



January 1, 2013

Dear Fellow Investors,

We are heartened that so many people have come to want a copy of our annual letter. Thank you. In an effort to candidly address all the topics people have asked us to cover, the letter has become fairly lengthy. So this year we will divide the letter into sections so you can easily navigate to what is important to you. Those sections are (and what we hope your takeaways are from each):

Events of 2012 – Events repeat themselves throughout history and we should not be too influenced by the news of the day.

Investment Markets in 2012 – The Recovery from the 2008 financial crisis continues – albeit it slowly.

Forecasts for 2012 – As forecasting goes we did pretty well with 7.5 out of 11 correct. A couple of the forecasts were absolutely perfect!

Forecasts for 2013 – Never learning our lesson we will forecast the future once again!

Thoughts on the Economy - Still challenged, but absent any major shocks, still in recovery mode.

Thoughts on Equities – Overweight for 2013

Thoughts on Real Estate – Overweight for 2013

Thoughts on Fixed Income – Underweight for the next decade or so!

Closing Comment and Thanks

So grab a cup of coffee and spend a few minutes with us as we look back on 2012 and look forward into 2013 and beyond.

EVENTS OF 2012

"History is a gallery of pictures in which there are few originals & many copies" – Mark Twain

Once again we picked up a newspaper to see if the old adage is true – that only the names change but the stories remain the same. We were struck by the similarities to the past in just about all of 2012's major headlines. It is said that the most dangerous saying on Wall Street is: "This time it's different", because it never really is. With this in mind, let's review 2012's headlines and offer some historical reference with a few comments of perspective thrown in.

- **The *Costa Concordia* runs aground in January** – Not the first cruise ship to have problems. The Achille Laro was Hijacked in 1985 then caught fire and sank in 1994. The Sun Vista caught fire in 1999 and sank with all the passengers and crew in lifeboats for eight hours. And of course there was the Titanic.
- **Facebook IPO in February** – Much talked about and anticipated – certainly not the first major IPO to go poorly. Of course you may not remember some of the others such as Webvan.com, Groupon, Zynga, Pandora – all of which are/were down significantly in the first year following their IPOs.
- **Second round of Greek Bailout (130 Billion Euros)** - I guess all we have to do is look to the first round! But seriously has everyone forgotten the Latin American Debt crisis of the late 1970's and Secretary Brady's financial engineering that allowed for the United States to bail out the "Less Developed Countries" (LDS).
- **Vladimir Putin was elected Russian President in March** – Did anyone doubt for a minute that this election in Russia would be any different than those of the past 100 years since the overthrow of the Tzar? Another "democratically elected" strongman.
- **"The Scream" by Edvard Munch sells for \$120 Million** – This caught our eye because we are not sure any painting is worth that much money – and every time a new record amount is paid we are astounded. \$267 Million for "The Card Players" in 2011, \$118 Million for "Nude, Green Leaves and Bust" in 2010; truly amazing to us.
- **Spain accepts 100 Billion Euro Bailout deal in June** – Much the same as Greece. But think about this, the Irish bailout worked. Portugal is out of the headlines for the moment. And if you really want to think about big bailouts of sovereign debt just look at America in 1780 when Hamilton organized the Federal government taking over all the state debts.

