand its balance sheet forever without unleashing an inflationary spiral that is against one of its mandates.

And, as one of our major trading partners, China, refocuses on internal growth and exports become a smaller part of their GDP, their appetite for US Treasuries should decrease. China may even become an additional source of supply of treasuries.

Thus, we continue to believe short-term rates will remain artificially low in 2012, out of necessity. Initially to continue to stimulate the economy and build banking reserves, and later to keep the government borrowing costs as low as possible in order to finance the deficits that will have no meaningful resolution until after the elections.

Longer-term interest rates are due to finish the bottoming process and start a slow and sustained move higher over the coming years. The fed will make valiant attempts to constrict the rise in rates but we think the market will start to poke holes in the bubble that is the government bond market. It comes down to simple supply and demand. This year's bold forecast on interest rates is that we will see the ten-year treasury yield move from its current level at around 2% up to higher than 3% over the year 2012.

2% to 3% doesn't sound like much but it will result in a 7 to 8% decline in the principal value of 10-year bonds. While the interest rate may equal the inflation rate so that the negative return is only that price decline, we would not be surprised if consumer prices start to increase as interest rates do and cause negative total rates of return on the longer U.S. Government bonds in excess of 10%.

REAL ESTATE:

- **Vacancy rates slowly work their way down, additional space added on an as-needed basis.**
- **Residential markets mixed**

Commercial Property appears to be bottoming out. Last year we called for the market to see a flat year and a longer bottoming process. We called this one spot on. With commercial real estate having longer-term leases, the bottoming process takes a longer time to get through the cycle. Owners of properties are focused on retention of tenants. As their leases are rolling over, rent roll backs appear to be moderating.

Now owners are shifting their focus to once again getting more tenants. Recently, as profits have started to improve, corporate America has been looking to upgrade and showing some interest in adding some marginal space. Gone are the days of “build it and they will come”. Now it is “when we desperately need it we will take on the additional space”. The economy needs to improve and businesses need to see the improvement before they will take on the long-term commitments to additional space.

In this environment of slow to no growth, existing mortgages that need to be rolled over will continue to be a major focus in the industry. Cash flow to service the mortgage and quality and length of leases will be the focus of the lenders. The challenge of most developers is finding capital so new commercial construction should remain subdued. Until real growth of the economy emerges, development lending will be constrained. After all, we all know when money is available, developers develop! The tight supply of money should allow existing vacancy rates to slowly work their way down.

This year’s forecast for commercial Real Estate is another flat year with little new development and the bottoming process continuing.

Residential Real Estate is in a different world than commercial real estate. We mention it in the letter out of requests to do so – not because we are investors in the sector, but because it is a significant part of so many people’s balance sheets. Last year we delivered the bad news that housing prices had still not stabilized and the backlog of foreclosures and unsold homes remains at very high levels. But, the prices of houses were approaching the level where prices versus owner equivalent rent were almost equal again. Unfortunately, we were absolutely correct on this forecast.

This year we are pleased to report a mixed outlook – which is better than being all-negative. There are areas of the country where the younger generation are moving to find jobs and where the cost of living and housing is cheaper. We believe those areas have seen their residential real estate prices bottom. In fact, in some of those areas there is even new home construction once again. But in other states that are high tax states, or have seen businesses depart due to regulation, work rules and other reasons, the inventory has not yet been assimilated and prices will probably continue to be weak.

Eventually residential real estate will reflect inflation once again. But it will take further growth of the population, the next generation saving down payments and being able to qualify on an income basis for mortgages, and the absorption of the shadow inventory of foreclosed and short sale homes. We think rental properties purchased today with an eye to holding them for ten years or longer will turn out to be okay investments, but would prefer investments in the equity markets over that same time frame. With one caveat – if either of the proposals at the end of this letter were adopted, then we would see a far more rapid recovery in housing prices.

2012 FORECAST SUMMARY

- U.S. Economy: Continued slow growth with economy accelerating towards latter part of 2012
- European Situation: The Euro will survive as a currency and the US Dollar will come under question by the end of the year as the reserve currency.
- Middle East: Afghanistan sees the departure of NATO forces as the current government comes to a power sharing agreement with the Taliban.
- Koreas: North and South Korea sign a peace treaty cementing two separate Koreas.
- U.S. Equity Market: will be driven by earnings growth in 2012 of low double digits with some slight PE compression being offset by growing dividends.
- Fixed Income: Short-Term Interest Rates will continue to be held down by the Federal Reserve for all of 2012
- Fixed Income: Long-Term Interest Rates will start to rise in 2012 – with the ten-year US Treasury yield rising above 3% by year-end.
- Inflation: Inflation to remain benign and in control by the Fed
- Commercial Real Estate: will continue its long-term bottoming process with very little new development in 2012.
- Residential Real Estate: not all negative. Certain geographic areas continue to see bottoming of home prices and renewed interest.
- Planet Earth: The world will not end on December 21st, 2012 as some have interpreted the Mayan prophecy!

IF WE WERE IN CHARGE:

Many have asked us to put in print some of the common sense solutions we have to some of the big picture issues of the day. What we offer here is a fresh framework for solutions. These ideas certainly need fine-tuning so that the unintended consequences can be minimized. So, never wanting to shy away from at least some controversy in our annual missive we will give thoughts on just two areas – immigration and fixing the housing market.

- ***Immigration***

We feel that anyone who has completed four years of education at one of our colleges should be allowed to have a ten-year workers permit to stay in the country. A Masters or Doctorate should have an accelerated track to obtaining a permanent green card. Let's also fund immigration control and programs by having a cost associated with non-educational workers permits and green cards. All other immigrants would have to pay the costs associated with their entry and assimilation into our society and have a financially responsible sponsor. Immigration will be based on being a productive member of our society and having employment. Lose the employment, you would have a period of time (During which your sponsor supports you and not the taxpayers of America) to gain another job or then you would return back to your country of origin. If you are here illegally and have a job, you are granted a workers permit. No job, you are deported. The attraction to immigrate should be opportunity and freedom and not societal largess. Those with workers permits and a history of continued employment and paying of taxes should then be in line for green card applications. No lotteries for Green Cards – they should be earned, after all, America is a meritocracy.

- ***The Housing Market***

We note that a recent Barron's article on refinancing in the housing industry is getting closer to the solution we floated two years ago – 2% mortgages for long-term owner occupiers of residential housing. There are multiple issues surrounding the residential housing bubble bursting. Some of those issues are: robo-signed and "mistaken" paperwork, Fannie Mae and Freddie Mac having to be bailed out and still guaranteeing huge amounts of CMO's, mortgages that never should have been granted in the first place!

We propose that anyone in a home presently should be allowed to refinance (or finance for those who own their homes free and clear) at a rate of 2%. This rate is conditioned upon them staying in their house for five years or longer. If they leave before then, then a market rate of interest of 4.5% would be assessed and the unpaid difference would be recouped by the loan provider in escrow. The Federal Reserve owns a huge amount of these existing loans now, and the Treasury has opened its wallets to Fannie and Freddie already to a point where they are on the hook for the losses anyhow. Lets admit it, refinance, create some stability and demand, and get back to work!

As always we want to thank you for your continued confidence and the opportunity to manage your investments. We take very seriously our responsibility and will always endeavor to be responsive to your questions and concerns. We welcome and encourage your comments as well.

Two Oaks Investment Management's Mission: To provide diversified, disciplined long-term investment solutions, service and guidance for helping our clients achieve their "Financial Independence".

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