Commentary - 4th Quarter 2011

How disappointing! After all the anxiety producing volatility last year, we enter the New Year with the S&P 500 Index virtually unchanged from December 31, 2010. We suffered through all the pain and have nothing to show for it! Who's in charge? We need to demonstrate or occupy something!

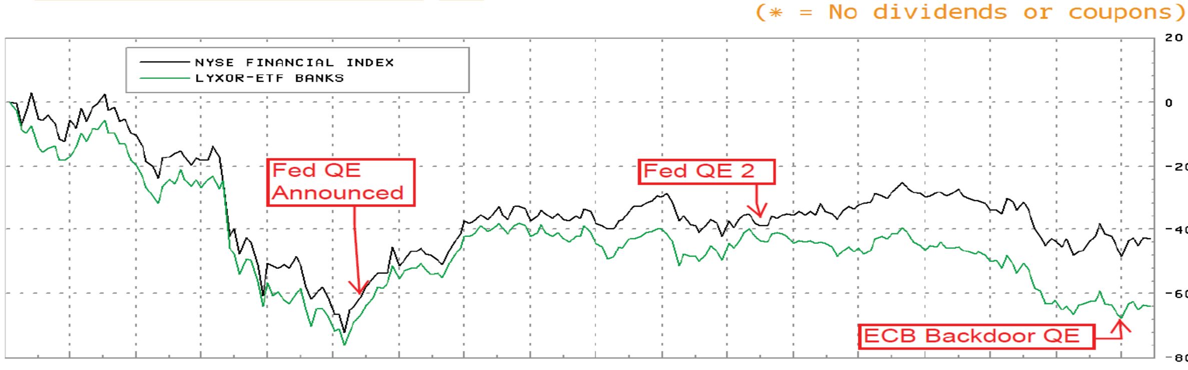
This time last year we were optimistic that the economic recovery was gaining momentum. The recurring European debt problems, the Japanese earthquake and the Mid-East revolts against dictators stopped that momentum and when we were faced with a potential U.S. default on our debt because our representatives in Washington could not reach a mature compromise, another slowdown in the economy was at hand. The third quarter was brutal. The fourth quarter was almost as volatile, but the domestic economic reports came in stronger than expected. Additionally, after the European leaders completed their millionth emergency meeting and agreed to speed up their austerity measures, the European Central Bank (ECB) launched a backdoor version of quantitative easing. The ECB program allowed banks to borrow up to three years by posting collateral against loans at the ECB. Also the ECB lowered the quality standards of the collateral they would loan against making it easier to obtain credit. The latest round of ECB lending was over $500 billion. Many European banks used this opportunity to borrow from the ECB at low fixed rates for three years and finance their holdings of European sovereign bonds that had dropped in value. This exercise buys the banks time to shrink their balance sheets or raise capital in an orderly manner. Much like the U.S. Federal Reserve's quantitative easing program pumped money into the financial system and helped stabilize our banks, the ECB version should reduce the panic in the European financial markets and buy them time to allow the other EU financial programs to support the banking system. The European debt problems are far from solved, but at least they may have bought time to work through them without another disorderly credit crisis. Fears of a European credit crisis damaging U.S. money center banks caused the drop in bank stock values in the second half of 2011. We have enjoyed a month of stability since the ECB announced their easing measures, as shown on the following graph. Now the European governments must pass budgets that are more fiscally responsible and figure out ways to make their labor sectors more productive. The only way out of their dilemma is to promote economic growth through economic liberalization. Otherwise the path to default lies straight ahead.