- **London Olympics** – We included this story as it repeats every four years and for a couple of weeks the world can marvel at the accomplishments of athletes around the world coming together in peaceful competition. Bravo!
- **Rover “Curiosity” lands on Mars** – Actually a major success for NASA and JPL– much like Voyager, Apollo, Hubble Telescope, Pioneer and so many more. The frontiers of science and engineering expanded by the quest to reach to the stars. Repetitive events of success!
- **US Ambassador Chris Stevens killed in Libya in September** – John Mein – Guatemala 1968, Cleo Noel – Sudan 1973, Roger Davis – Cyprus 1974, Francis Meloy Jr – Lebanon 1976, Adolph Dubs – Afghanistan 1979 – all were United States ambassadors that were killed by terrorists. Lest we forget they were all serving our country honorably and obviously security let them down.
- **Israel Gaza conflict erupts** – I don’t think this needs any references – it is all too common in the region for tensions to escalate into violence.
- **Hurricane Sandy strikes the Northeast.** – This is almost an annual story, but let’s review the costliest hurricanes of the past. Katrina in 2007, Andrew in 1992, Ike in 2008, Wilma in 2005, Lynn in 2004, Charley in 2004, Irene in 2011. And for the global warming folks let’s not forget Diane in 1955, the New England storms of 1938, and Carol in 1954 – all that hit the New England states before anyone thought of “An Inconvenient Truth”.
- **Barrack Hussein Obama Re-elected president of the United States** – Every four years our great country does something that other nations envy and have the greatest difficulty doing. We have a free election where dissenting opinions are vociferously espoused and intellectual nerves are frayed. Then we elect someone to lead the country for four years and we peacefully transition power if there is a change in leadership. We are proud to be Americans and even if we did not vote for Obama, he is our president for four more years.
- **Felix Baumgartner breaks the sound barrier on a “Spacedive”** –We included this headline as Blake remembers what difficulty he had doing a bungee jump of just 150 feet! He can’t imagine doing it from 24 miles up at the edge of space! But every year (maybe every month) there are remarkable world records being set and making the news that we can all marvel at.
- **North Korea Launches long range rocket** – Nuclear threats are news more often than we would like – The Cuba Crisis in 1963, India’s “Smiling Buddha” in 1974, Pakistan’s Changai-1” in 1998. Israel and the Vela Incident of 1979. South Africa getting the bomb and then self-disarming. And every time the outrage that is in the press stokes our fears and gets us to buy more newspapers!

- **Newtown Connecticut school shootings** - As parents, we saved the worst for last. The fear we have as we drop our kids off at school (an environment we trust to be safe and secure) after yet another school massacre. We are sure you feel it as well. Senseless loss. Unfortunately, it is not the first time and most likely, not the last. If we step back from the horror of the moment we can see this senseless act of violence happens in schools around the world:

Ecole Polytechnique in Montreal 1989 - 14 dead
 Cologne Germany 1964 - 10 dead
 Dunblane England 1996 - 18 dead
 Erfut Germany 2002 - 17 dead
 Kauhajoki Finland 2008 - 11 dead
 Winnenden Germany 2009 - 16 dead
 Ma'a lot Israel 1974 - 25 dead
 Baku Azerbaijan 2009 - 13 dead
 Rio De Janero Brazil 2011 – 13 dead

And then there are those in the In the United States. The history is too long to list here – it goes back to the 1700's. One will note that while the frequency does not seem to have increased, as the sophistication of the weapons has increased, so has the death toll.

The more we think we are in unique times and will never recover from today's events, the more we need to remember our past and how resilient we are. The disasters and travails being thrown in our faces every day by our instant and ever-present media are not always new and in many instances, been dealt with before. We hope our commentary and perspective can serve as somewhat of a voice of calm and reason in today's often irrational world.

INVESTMENT MARKETS IN 2012

Stock Market - The S&P 500 Total Return was up 16%. We attribute the strong performance to the following:

- Recognition that the worst of the financial crisis is most likely behind us
- Solid dividend yields on many high quality stocks
- Reasonable valuation levels on stocks when looking at various fundamental metrics such as price/earnings, price/sales, price/book value, etc.

Real Estate - The MSCI US Reit Total Return Index was up 13.56%. We attribute the strong performance to the following:

- As absorption of space continued and a lack of significant development projects on the near term horizon, and rent roll downs have moderated.

- With REIT's offering a long-term inflation hedge and a significant current cash flow advantage relative to fixed income investment alternatives

Fixed Income – The Barclay's Aggregate Bond Index was up 4.2%. We attribute the performance to the following:

- Artificially low interest rates were maintained by the Federal Reserve. The Federal Reserve then purchased fixed income securities with longer maturities in a successful effort to lower long-term and mortgage borrowing costs.
- Strong inflows into the bond markets as evidenced by the fact that for the first time in history Fidelity is managing more money in their bond funds than in their stock funds!

