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Excerpts from Fourth Quarter 2011 Report

ECONOMIC BACKDROP AND PORTFOLIO PERFORMANCE

"…What we didn't appreciate (in 2011) were the lengths that governments would go to in order to perpetuate their failures. Global economies depend on confidence, trust, sound banking fundamentals, and truth – all of which were, to a great degree, lacking in much of the developed world. To paraphrase the famous George and Ira Gershwin song, "How long has this be going on?" is anybody's guess.

How long has this been goin' on ?
How long has this been goin' on ?

Well your friends with their fancy persuasions
Can't admit that it's part of the scene
But I can't help but have my suspicions
'Cause I ain't quite as dumb as I seem

And you said you were never intendin'
To break up our secret this way
But there ain't any use in pretendin'
It could happen to us any day

How long has this been goin' on ?[1]

Our performance was affected by thinking that confidence games played by confidence men could not be played forever. The big surprise in 2011 was that the U.S. equity markets recovered somewhat in the fourth quarter and did better than we expected.

Nowhere was economic fragility more evident than in Europe. Many countries have run up sovereign debts greater than their gross domestic product. Much of that debt is owed to banks that created private sector loans based on the belief that their sovereign bonds would perform. In 2011 the banks recognized that they hold credits of dubious quality, but stubbornly resisted taking losses. Since the adoption of a single currency (the Euro), single country devaluations, which formerly served as a clearing mechanism, have become nearly impossible without widespread pain. The banks need liquidity while attempting to unwind their excessive debts. Since their equity values have plummeted, they resist raising additional equity capital to shore up their balance sheets. Before they will be willing to make new loans, they need to address their existing portfolios. This debt spiral is highly deflationary, and yet, equity markets in 2011, while stirred, were not shaken.

[1] http://www.lyricsmode.com/lyrics/a/ace/#share (accessed February 13, 2012)

A deflation-ridden financial world is both fragile and unhealthy. Strong nations in the European Union are asked to rescue the weak members. Most assuredly, they would not do so unless they learned that their banks, with a weakened immune system, have caught the same disease, and that, if left unattended, would produce more contagion. So what is the recommended treatment? Starve the fever with localized austerity measures and feed the cold by flooding the system with more debt.

We ask ourselves, "Why are central banks creating an environment where greater risk taking is encouraged?" The Federal Reserve believes that by creating an accommodative low interest environment we can beat back deflation. They pretend that somehow our financial institutions are immune to contagion for, after all, we have the vaccine of fiat money printing as long as the U.S. dollar remains the reserve currency of the world.

The Fed claims this has worked for us, so far, so why shouldn't it work for Europe? In the meantime, if they can keep interest rates at historic lows for a prolonged period, they hope to buy time until the banks in the U.S. and Europe recover. While many see this as a liquidity driven crisis, we see it as an issue of solvency. We think it is folly to think that you can repair overleveraged, under-achieving nations by letting them borrow more.

In the latter half of 2011, the world held its breath, waiting for some resolution to problems in Greece, Portugal, Spain and Italy. It seemed like every day for months the U.S. equity markets reflected drama. It was hard to tell whether we were watching a comedy, a tragedy or both.

Given the importance and significance to Europe and the rest of the world, we felt it was only prudent to stay focused on reducing risk in the short-term, while seeking longer term opportunities based on our value orientation. In other parts of the world, not surprisingly, money creation out of thin air leads to inflation in emerging countries, particularly those in Asia, notably China, as well as Brazil and Russia. Each is dealing with inflation in different ways – credit has become tight, trade restrictions have been imposed on imports, and capital controls have been legislated.

It is little wonder that equity returns in China continue to increase while China, also based on a leveraged growth strategy, slowed down their purchases of U.S. Treasury debt. When the Federal Reserve creates debt at the same time that our nation runs a massive fiscal deficit, entities need to show up at our government's periodic debt auctions. In the recent past, auctions of U.S. government securities have relied increasingly on foreign purchasers – most notably the Chinese. The interest paid on the debt, until recently, offset any possible deterioration of the principal. With massive issuance of debt, confidence has been shaken in our long-term ability to honor those obligations without printing our way out of the problem. Foreign purchasers have begun to figure this game out. We purchase their goods and services and run trade deficits and, in exchange, they take back a growing mountain of debt that pays them an insufficient amount of real interest to compensate for the risk. When the Federal Reserve decided that it had to intervene with further stimulus, much to the Fed's dismay, longer term interest rates began to rise to reflect the reality that the U.S. is exporting inflation. The response from our trading partners initially was money tightening. Their next response, though, has been to demand greater fiscal responsibility and higher interest rates. Higher rates can choke off the fragile U.S. recovery and dampen returns in global markets. For the time being, the Fed's quantitative easing program has succeeded in convincing U.S. treasury investors to move off the sidelines into the equity markets. The Fed claims that they have the situation under control. The orchestrated policy that has made investments in the U.S. equity market appear to be more attractive on a relative basis is, in our opinion, responsible for a large part of the improved price level of the U.S. equity markets in the last two months of 2011….

