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COMMODARI ANTINORI GROUP

SAFEGUARDING YOUR WEALTH

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"It is not work that kills men, it is worry. Work is healthy; you can hardly put more on a man than he can bear. But worry is rust upon the blade. It is not movement that destroys the machinery, but friction."
– Henry Ward Beecher

Equity markets in 2011 behaved like a pot of chili bubbling away on a stove top: the same issues kept coming to the surface, only to simmer back into the pot for a while until rising to a boil again.

Indeed, rising unemployment and tepid economic growth, failed debt reduction deals in Washington, the downgrade of U.S. debt and the saga of seemingly ineffective bail out deals in Europe left many with a bad case of indigestion as markets experienced some of the worst volatility in decades.

In the case of the S&P 500 Index, the cumulative difference each trading day between the high and low was 5,732 points. This number is 32 percent higher than it was in 2010 and more than double what was posted in 2006.[†] Despite this flurry of activity however, the index failed to move forward and ended the year only 0.04 points higher. Perhaps we should add whiplash to the list!

For the year ended December 31, 2011, the total returns in Canadian dollars for the S&P/TSX Composite and the MSCI World Index were negative 8.71% and negative 2.88% respectively, while the Standard & Poor's 500 managed to creep out a gain of 4.41% - thank heavens for dividends.

In contrast, and in keeping with our long-term track record, portfolios managed by Commodari Antinori Group posted excellent results in 2011. These results are the product of adhering to a clearly defined set of investment principles and, more importantly, having the courage and conviction to keep emotion from corroding those principles. As always, we encourage you to review your enclosed *Portfolio Review* along with our commentary and we welcome your thoughts.

A WORLD OF WORRY

Many investors steer clear of taking important actions with their investment portfolio, because they are afraid, that in hindsight, they will make the wrong decision. At times this inability to take decisive financial action can cause you to be too conservative or rather too aggressive. In either case, the outcome is the same, poor results.

Given the sombre headlines and political rhetoric we are constantly exposed to, it is easy to see how such paralysis can occur. In our adult lifetime, we have listened to implacable predictions of growing poverty, coming famines, expanding deserts, imminent plagues, impending water wars, inevitable oil exhaustion, falling sperm counts, thinning ozone, acidifying rain, nuclear winters, mad-cow epidemics, Y2K computer bugs, killer bees, sex-change fish, global warming, and so on.

Why is it that when we see nothing but improvements behind us, are we to expect but deterioration before us? The answer is human nature and sadly, when it comes to investing, it is counter productive.

One look at the historical measure of consumer confidence is all that we need to prove our point. In each case going back to 1967, when consumer confidence reached their lowest levels (1974, 1982, 1992, 2008), investors shunned equities and subsequent returns as measured by the S&P 500 were above average. Inversely, in each case where confidence was at it's highest – most recently 2000 – investors piled into equities and subsequent returns were quite modest.

Source: www.tradingeconomics.com | Conference Board

Based on a normalized confidence level of 100, the current sentiment still remains quite pessimistic and thus returns going forward promise to be above average.

As we wait for sentiment to reverse itself, how can we prevent fear from overruling reason and thus make rational decisions. For starters, it helps to remember that the financial media have business reasons to make us believe that the world will soon become unravelled and that we need to follow every zig and zag of the market to stay one step ahead. That is not so!

All we need do is continue to apply the same approach that has worked for us in the past and remember to always be accommodating. When others want to sell in a panic, we should accommodate them and buy. When everyone wants to buy in a frenzy, we should accommodate them and sell.

DIFFERENT THIS TIME – REALLY?

Recent volatility has led many to believe that the future seems uncertain in ways we have not experienced during our lifetimes. In turn, this has fuelled a perception that stock markets are unfriendly and that *it's different this time*.

Of course, no one can say for certain what our economic future will look like just like no one can predict general stock market or business fluctuations – sorry to disappoint. What we can do is apply the perspective that we have gained from managing money over the years. In doing so, we realize that often what is termed unprecedented has occurred many times before.

We point to an excerpt from an article printed in the Financial Analyst Journal. Here is what was written: "I think the future of equities will be roughly the same as their past … It may be objected that it is far too cursory and superficial a conclusion; that it fails to take into account the new factors and problems that have entered the economic picture in recent years – especially those of ... the movement towards less consumption and zero growth. Perhaps I should add to my list the widespread public mistrust of Wall Street as a whole, engendered by its scandalous behavior during recent years in the areas of ethics, financial practices of all sorts, and plain business sense."

The most interesting thing about this excerpt is the date it was published. It was September 1974, and the excerpt was a written account of a speech given by Benjamin Graham in June of that year. The similarities to present day are striking. We have no doubt that the wisdom imparted in the article back then was ignored by its readers because, then like today, "things are different this time."