FORECASTS

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 enjoy this process of using "What If" in our thought process as it allows us to think outside of the box and challenge our (and your) assumptions. As we are often heard saying, "We cannot manage the future by looking in the rear view mirror. We must look forward and see the road ahead".

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 let's review our forecasts from 2012's annual letter and make some new and bold (and perhaps foolish given our longer term perspective) forecasts for 2013.

First we will check and see how we did last year.

2012 FORECAST SUMMARY

- U.S. Economy: Continued slow growth with economy accelerating towards latter part of 2012 – ***This one we hit right on! Full Point***
- 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. – ***The Euro has survived but at this point the US Dollar has not yet come under question as the reserve currency – Half a point.***
- Middle East: Afghanistan sees the departure of NATO forces as the current government comes to a power sharing agreement with the Taliban. – ***The NATO forces are training the ANSF forces and have announced the timetable for completion to be the end of 2014. While rumors of talks with the***

Taliban circulated at various times during the year nothing occurred. Too bad because in our opinion there can be no lasting peace in Afghanistan without their participation. While we got the direction right we cannot take a point on this one.

- **Koreas:** North and South Korea sign a peace treaty cementing two separate Koreas. – ***The Death of Kim Jong-il provided the perfect time for reconciliation however, the opportunity to cement a peace treaty has passed. No point here.***
- **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. – ***Another one we hit right on! Full Point***
- **Fixed Income:** Short-Term Interest Rates will continue to be held down by the Federal Reserve for all of 2012 – ***Perfect – Full Point***
- **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. – ***The rate actually declined very slightly in 2012 as the Federal Reserve used purchases of bonds to keep all rates down along the yield curve. No point here***
- **Inflation:** Inflation to remain benign and in control by the Fed – ***Perfect – Full Point***
- **Commercial Real Estate:** will continue its long-term bottoming process with very little new development in 2012. – ***Absorption of space was the focus of the market and development was muted as corporations continue to rationalize their space commitments. Full Point***
- **Residential Real Estate:** not all negative. Certain geographic areas continue to see bottoming of home prices and renewed interest. – ***In fact there has been some increasing prices on a year over year basis, as investors have been purchasers of foreclosed and rental properties. It is not country wide so we will take a Full point***
- **Planet Earth:** The world will not end on December 21st, 2012 as some have interpreted the Mayan prophecy! – ***This was the proverbial gimmie – if we got it wrong no one would have been keeping score! Full point.***

So in scoring our 2012 forecasts we got 7 ½ out of 11. Importantly for us the ones we did not get right either did not affect the investment landscape dramatically or the timing may just have pushed out into the future.

2013 FORECASTS

After much feedback last year we had a number of people who wanted the forecasts with a bit shorter explanation to each. As always we invite your comments and love nothing more than to have a discussion about the reasons behind these forecasts. With no further ado....

- **U.S. Economy:** Slowing growth in the first half of the year with businesses beginning to make investment in longer-term projects in the second half of the year. With government still too large a percentage of GDP we see headwinds to robust economic growth. Full year GDP growth anticipated to be 3% or less.
- **European Situation:** Continued pressure on the Euro, as France becomes the next weak link in the chain. By the end of the year speculation will emerge about a new Pan-European agreement that gives sovereignty over fiscal matters to a centralized European body. It will not happen and nationalism will once again fracture any chance at a United European Government. Germany will continue to benefit from the declining standard of living of the peripheral countries. (Is Germany taking over Europe with Euros instead of guns this time?) We forecast the Euro limps through another year without defections.
- **Middle East:** Syrian President Assad is no longer in power and by the end of the year another Islamic Fundamentalist democracy will be in place.
- **Japan:** The Yen begins a devaluation slide that will not end for many years. An aging population that will start cashing in their postal savings accounts to live on, a new generation that does not save as much, government debt that is unsustainable (too large relative to GDP), and a culture that cannot admit failure. The government will do many unpopular moves to impact the balance of payments – including reopening many of the nuclear plants to cut down on imported energy.
- **U.S. Equity Market:** Will be driven by corporate issuance of debt to fund significant equity buybacks leading to greater than expected earnings per share growth in 2013. The lack of real revenue growth during most of the year will cause some PE compression in the first half of the year followed by forward looking optimism at the end of the year. We forecast a net result of another year of up over 10%.
- **Fixed Income:** Short-Term Interest Rates will continue to be held down by the Federal Reserve for all of 2013. The employment rate will not get below the Fed target of 6.5%; if it does the Fed will site U6 Unemployment as still being too high. In reality the Fed will want easy money around as Obama-care hits the economy in 2014.