Throughout 2011, we remained skeptical that accommodative monetary policy would counteract deflationary forces. However with the expenditure of over $2 trillion some cyclical recovery did in fact take place, not enough to impact the structural problems, but enough to create some impetus to the U.S. economy. When you create new debt to add to old debt at a faster rate than the growth in GDP, theorists tell us that there should be acceleration in economic output until the outstanding debt exceeds the GDP. In the U.S., we have reached debt equal to the annual GDP. At best, the real GDP growth will remain tepid and unemployment stubbornly high….

The only strategy in that environment that makes sense would be to find equities that have part of the expected total return come from cash flow that benefits patient holders with dividends and to a lesser extent share buybacks….

We also anticipated that the market would be far more volatile than it turned out to be. We do not share Wall Street's conventional belief that the global economy has recovered sufficiently to justify the price level of equities generally, particularly in the developed world (U.S. and Europe). As value investors, we maintain a cautious posture. We continue to emphasize tactical allocation to cash in spite of the lack of yield as a means to mitigate risk. During the year, we noted a need for caution during this heightened period of uncertainty….

MARKET REVIEW

During 2011, our patience was tested and we approached investing with caution. We continued to believe that investors would behave rationally. We believed that interest rates on Treasuries would rise as the economy improved, existing bonds would lose principal value as the yield curve steepened and equities would only perform relatively well, if the nation dealt with its structural issues. As the months went on, the growing consensus was that the cyclical recovery was tepid at best.

Deflationary forces remained the primary focus of the Federal Reserve and the Treasury as they attempted to get the banks to lend and deal with unemployment. Deleveraging the massive debts of the past forty years takes time and weighs on the pace of economic recovery. Instead of a normal recovery, the Federal Reserve announced Operation Twist in an effort to maintain short-term interest rates at, effectively, zero. Real Estate values remained depressed, unemployment high, industrial capacity under-utilized and demand suppressed.

Only after stating that this zero-interest-rate policy would go on through at least 2014 did the equity markets get the signal that the *risk on* trade would be rewarding. An era of the new asset bubble – the stock market was the place to be. The Federal Reserve would see to it – you need not know much more.

Fiscal 2011 was not the year that rewarded stock picking and safe haven assets with the exception of U.S. Treasuries and the dollar. Globalization based on expansion didn't help investments in China, Brazil, and India, which fell substantially. Nowhere was this truer than observing the problems in Europe. Fortunately, when we saw how each sovereign nation was dealing with the problems common to them, we cut back on our commitment to the global scene. While we believe that commitments to economies outside the U.S. will work out long-term, the short-term picture is blurred by excess debt and leverage, inflation expectations, capital controls and strained financial resources.

ISSUES AND CHALLENGES FOR 2012-2013

'More than any time in history mankind faces a crossroads. One path leads to despair and utter hopelessness, the other to total extinction. Let us pray that we have the wisdom to choose correctly.' (Woody Allen) The near-term focus for 2012 will be on deflationary forces in the housing market and measures to improve employment. Lest we forget to mention it, the Obama administration wants four more years to bring about change in everyone's lives. Keynesian economic policies are at odds with prioritization of debt reduction or reduced taxes, investment incentives and reduction of entitlements. The hope is that the direction of the country will be settled at the ballot box. Only one thing is near certain – the country will remain divided no matter what the outcome of the November elections.

As we attempt to wind down the nation's engagement in two costly wars in the Mid-East, the budget deficit still exceeds $1.2 trillion dollars in fiscal 2012. These deficits will need to be financed.

Higher levels of debt are debilitating – diverting resources away from growth. If it were not enough, gross debt in excess of 100% of GDP is a near certainty. What is more troubling is the real debt when the present value of unfunded liabilities is put on the nation's balance sheet. By some measures, the unfunded liabilities in Social Security and Medicare are at least four times current GDP and growing.

