COMMENTARY 2012 Q2

Inverness
Counsel

After strong first-quarter performance, equity markets retreated as European macroeconomic concerns once again resurfaced, reigniting market volatility similar to what we experienced last summer. Despite this ongoing uncertainty, we remain constructive on the long-term outlook for the U.S. economy and corresponding equity markets.

Although the S&P 500 Index declined just 2.8% for the second quarter, equity markets performed quite differently throughout the quarter. Following a relatively stable month in April, equities declined nearly 10% into early June as macroeconomic fears reemerged in the markets, and then subsequently rebounded nearly 7% as these fears subsided.

This quarter also marked another shift into defensive sectors (Utilities, Telecommunications, and Consumer Staples), which all outperformed the index. These were among the worst performing sectors in the first quarter. In the second quarter, higher-beta sectors, such as Technology, Financials, and Materials, all underperformed the index. The Energy sector again lagged the broader index, as oil prices have declined over 20% from their recent peak.

The U.S. Remains on the Long and Winding Road to Recovery

U.S. economic activity will undoubtedly continue to fluctuate from quarter to quarter; nonetheless, we remain positive on the outlook for the U.S. economy. The housing market appears to have bottomed, and record-low mortgage rates are providing additional support. Gasoline prices, after rising dramatically in the first quarter of 2012, have declined nearly 12% from their recent highs, and prices are expected to ease further as we head into the peak summer driving season. Commodity prices have softened with declining emerging market demand, and inflation remains benign. The Federal Reserve is also prepared to provide additional stimulus as necessary and recently extended "Operation Twist" to keep interest rates low.

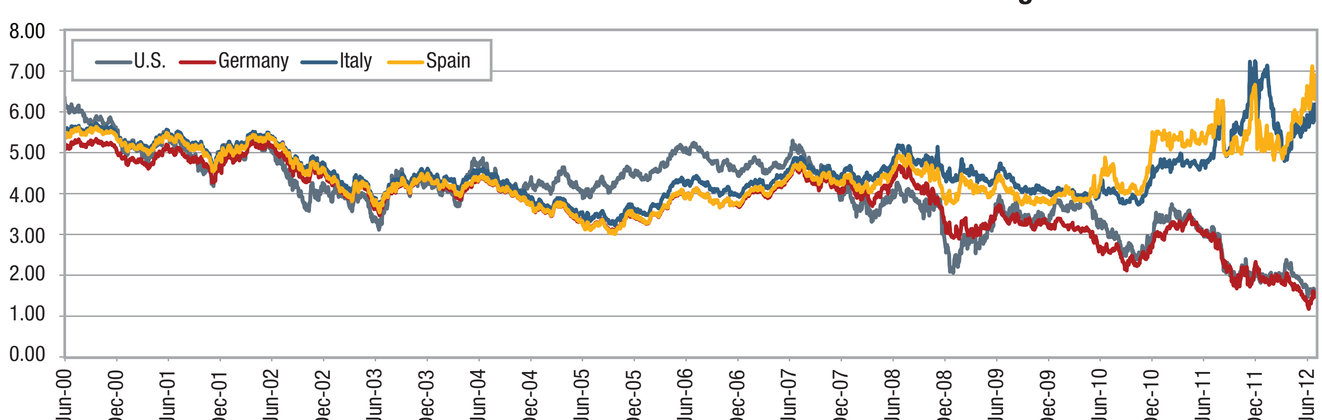
Given these factors, economic growth is expected to accelerate in the second half of the year; however, the recent rate of improvement appears to have moderated. Key economic indicators such as gross domestic product (GDP) growth, consumer spending, and job creation came in below expectations during the second quarter. Companies appear to be a bit more conservative regarding their near-term outlook due to the ongoing debt crisis in Europe and the political and fiscal unknowns in the U.S. While a significant portion of this caution is likely related to macroeconomic events in Europe rather than domestic concerns, management teams and investors remain focused on the presidential election and the looming "fiscal cliff" (a combination of tax increases and spending cuts scheduled to take place in 2013). These concerns have resulted in record corporate cash balances, as management teams want to be prudent in the face of global uncertainty. When some of these current headwinds subside, we could see a meaningful increase in dividend payouts, share repurchases, and merger and acquisition activity as borrowing costs remain low and equity valuations well below historical levels.

It Must Be Déjà Vu—A European Financial Crisis

The events that unfolded across Europe during the month of May looked eerily similar to the developments that occurred last summer. Greece was once again seeking assistance with its financial restructuring, as the country's debt burden remains unsustainable. Contagion fears spread across Europe, in particular to Spain and Italy, resulting in increased economic uncertainty and market volatility. Spain was forced to seek outside support in the form of a €100 billion ($125 billion) loan to fortify its banking sector. Overall, the perceived pro-European Union results from the Greek elections and the Spanish banking sector bailout have done little to ease investor concerns.