- **Fixed Income:** Long-Term Interest Rates will start to rise in 2013 – with the ten-year US Treasury yield rising above 3% by year-end. (Yes this is the same direction as last year and we will continue to believe this will happen, it is just a matter of when. Not paying attention to this risk could potentially be the most devastating event to impact investments in the foreseeable future)
- **Inflation:** Inflation to remain benign and in control by the Fed – but with corporations coming in a big way to the bond market in the second half of the year, Money Supply will become a talking point by yearend. Corporate issuance of debt coupled with Fed easing and US Government Deficit spending may begin the parabolic end game to the Debt Bubble that has been building for quite some time. We will write a position paper on the debt bubble latter in the first quarter.
- **Commercial Real Estate:** Absorption will continue to be the focus in offices – but surprisingly industrial space will see some strength as a new shift of bringing some manufacturing back to America starts to materialize.
- **Residential Real Estate:** Investors have helped define a bottom in residential Real Estate. The bottom end of the housing market will continue to do well, but the top end will continue to suffer as high income earners are squeezed by higher taxes and a desire to downsize – the baby boomers are becoming empty nesters and just don't need McMansions any more!
- And in keeping in our theme of the last quarterly letter, and being a California based firm, a sports forecast. With two of the biggest payrolls in baseball, and for the first time since 2009, both the Dodgers and the Angels will make the playoffs. (Not quite the lay-up prediction as the Mayan calendar last year!)

THOUGHTS ON THE ECONOMY

"Be courageous. I have seen many depressions in business. Always America has emerged from these stronger and more prosperous. Be brave as your fathers before you. Have faith! Go forward!" – Thomas Edison

Last year we differed with economists and said we wanted employment to truly recover before we could say that we were in a recovery. As we made reference to in our April and July letters, there were too many "Unknowns" facing us in 2012 for businesses to have the confidence to make substantial investment in the future and drive a robust recovery. One by one during the year those issues were addressed and resolved:

- Obama-care was upheld by the Supreme Court – it is now the law of the land.
- Obama was re-elected – more taxes to be paid by the high income earners, less defense spending, and more government regulation are three of the more significant takeaways from the election.

- The “Fiscal Cliff” issue has been partially resolved. We are confident that additional compromises will be reached to raise the debt ceiling as well. We maintain that that these “fiscal cliffs” are more politics, grandstanding and emotional than economic.

Perhaps not the most business friendly resolutions on each issue, but now business knows what the playing field should look like for the foreseeable future and can plan accordingly. America’s business leaders are some of the brightest people in the world. They will figure out how to make the most of the new environment.

Last year we showed a chart of GDP Annual Growth – Official vs. SGS that showed that perhaps the economy was not in reality recovering, and that at the very least we were in an employment recession. An update of that chart draws the same conclusion this year. And even if one does believe the “official” statistics, the rate of growth is anemic at best.

