COMMENTARY 2011 **Q3**

Inverness
Counsel

During the quarter, the global markets experienced a significant increase in volatility as prospects for growth turned into fears of a global recession and a possible financial crisis in Europe. Investors quickly sold equities, with little regard to the fundamentals. As long-term investors, we view times like this as an opportunity.

The S&P 500 declined 14.4%, its worst performance for the third quarter in nearly a decade. This follows the first quarter of the year, which was the best first quarter return in over thirteen years. The range of these market movements illustrates the current increased volatility in the equity markets. Year to date, the S&P 500 return now stands in negative territory, declining 8.7%, including dividends.

Although this decline is considerable, the S&P 500 actually outperformed most global indices during the third quarter. For example, the German DAX index declined 25.4%, the MSCI Emerging Market index declined 23.1% and the MSCI All World index declined 17.6%. Outside of U.S. Treasury bonds, there were very few places in the world to hide.

From a sector perspective, the performance trends we experienced last quarter continued in the third quarter. Defensive oriented sectors (Utilities and Consumer Staples) outperformed the broader market, while growth concerns weighed on economically sensitive sectors (Industrials and Materials).

Global Uncertainty Weighs on Economic Growth

The market's sharp decline in late summer was fueled by slowing global growth concerns coupled with renewed fears of a European sovereign debt crisis. Although the downside risks have increased, we think it is unlikely that the U.S. will experience another deep recession similar to 2008.

Through the first three quarters of the year, U.S. economic data (GDP growth, consumer confidence, and job creation) is running below the Federal Reserve's expectations. Some of this weakness can be attributed to further deleveraging by the consumer. Today, the consumer accounts for close to 70% of U.S. economic activity versus its historical average of 65%. The deleveraging process could take years and may result in slower economic growth.

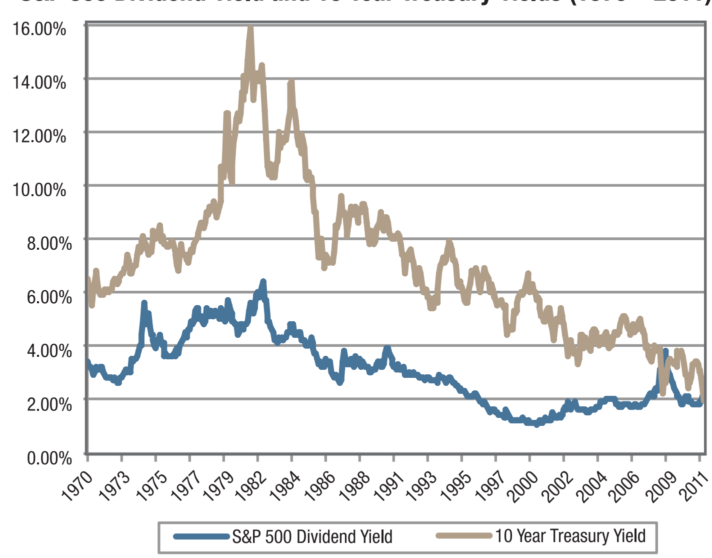
Today the hundred largest companies in the S&P 500 generate nearly 45% of their revenue from emerging markets. These markets have been an important engine for growth, but have recently slowed due to higher interest rates and economic weakness. In Europe, fears of financial crisis have escalated as the potential for Greece and other European nations to default on their sovereign debt has increased.

Despite these factors, we think the state of the global economy and outlook for equity markets are not as bleak as some have indicated. The U.S. economy is still expected to grow in the fourth quarter and strengthen in 2012. Resolution of the European financial crisis should begin to take shape with a possible recapitalization of European financial institutions. Furthermore, many emerging market countries have strong balance sheets and have started to take the necessary steps in order to stimulate growth.

Additionally, corporations are in much better shape financially today than they were in 2008. Balance sheets have been restructured through debt reductions and refinancings at significantly lower interest rates. Cash balances are at record highs and profit margins continue to expand as management teams shed underperforming assets.

At the same time, the dividend yield on the S&P 500 now exceeds the yield of the 10 year Treasury bond. This has only occurred twice in the past forty-one years. Equity valuations are well below historical averages and interest rates are at record lows. Inflation has

S&P 500 Dividend Yield and 10 Year Treasury Yields (1970 – 2011)



Source: Bloomberg

proven to be much less of an issue than originally anticipated and the Federal Reserve has vowed to keep rates low through 2013.