Graph 1. NYSE Financial Index & European Bank Index Historical Performance, Source: Bloomberg

Range 1/ 4/08 - 12/30/11 Period W Weekly 208 Wk. Period

	Securities	Crncy	Prc Appr	Total Ret	Difference	Annual Eq
1	NYK Index	USD	-48.53 %	-42.87 %	20.71 %	-13.09 %
2	BNK FP Equity	EUR	-67.49 %	-63.57 %		-22.37 %
3						

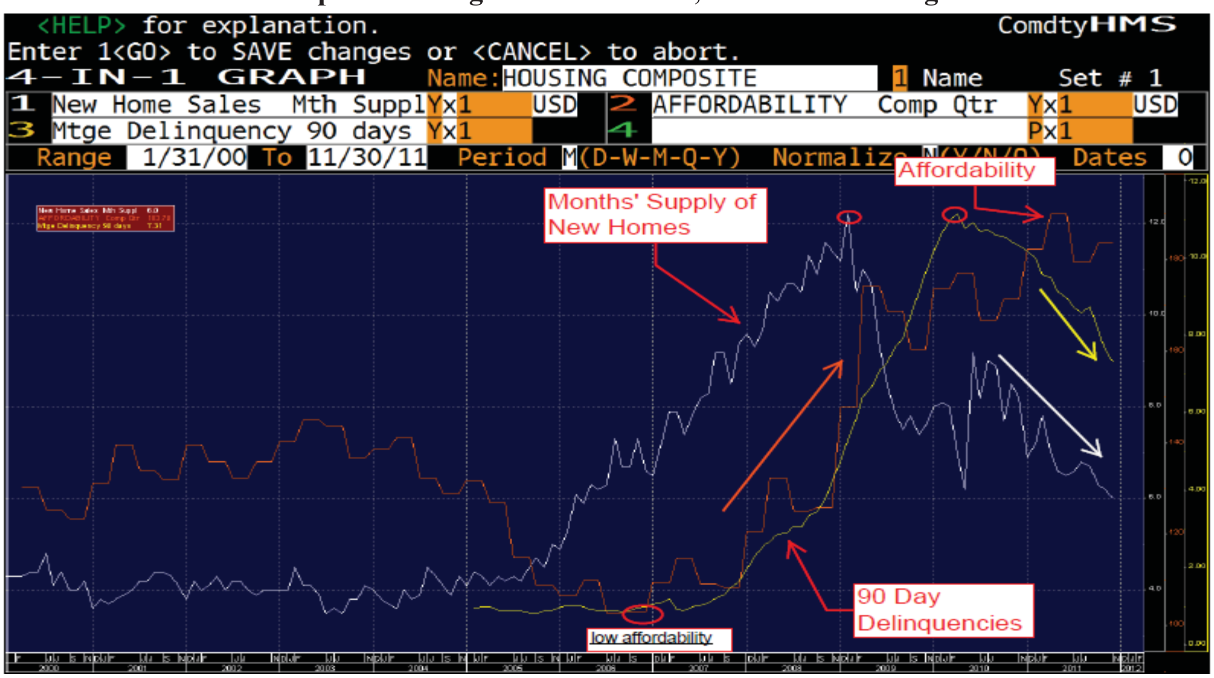
(* = No dividends or coupons)



Historically, the average banking crises take almost five years to recover from. The U.S. banking crisis started with the subprime mortgage meltdown in 2007. Our banking crisis quickly swept the globe as our supposedly AAA-rated subprime mortgage backed securities were stuffed in financial institution portfolios around the world. The typical banking crisis and subsequent economic recession leads to stimulative central government fiscal policies and declines in tax revenues that produce an 86% average increase in government issued debt. Before the debt burden becomes unsupportable, governments must promote policies that increase economic growth and consequent tax revenues or they face the possibility of default. That is the situation Europe is in now and that we face in the near future.

The second big issue facing the domestic financial markets in 2012 is the recovery in the housing sector. We think this is a key component of stronger growth in the U.S. economy. Housing construction has declined since its peak in early 2006. We read reports recently that showed in many areas of the country, it costs more to rent an apartment than to own a home. Housing affordability is close to an all time high, with historically low mortgage rates and a 30% decline in the average price of homes. The main question is whether the excess inventories of foreclosed properties will continue to weigh on prices. Once prices stabilize, potential buyers should increase their purchase activity to avoid paying high rents. The busy graph below shows three main indicators that point to a housing sector recovery. We think it is not a question of "if" the housing sector will improve but "when".