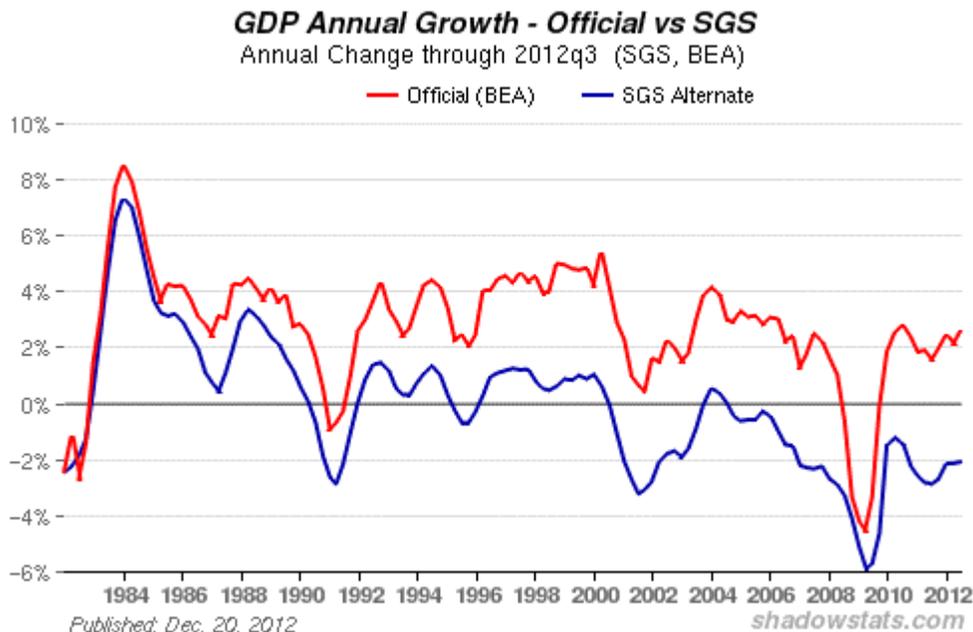


Chart #1 – Courtesy of ShadowStats.com

And in the spirit of updating past references, we include a copy of the Unemployment statistics, which while the U6 rate was still around 15% it is clear that the trend is improving, but we are still in an employment recession. Until we get people back to work we will not declare the average man’s recession over. The good news is that the Federal Reserve agrees with us and has stated that until unemployment improves and falls below at least 6.5% they will continue to maintain an accommodative monetary policy and keep interest rates low.

Unemployment - Total Labor Force

Seasonally Adjusted. Jan. 1994 - Nov. 2012 (BLS)

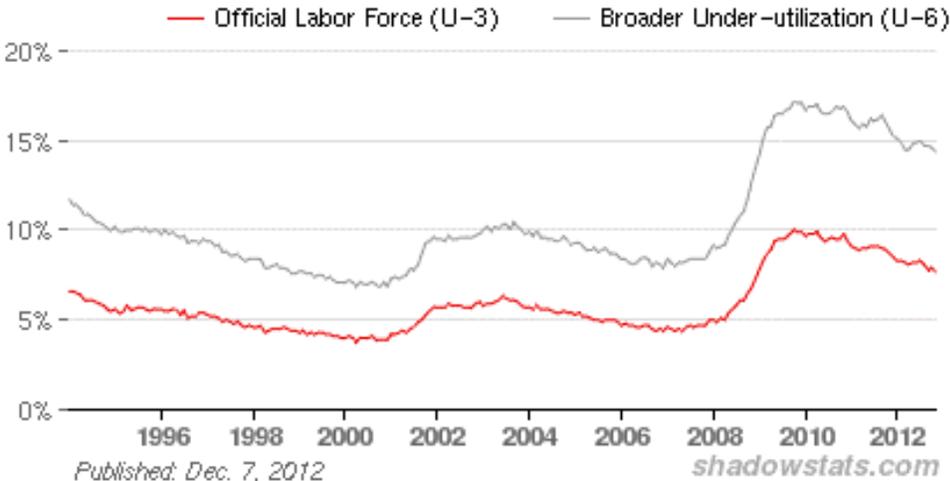


Chart #2 – Courtesy of ShadowStats.com

We believe there has been a return to financial sanity in corporate America (if not in political America). The best corporations in America are well positioned to take advantage of a stable, slow growth environment to garner additional market share and build a foundation to cement future organic growth. Absent any major, unforeseen shocks we believe the U.S. Economy will continue in recovery mode.