As the chart below indicates, investors continue to flock to safe-haven investments such as German and U.S. Treasury bonds (with the 10-

10 Year Government Bond Yields – Rates Continue to Diverge



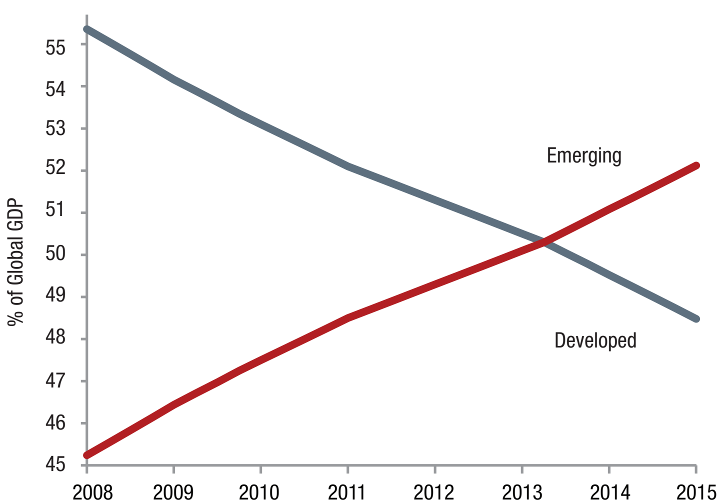
Source: Bloomberg

year U.S. Treasury bond yield reaching an all-time record low of 1.45% in early June), while Spanish and Italian government bond yields are at record-high levels.

Although programs such as the LTRO (Long-Term Refinancing Operation) and other short-term lending packages are an important bridge, structural reform will likely be required in order to fix the fundamental issues in Europe. Until such changes are enacted, we will continue to face these periods of macroeconomic unrest. As we stated in our 2011 Q2 commentary, "*difficult decisions will be required in order to see meaningful and lasting resolution to these issues.*"

Decelerating Emerging Markets Could Hamper U.S. Earnings Growth

Emerging market economies have been a major source of economic growth both on a global scale and for U.S. based companies over the past decade. Today emerging market economies account for nearly 48% of global GDP, and by 2014 they will overtake developed economies as the largest contributor.



Source: World Economic Outlook Database, International Monetary Fund

Much of this growth has come from the largest emerging market countries, known as the BRIC nations (Brazil, Russia, China, and India), which combined represent 26% of global GDP compared to just 20% from the United States. However, these countries have recently begun to experience a noticeable slowdown in the growth rate of their respective economies.

The Chinese economy (the second-largest economy, accounting for 14% of global GDP) in particular has experienced a meaningful deceleration. China could face added pressure if the situation in Europe further deteriorates, as Europe accounts for over 20% of China's total exports. Our concern about a slowing Chinese economy was one of the primary reasons we reduced our Industrials and Materials exposure earlier in the year.

U.S. corporations across almost every industry and sector have made significant investments in emerging markets and expect a sizable amount of future earnings growth to come from these regions. Possible further deceleration of economic growth for these nations over the next several quarters or even years would undoubtedly impact U.S. corporations. However, the BRIC nations have begun to take action to stimulate their economies, and these nations have substantial capacity to support their respective economies.

Course of Action

In response to the recent market volatility, we have taken a more proactive approach to managing our equity positions. While we continue to seek to identify companies that can outperform over a multiyear time period, stock fluctuations, in both directions, have intensified given the current environment, encouraging us to be more nimble in our decision-making process.

During the quarter, we increased our cash balances through a reduction in Technology sector holdings, as the outlook for enterprise IT spending has deteriorated. At the same time, we have slightly increased our exposure to the Financials and Healthcare sectors, as we continue to see long-term value in premier global franchises in these sectors.

While each investment is judged on its own individual merit, there continue to be common themes found throughout our portfolios. Themes on which we are focusing today include the emergence of a global middle class, the downstream implications of record U.S. corporate cash balances, and the impact of social networking in a constantly connected world.

We are also exploring the potential for a renaissance of the American manufacturing industry. Major advances in the discovery and extraction of natural resources have generated significant natural gas and oil findings within the United States. At the same time, wage rate inflation in export-oriented emerging market nations has dramatically increased, resulting in a narrower spread in wages compared to the United States. Corporations that previously outsourced manufacturing activities to other regions across the globe will likely begin to consider returning these functions to the U.S. in order to take advantage of lower domestic energy input prices and the shrinking wage gap. Ultimately, a resurgence in domestic manufacturing activity would result in a meaningful increase in total job creation and an acceleration of U.S. economic growth.

845 Third Avenue
New York, NY 10022

www.invernesscounsel.com

(212) 207-2122

Inverness
Counsel