Graph 2. Housing Sector Indicators, Source: Bloomberg



The graph shows that housing affordability, shown in orange, is at an all time high. The supply of new homes, shown in white, peaked in late 2008 and is now back to more normal levels. The delinquency rate on mortgage payments, shown in yellow, peaked in early 2010 and is now declining. If banks and regulators will ease their stringent mortgage underwriting requirements and consumer confidence improves from better jobs growth, we could see a nice recovery in the housing sector and that would boost employment in the construction industry. Banks should make it easier to borrow once they see home prices stabilize.

We worry that the Federal Reserve will become impatient with the pace of the economic recovery and start another round of bond purchases, i.e. quantitative easing. In our view, the current slow economic recovery is not being caused by the cost to borrow money, it is due to the desire on the part of consumers and business to de-leverage and due to the stringent underwriting standards that regulators are forcing on the banks. The regulatory environment has become pro-cyclical. When the economy was growing strongly pre-2007, the regulators were lax in their oversight of the banking system. Now that the economy is weak, the regulators are fighting the last battle, and are overly restrictive on bank lending. It does not help that many state attorneys general and the federal regulators continue to attack the banking industry over the credit crisis. (Poor Bank of America cannot make it out of the headlines for a week or two before another lawsuit is filed against them or another judgment is forced upon them.) The slow growth economy will continue as long as it takes for the financial sector to recover. If the Fed decides to execute another QE program, we fear it will translate into a weaker dollar, higher commodity prices, inflation and slower growth.

The final concern for 2012 is whether Chinese authorities are able to maintain adequate growth in their economy. A command and control economy has never been successful in the past without generating major imbalances. Do they have enough market competition and private sector decision making to avoid a real estate shock or over investment in capital goods? A recession in China would have damaging implications for the global economy and the U.S. economy. As long as the U.S. economy grows at sub-par rates (less than 3%), it is subject to external events like last year's Mid East problems, the Japanese earthquake and the European debt problems throwing us back into recession. Right now we are in favor of continued moderate growth in the U.S. The employment picture is improving and that will help make other problems easier to overcome. A growing economy will support higher corporate earnings and stock valuations.

Blue Chip Strategy: Last year we stressed the value of large cap dividend paying stocks. This view was sustained by the performance of our Blue Chip Strategy, which rose 12.45% in the fourth quarter versus the S&P 500 Index gain of 11.74%. For the full year our large company stock strategy rose 8.20% while the S&P eked out a gain of 2.23%. Our large company stock portfolio follows the Dow Jones Industrials and for 2011, the Dow was the best performing major stock index in the world. All the investors who are looking for emerging market stock returns were disappointed as the Dow was the best performer. We think there is a good chance that the Blue Chips will continue to be strong performers over the next few years as they benefit from the economic recovery in the U.S. and global growth. They are well positioned to generate earnings overseas from emerging and developed economies and if the U.S. economy maintains its moderate growth, earnings should continue rising. Another factor that favors our big stocks is the under allocation to U.S. big company stocks by pension funds. The favorite sectors for pension funds have been alternative assets and emerging markets. Domestic mutual fund investors pulled over $100 billion from U.S. stocks last year. Bond funds and ETFs were the major beneficiary of that move. Another year or two of outperformance by U.S. multinational stocks will start the stampede back into the Dow and S&P Index members. The best performing member of the portfolio during the fourth quarter was Home Depot, rising 28.8%. The weakest performer during the quarter was Alcoa, which fell 9.3%. For the full year, McDonalds was the best stock, gaining almost 35.0%. Bank of America could not make it out of the doghouse, dropping over 58.0% for the year, as their purchase of Countrywide continues to cause headaches. The Blue Chip Strategy (2.60%) still yields more than ten year Treasuries (1.98%) and its dividends increased more than ten percent last year. High quality big company stocks that pay dividends are still a good place to be.