THOUGHTS ON EQUITIES

"We should not look back unless it is to derive useful lessons from past errors, and for the purpose of profiting by dearly bought experience." – George Washington

OVERWEIGHT

In our nascent economic recovery we see corporate boards challenged to deliver acceptable returns to shareholders. With little to no real organic revenue growth they have been using cost cutting and productivity enhancements to wring out additional profits in the past few years. At the same time they built corporate cash balances in preparation for a better business environment. We believe that absent organic growth those corporations with financial flexibility will implement strategic moves to enhance shareholder value either by divesting lower margined businesses or making bolt-on acquisitions that can be accretive in a very short period of time.

In addition, corporate board rooms are full of very cyclically seasoned, intelligent managers. We believe they will recognize that the cost of capital is at historically low rates in the bond markets. The fear of regression to the mean of rates and inflation will make today's rates too attractive for corporations not to retool their balance sheets by adding cheap debt and buying back equity. When the tax deductible cost of debt is less

than the after-tax dividend distributions paid on equity, the opportunity to increase earnings per share by reducing the number of shares outstanding will prove irresistible.

Once again, we will show various methods of valuing the market this year. These statistical valuation methods can at times result in very differing projections, and are by their very nature only as good as the assumptions used in the calculations. However, we find it interesting that this year they all seem to bring us to the same conclusion – we expect the US Equity markets to rise by over 10% in 2013. We offer the following three valuation methodologies for your consideration. (Again, same as last year. We recommend those who are not into the calculations of complex formula to perhaps pass over the next three points)

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:

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

Our input forecasts for 2013 are as follows:

$Div_1/P_0 = 2\%$, $i = 2.5\%$, $g = 3\%$, $chg\ Shares = -4\%$, $chg\ P/E = 0\%$

(We are forecasting a 2% dividend yield, 2.5% rate of inflation, 3% real growth rate in corporate earnings, companies buying back stock reducing share count by 4% & no change in P/E multiples)

Running our input forecasts through the Grinold-Kroner Model gives us an 11.5% 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 3.8 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 2.1 – still well over a reading of 1 which signals a buy for stocks.