We believe this realization makes investments in U.S. government debt (with the exception of inflation-protected securities) a fool's game, currently making bonds a difficult asset class in which to invest. Franz Pick termed government bonds as legalized certificates of confiscation.

Faced with the grim reality that doing nothing is no longer a strategy, we believe that 2012 will be the first year on the road to sanity. Before we can stop the "MERRY-GO-ROUND" of more bailouts, more deferrals of decisions and more denials of misdeeds in the world of pretend and extend, we need leadership to recognize that the structural elements in our system are more in need of replacement rather than repair.

We believe 2012 is the year when you and we get to make choices between the perpetuation of failed policies and common sense. We believe that there are checks and balances on the promises that have been made and not honored. The focus will be on the sectors and companies that stand to benefit from elections of officials who choose reality over fantasy….

At this juncture, however, calling this coin flip while it is still in the air is dangerous. Rather, we need to pay attention to what the markets are telling us and less on the words of those that favor getting elected over getting things done – Politics over Progress.

We believe that 2013 will be the year for action, shared sacrifice and recognition of the importance of the individual in society. If you believe as we do that the freedom we enjoy in this country is all about choice, then freedom we will have.

With less government interference, certain market sectors will do much better than others. This is the year we get to find out whether we are in a Constitutional Democracy, that the rule of law is backed by justice, or we tear up the Constitution and write a new one.

That observation is the lens through which we will gaze at each sector and investment candidate. The ultimate question is whether we observe that our citizens will remain free to pursue their individual aspirations or become ever more dependent on government.

There is something about the American spirit which leaves us thinking that freedom will win out. Call us cockeyed optimists as the song goes.

> *I have heard people rant and rave and bellow*
> *That we're done and we might as well be dead,*
> *But I'm only a cockeyed optimist*
> *And I can't get it into my head.*
>
> *I hear the human race*
> *Is fallin' on its face*
> *And hasn't very far to go,*
> *But ev'ry whippoorwill*
> *Is sellin' me a bill,*
> *And tellin' me it just ain't so.*
>
> *I could say life is just a bowl of Jello*
> *And appear more intelligent and smart,*
> *But I'm stuck like a dope*
> *With a thing called hope,*
> *And I can't get it out of my heart!*
> *Not this heart...*[2]

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[2] http://www.allmusicals.com/lyrics/southpacific/acockeyedoptimist.htm (accessed February 13, 2012)

No, the world is not going to end on December 21, 2012 as predicted by the Mayans, but it is going to be different come 2013 and beyond.

OUTLOOK AND STRATEGY

There are two hearts beating inside of us. One that listens to rational economics instead of hype, spin and propaganda, and one that responds to market trends in an attempt to capitalize on events. In 2012, a presidential election year, we are listening attentively to the promises of a better tomorrow made by politicians, bankers, and corporate executives, many of whom are engaged in wishful thinking at best, and deception and duplicity at worst. Seldom are promises made with the intent of making people feel good ever kept.

If we try to separate reality from the wishful portrayal of economic conditions better known as Government statistics we find inconsistencies – for example, inflation reports that ignore the rapid rise of core inflation in food and energy or unemployment statistics that do not include people who are no longer looking for jobs. It is entirely possible that these inconsistencies are intentional contrivances to make people feel better. It works for a time but eventually truth wins out. We believe that it is better to know the truth than to buy into the lie. We believe that the aftermath of deleveraging, initially, will unleash deflationary forces that are not easily overcome by monetary stimulus. The Federal Reserve holds a different view, i.e. that more debt needs to be created, price stability can be targeted, interest rates can remain low, and that deficits can be fought by changes in fiscal policy and Fed action. The markets have less and less confidence in orchestrated central bank initiatives and, as a result, economies in the developed world may not grow at above historic trend. We tend to listen to the markets rather than political pundits and muddled thinking optimists. It is times like these that turn skeptics into cynics. For the time being, we believe we will see a period where investor euphoria overtakes disillusionment…

any recommendations herein, in the securities or options of the issuers mentioned herein and may serve as directors of such issuers.

FORWARD LOOKING STATEMENTS

This discussion and analysis contains certain forward-looking statements and projections that involve a number of risks and uncertainties. Actual events or results may differ materially from the expectations and projections. Past performance does not guarantee future results. Market and other risks may affect the actual results achieved by accounts or investment vehicles managed by IPAM and/or its affiliates.