Small Cap Value Strategy: Our small company stock portfolio enjoyed a nice recovery in the fourth quarter, gaining 13.12%. Unfortunatley that was not enough to recoup the losses from the third quarter, so the strategy ended the year down 14.67%. The Russell 2000 Index of small company stocks gained 15.47% in the fourth quarter, reducing its decline for the year to 4.18%. Our move to increase exposure to financial stocks in 2010 has not helped our performance to this point. We still expect the banking sector to recover and bank stock valuations should return to historical norms. Our bank stocks were strong performers in the fourth quarter, with Southwest Bancorp rising 41.2% and Susquehanna Bankshares gaining 54.2%. But the strongest position in the portfolio during the last three months of 2011 was Winn Dixie Stores, a Florida based grocery chain that agreed to be purchased by a privately held competitor. Winn Dixie rose 58.5% in the fourth quarter, but we were disappointed that it is selling at a discount to book value. This stock has long been a frustration for us, since we purchased it after it came out of bankruptcy and had no long term debt. In a weak economy, Winn Dixie struggled to compete against their better funded competitors. Imperial Sugar was the weakest performing position during the quarter and full year, dropping 44.6% in the last three months as they have difficulty maintaining operating margins in the face of higher commodity cost inputs. The strongest holding for the year was Crosstex Energy, which rose 47.8%. Crosstex is the general partner of a publicly traded master limited partnership, Crosstex Energy LP, whose business is improving. The MLP has many growth opportunities and is aggressively raising its distribution. We sold two positions during the fourth quarter, Universal Corp. and Genco Shipping. We booked a small gain on Universal Corp, a wholesale tobacco supplier. The tobacco business is under attack around the globe and their operations will slowly erode. We owned Genco Shipping prior to the market decline in 2008 and sold half of our position in May, 2008 at a substantial profit. The second half we sold at a loss in December. When we first purchased the stock, they paid an attractive dividend and were growing earnings with the booming global economy. In the current economic environment, they had to eliminate their dividend and concentrate on paying down debt. We added one new position in October, Rofin-Sinar Technologies. Rofin-Sinar is a global supplier of laser based cutting, welding and marking tools. They have minimal levels of debt and strong growth prospects. Small company stocks lagged in the tumultuous market environment as their higher risk characteristics were avoided during the periods of volatility and anxiety. We are still focused on companies with strong balance sheets who will experience strong earnings growth as the global economy improves. Typically the best time to add to this asset class is when we underperform the index.

Convertible Securities/High Yield Strategy: The high yield sector was a treacherous place to be in 2011. Fears of another credit crisis led to fund outflows from the sector and slow economic growth caused investors to demand higher yield premiums from lower quality issuers. Our high yield convertibles portfolio gained 12.23% in the fourth quarter, bringing the full year's rise to 8.06%. The Merrill Lynch High Yield Index rose 6.17% in the quarter and 4.50% for the year while the Merrill Convertibles Index rose 4.22% in the quarter but declined 3.42% for the year. We did not avoid all the potholes last year as our purchase of Eastman Kodak bonds has not turned out well. The company is trying to avoid bankruptcy by selling some of their patents. Proceeds from a patent portfolio sale could range from $1 billion to $3 billion, giving the company some breathing room. But potential buyers know the company needs liquidity so they are not willing to pay top dollar. The company's move into commercial printers and color printers has not grown as quickly as they needed in the current economic environment. But we had enough positive moves to overcome Kodak. United Rentals convertible preferred was our strongest performing position during the fourth quarter, gaining almost 30%, as their operations improved and they announced an aggressive acquisition of a competitor. For all of 2011, besides positions we booked realized gains on, Cubist Pharmaceuticals was one of the best performing positions rising over 36% as the company reported strong earnings and the stock price rose above the convertible bond conversion price. We are seeing better opportunities now than last spring, with reasonable yields and manageable credit risk. We believe this sector offers attractive potential returns in 2012.