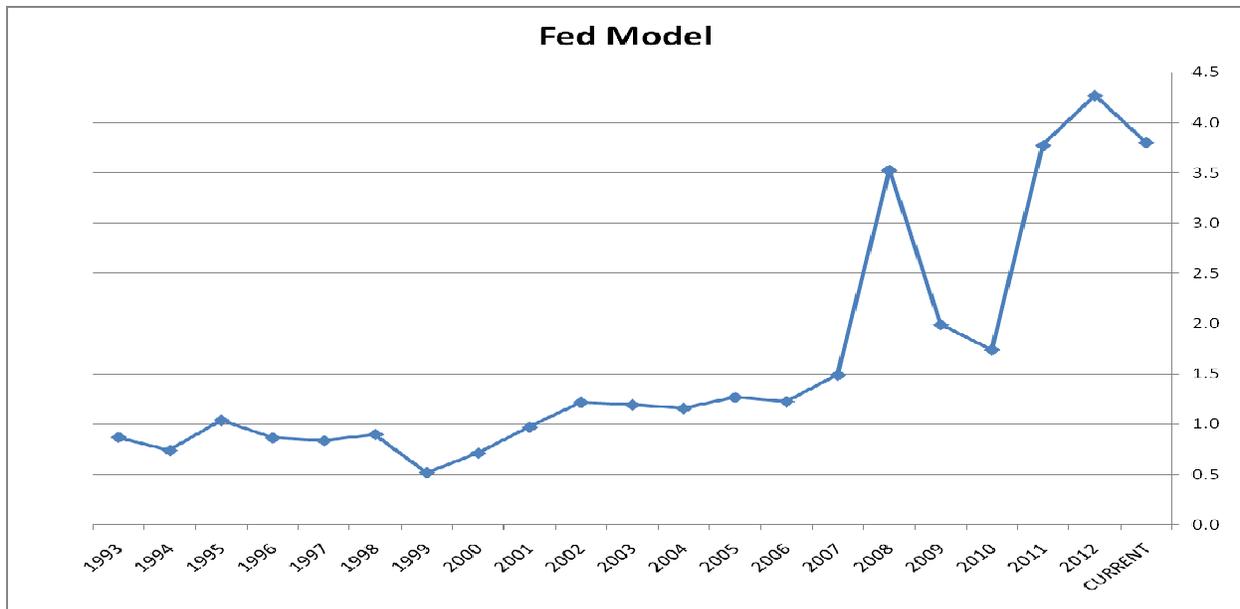


Chart created from Baseline statistics

Estimated Growth Rate: One of the simpler forms of estimating growth for a stock is to look at how much in profits the company is keeping (retention ratio) multiplied by the return the company is earning on their capital (in this case their return on equity). Currently, the companies that make up the S&P 500 index are paying out 30% of their earnings in the form of dividends. This means the retention ratio is 70%. Also, these 500 companies are currently earning 16% on their equity. Multiplying this return by the retention ratio gives us an estimated growth rate of 11.2%, which is just about in-line with our return forecast using the Grinold-Kroner model as well.

THOUGHTS ON REAL ESTATE (and Asset Based Securities)

"...out here I had been putting what little money I had in Ocean Frontage, for the sole reason that there was only so much of it and no more, and that they wasn't making any more..." – Will Rogers

OVERWEIGHT

When the printing presses of money get cranked up into full print mode, the currency will devalue and items of finite quantity will go up in price. Will Rogers said it so well with his often paraphrased comment on the scarcity of Real Estate. We would like to extend that thought process to other commodities as well that have a certain scarcity to them – Oil and Gas, Precious Metals, and Timberland are three examples. Our preference is to own those real estate and asset-based securities that will not only inflate in value due to owning an underlying finite quantity of an asset, but also pay us dividends/interest while we own them.

Commercial Real Estate has proven to be a great generator of cash flow. The long-term rents continue through tough market cycles. During those tough periods as leases

come due there can be some adjustments to the lease rates, and if they are lower than when the first lease was signed, then there can be "Roll Backs". During the past three years we were in such an environment. The good news is that with absorption of commercial space occurring and less development projects in the pipeline these lease roll-backs are abating and landlords are having to offer fewer concessions to re-lease space. Commercial Real Estate is fragmented into a number of sectors that have very different outlooks.

Multifamily and industrial properties are enjoying cap rates lower than before the recession. With long term financing available at 3% acquirers can still get a 200 basis point margin buying the properties at a 5% cap rate. There has not been development in these areas for quite some time and the space is tight so everything is lining up well – until the ten-year bond rate increases and cap rates adjust higher. We see the beginning trend of corporations bringing manufacturing back to the United States to save on transportation and logistics costs. While this trend is just starting, if our prediction of higher raw materials and energy costs plays out, this trend will accelerate.

Retail space still has to work off a large amount of excess space. As a result, the cap rates of these properties are not at peak valuations. Retail is an ever-changing environment and with the pressure of online order fulfillment, the demand for retail that declined in 2008 and 2009 has not rematerialized. We continue to avoid this sector.

Office space is still working off large amounts of excess inventory. Many of the businesses that folded in 2007-2009 and gave up their space, that space has not been reabsorbed by other businesses. Many other businesses have been actually rationalizing their space and giving unneeded space back. Only expanding as business warrants it – and the economy has not been growing. Triple net properties leased to high credit quality tenants are an exception to our otherwise avoid of this sector.

Specialty real estate such as Mobile Homes, Senior Living communities, Entertainment and education can be looked at on a case-by-case basis. Where there are significant barriers to entry and/or demographic imperatives that create long term value, we will also pay attention to those sectors.