While we remain constructive, we continue to monitor events closely to determine if global macro-economic conditions warrant further changes. Key items we are focusing on that could change our view include the availability of credit, unexpected changes in government policy, unforeseen changes in inflation, and significant changes in company fundamentals.

In Times of Trouble - U.S. Still Safe Haven

Today the two major political parties appear more polarized than in recent memory. This was clearly evident during July's debt ceiling debate with Democrats pushing for increased taxes while Republicans focused on cuts in entitlements. With the entire world watching, an eleventh hour compromise was reached with additional cuts to be determined by a bi-partisan subcommittee.

In the wake of the agreement, Standard & Poor's downgraded the U.S. credit rating as the deficit reduction plan fell short of its target. This set off a sharp decline of U.S. equity markets over fears that higher borrowing costs and imposed austerity measures would impact future economic growth.

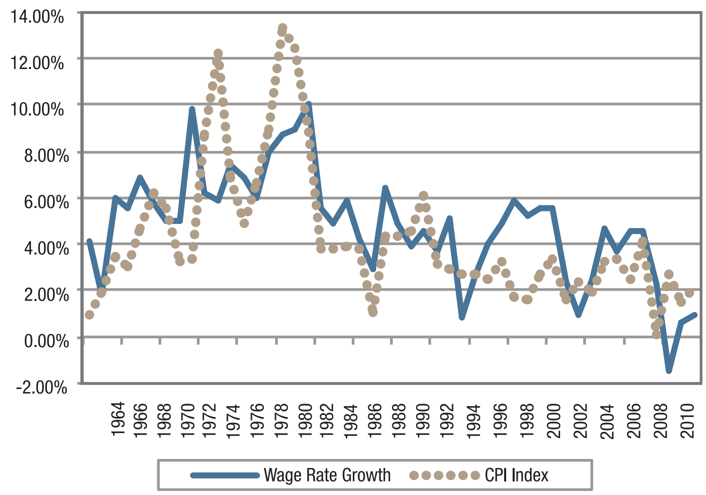
The longer term consequences of the downgrade remain unknown. Interest rates in developed markets along with investors' appetite for risk are both exceedingly low. As markets stabilize and risk tolerance increases, we may see capital outflows from U.S. Treasuries resulting in higher interest rates. This could put added pressure on the dollar and force the Federal Reserve to act.

Inflation Concerns Appear to be Easing

Entering this year we were concerned that rising commodity prices along with the Federal Reserve's quantitative easing programs would generate higher inflation. However, in spite of the Federal Reserve's efforts, increases in the Consumer Price Index (CPI) have remained subdued. Until we begin to see a meaningful decline in unemployment coupled with wage increases, inflation has likely peaked in the near-term and should trend lower through the end of the year.

Rising commodity inputs have had the greatest impact on inflation this year. However, over the past six weeks, commodity prices have experienced sharp declines as the outlook for global demand has weakened. Corn, wheat, and soybean prices have all declined nearly 25%, while oil prices have declined 20% and are back to their September 2010 levels.

Annual Wage Rate Growth and CPI Index (1964-2011E)



Source: Bloomberg, www.socialsecurity.gov, Inverness Counsel LLC

Course of Action

Since the spring, we have held larger than normal cash balances as we found it increasingly difficult to identify compelling investment opportunities. We have started to put this cash to work. We have selectively increased our weighting in leading global franchises that continue to execute in this challenging environment and have reduced our exposure or eliminated positions in companies that are experiencing fundamental changes in their end markets.

We remain underweight the financial sector and think the Federal Reserve's latest tactic, "Operation Twist," will put added pressure on banks' earnings power. We are also incrementally more cautious on companies exposed to reduced government spending.

Common characteristics among the companies in our portfolios include secular growth leaders in their respective industries, companies that are proactively utilizing cash balances either through increased dividends, share buybacks or accretive merger and acquisition activity, and companies that are able to monetize their competitive advantages. Overall, we continue to focus on identifying companies that offer compelling growth opportunities at attractive valuations.

845 Third Avenue
New York, NY 10022

www.invernesscounsel.com

(212) 207-2122

Inverness
Counsel