Intermediate Bond Portfolios (Chas Craig): The Intermediate Taxable Bond Portfolio gained 0.05% in the fourth quarter finishing the year up 2.19% while the Citigroup 1-10 Year Government/Corporate Index rose 0.84% in the fourth quarter finishing the year up 5.76%. The Intermediate Tax-Exempt Portfolio climbed 1.14% in the quarter finishing the year up 5.50% as compared to a gain of 1.17% for the

Merrill Lynch 3-7 Year Insured Bond Index for the quarter finishing the year up 6.32%. Despite the continued uncertainty related to the European debt crisis the domestic economy has started to show signs of life in the fourth quarter from factory orders to jobless claims. The backdrop of improving economic data traditionally would be a cause for higher interest rates. Our below benchmark duration has been a core source of underperformance for the year, so if higher interest rates are on the horizon it could prove to be a source of outperformance moving forward. However, the Federal Reserve has stated that it will take measures to assure rates stay low until at least mid-2013. In response to Mr. Bernanke's pledge we did take steps to provide a modest amount of duration to the Taxable Bond Portfolio by adding a five year agency bond (FNMA 1.375 11/15/16) to the portfolio. This bond increased both the duration and credit quality of the strategy. In other Intermediate Taxable Bond Portfolio news the best performer was ZIONS Bancorp (ZION 7.75 9/23/14) which returned 4.26% for the quarter. ZIONS is a well capitalized regional bank providing services primarily in the western U.S. The worst performer in the portfolio was Jefferies Group (JEF 3.875 11/1/29 putable 11/1/17) which returned -8.94% for the quarter. Jefferies is a mid-sized investment bank with operations in the Americas, Europe and Asia. Jefferies' decline can be traced most directly to the failure of MF Global and the subsequent downgrade of Jefferies' credit by Egan-Jones Ratings Company (though the major ratings agencies left their ratings unchanged). The most noteworthy difference between MF Global and Jefferies is that the leverage employed at now bankrupt MF Global was roughly four times the amount used at Jefferies. Additionally, we are impressed with management's response to disprove factors used by Egan-Jones in their downgrade decision and to improve their capital position post downgrade. In the Tax-Exempt Portfolio we continue to see value in the municipal bond space with spreads to treasuries still far above historical averages. We are currently focusing our buying in the 10-15 year maturity area as we consider this to be the most attractively priced sector of the municipal bond yield curve.

Tax Reporting (Chas Craig): This year marked the first year that parts of the Emergency Economic Stabilization Act of 2008 went into effect. Part of the goal of the legislation is to ensure that investors accurately report to the IRS. The implication is that custodians like Schwab and Fidelity will now report cost basis information to the IRS, as well as to you, the taxpayer. For tax year 2011, Schwab will report cost basis for equities acquired on or after January 1, 2011. Next year Schwab will report cost basis on mutual funds, ETFs, and dividend reinvestment plan (DRIP) shares acquired on or after January 1, 2012. It is important to note that equities (only applicable asset class in 2011) purchased before January 1, 2011 will be covered under the old rules. Therefore, the only time there will be a discrepancy between the new rules and the old rules for 2011 tax return purposes is when shares were both bought and sold in 2011. We have been told by the custodians that they have taken steps to help facilitate the reporting process and make your tax preparation easier by improving the information reported to you. You should be receiving 2011 tax documentation from the applicable custodian shortly.

You may have noticed that Chas authored the commentary on our investment grade bond portfolios and tax reporting above. He has been with us for over a year now and you can see he is making strong progress working on our bond portfolios. He also completed his examinations for his Certified Public Accountant designation and was awarded his CPA in December. Congratulations Chas.

There are many doomsday prognosticators airing their views these days. The global developed country problem of too much debt is a cloud that obscures the horizon. Consumers are well along in their efforts to reduce their leverage. Governments have taken on more debt to stimulate their economies and prevent social unrest. Last year's endeavors to fix developed countries fiscal problems were not impressive. Politicians have been unwilling to make the hard choices to reduce benefits to their constituents and put in place policies that will lead to growth in the private sector. Austerity alone is not a solution. Tax reforms, labor market reforms, regulatory reforms and political compromise are necessary to put the developed countries economies back on a strong growth path. Otherwise their will be many more opportunities for demonstrations and occupying.