Other Asset Based investments are beginning to become a larger focus for us as we see the fiat currency issues becoming more and more evident. As we mentioned above, we see a trend developing for higher raw materials and energy costs. Therefore, we are paying more attention to companies that own finite commodities such as oil and gas or precious metals. We do need these companies to generate earnings that are paid out to shareholders as dividends. We feel these companies have a place in portfolios as they are both competitive in this yield environment and prudent as a hedge against future devaluation of paper money.

THOUGHTS ON FIXED INCOME

"I, however, place economy among the first and most important republican virtues, and public debt as the greatest of the dangers to be feared." – Thomas Jefferson July 21, 1816

Underweight for the next decade or so!

We feel strongly that there is a "Bond Bubble" that is forming now and could be the most important financial topic of the next few years. It is so important that we intend to write a detailed special report soon that discusses it in more detail. For the moment we will leave you with the following two observations.

- Interest rates have been declining for over 30 years and absent a sustained period of deflation they have virtually no more room to decline.
- The absolute amount of government debt is expanding at an alarming rate – even before potentially higher interest rates in the future would accelerate it's compounding.

For the next year, we think it is important for everyone to understand that fixed income investments can have a negative total return. We know that those who followed the CFA level formulas on equities may find this a basic review, but bear with us please, as it is important to understand this – before it hits the value of the fixed income portion of portfolios!

With a traditional bond Investment we are dealing with several knowns. They are as follows:

- Amount of income we will receive (Coupon Payments)
- Principal amount we will receive (Amount the bond will mature for)
- Maturity date (When we will receive our principal back)

While there are several knowns in fixed income investing there remains a major unknown:

- The value of the bond at any given point in time

The change in value can happen due to a change in the credit worthiness of the lender or more likely from a change in prevailing interest rates. Our biggest fear for fixed income investors is they're not recognizing how quickly interest rates can move higher, therefore decimating the value of existing bond holdings. To illustrate this risk let's take a look at a simple example:

- Today we purchase \$1,000 of a 10-year U.S. Treasury Bond yielding 1.8% (Approximate yield as of 1/1/2013)
- After one year interest rates rise by 1% and new 10-year U.S. Treasury Bonds yield 2.8%

Our bond yielding only 1.8% will not be desired by anyone. If we need to sell our bond it needs to be discounted down so that a purchaser of the bond will receive interest and discounts equal to 2.8% per year for the remaining 9 years until it matures. On a simple basis, the bond we purchased for \$1000 will need to be discounted in price by

1% per year so the discount and the interest payments will give the buyer the 2.8% they could receive from a new bond. To summarize our bond holding:

- During the first year we received \$18 in interest payments
- In order to be comparable to new bonds our current holding would have to decrease in value by \$90 meaning our \$1000 bond would trade for \$910!
- This equates to a total return of negative \$72.

Of course the opposite is also true. Should interest rates decline, the value of the bond would increase as it is more valuable to new investors in a lower interest rate environment. This is what has happened over the past 30 years – interest rates have declined and the total return of bonds has been the interest received and the increase in value of the bonds.

From August of 2003 until November of 2007 the interest rate on the 10-year Treasury bond, in a more normal economic environment, was above 4%. With any economic recovery and renewed confidence we should see interest rates rise again. It may take more than this year to get to that yield, but as the starting interest rate is so low now, an increase in yields of just ¼% should lead to a negative total rate of return from bonds for the year.

CLOSING COMMENTS

The financial industry has always had oversight that has been there to protect the investor. And while the vast majority of the professionals in the industry have their clients' best interests always at the forefront (as we believe we do), there are inevitably the bad few that grab the headlines. In response more laws and regulations are put in place in an effort to further protect investors. We welcome and embrace the spirit of all of the regulations, rules and guidelines that are provided. There are of course unintended consequences associated with any laws and regulations. For most of the investors we work with the new regulatory mandates will necessitate our documenting information that we probably already know, but need to have in written form in our files to be in compliance with the regulations. We want to thank you in advance for your understanding and help in the process.

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".

Blake Todd
Portfolio Manager

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Associate Portfolio Manager

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