BONDS AND THE MANAGERS WHO CRIED WOLF

Today, with yields that are at historic lows, what makes the least sense to us is how anxious investors are to allocate money to long-dated bonds. Mathematically, it's impossible for these bonds to deliver the same total return going forward as they have in the last decade. Even if rates went to zero, past returns will not be duplicated!

You would be correct in recalling that we warned about the dangers of long bonds a year ago and yes, we are indeed aware that this asset class trounced stocks in 2011.

A year ago we believed that bonds had yields that offered insufficient reward for exposure to the risk of future inflation. Today bonds have an even lower yield than they did a year ago – the yield is less than 2% on a 10-year Treasury. Thus we believe that bonds are even more overvalued than they were a year ago and we continue to warn whoever is still willing to listen that they will be a poor investment choice going forward.

Like many of our past warnings, we may have been a little early in our sounding of the alarm, but that doesn't mean there's no trouble around the corner. To paraphrase the always quotable Charlie Munger, "if you jump out the window at the 42nd floor and you're still doing fine as you pass the 27th floor, that doesn't mean you don't have a serious problem." Owners of long-term bonds heed our warning. Based on current levels, bond prices have nowhere to go but down!

FOREIGN EXCHANGE

The ongoing worries surrounding the Euro and its effect on currency markets have led some investors to question the investment merits of owning foreign denominated stocks.

Our view remains unchanged. We believe that in time returns on foreign stocks will cancel out currency movements and thus, at the right price, we will never hesitate to invest in a company denominated in a foreign currency. After all, exchange rates are determined by relative inflation between countries, and stock returns will eventually compensate investors for this difference in inflation. So when it comes to currency, we are agnostic.

COMPANY DEVELOPMENTS

Fundamental to what we do is the simple insight that a share of a stock is a fractional share of a real business. These businesses are adaptive, competitive organizations with enormous financial and human resources that are able to constantly adjust to changing circumstances and markets. If the company does well, so too should the stock in time. Based on developments at our companies last year, we can confidently say that the future looks bright. Here are just some of the most noteworthy tidbits.

Omnicom Group – Once again, Omnicom agencies dominated the spotlight at this year's Digital Media Awards in Beijing, sweeping 11 out of 16 Golds, the Platinum award, and the Digital Agency of the Year title. Keep it up boys!

Wells Fargo – Credit quality continues to rebound. Measures for net charge-offs, loan losses, and nonperforming assets improved in the last quarter, marking the fourth consecutive quarter that all three metrics headed in the right direction. More importantly, after slipping for two straight years, loan growth has resumed and Wells' credit metrics are at their strongest position since early 2009.

Unilever PLC – Completed the purchase of Alberto Culver for 3.7 billion in cash. This business generated $1.6 billion in sales last year and adds a stable of leading beauty and personal care brands to Unilever's portfolio, the most notable being Alberto VO5. The move should provide a big boost for Unilever in its hair-care categories and prove to be highly profitable. All we can say is "Ooooh Alberto!"

Walt Disney – Successfully issued more than $1.8 billion worth of corporate debt in August. The offering saw the lowest ever coupons for bonds with maturities of five, 10 and 30 years at a mere 1.35%, 2.75% and 4.375% respectively.[‡] Talk about cheap financing. Flush with cash from their recently completed $663 million sale of Miramax studios, Disney plans to use the proceeds of the bond offering to fund a much higher returning share buy back.

General Electric – Profits from the consumer lending business continue to soar as losses on financing receivables fall. More importantly, General Electric continues to experience strong order growth in their core infrastructure business with orders rising 24% year-over-year and backlogs soaring to a record high $189 billion. Much of this growth is bolstered by their rapid expansion in international markets, such as India, China, and Australia.

CONCLUDING THOUGHTS

Today, we have the opportunity to buy high-quality stocks with yields that are much higher than bond yields. So are investors tripping over themselves to take advantage? Far from it. Investors continue to decrease their investment in large-cap equities. The headlines read "Buy and Hold Is Dead," "U.S. Investing: Are the Best Times Over?" and "Bury Buy and Hold." The newest fear seems to be volatility. The market is up 2% one minute and down 2% the next. Investors see the short-term results as being like a casino and they are scared.

How long this will last is anyone's guess. The proliferation of derivative and synthetic products has introduced more distortion to an activity that used to be much more closely associated with the fortunes of real businesses and real economies. In the end of course, fundamentals will prevail. In the meantime we have to focus on what we can control, which is where and how we invest!

Never forget, no matter how serene today may be, tomorrow is *always* uncertain. Don't let that reality spook you. We hope the story of how we have successfully invested over the past 16 years gives you the courage to block out the "this time is different" mantra and allows you to take advantage of what we believe is a generational opportunity for equity investors.

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Source: †Bloomberg, ‡Reuters.