

December 2011- Market Outlook

Our fourth quarter performance was up 14.4% compared to an increase of 11.8% in the S&P 500 and a 10.1% increase in the financial index (XLF). For the calendar year our performance decreased 4.9% compared to a rise in the S&P 500 of 2.1% and a decrease of 18.5% in the financial index (XLF). Our annual performance was hurt by exposure to securities brokers and asset managers. The core portfolio of insurance stocks performed better than the overall market and insurance stocks generally.

Our improved results in the fourth quarter reflected a strong move in our core insurance holdings coming after a third quarter where even high quality financial services stocks had been generally sold off indiscriminately. Financial stocks through the first three quarters of the year were impacted by domestic concerns related to the economy. At the same time fears about overseas sovereign debt and bank counterparty exposures put significant pressure on bank and securities broker stocks and those fears trickled into the performance of insurance stocks. Many insurance stocks appeared to move in lock step with other financial services stocks without regard to underlying fundamentals. The apparent indiscriminate swings in insurance stock prices gave us an opportunity to make some worthwhile changes to take advantage of the beginning of an industry wide upswing in property casualty insurance rates. Our fourth quarter performance reflected some of the benefits of those portfolio changes.

We have increased our exposure to certain specialty property casualty insurers who are well placed to take advantage of the current market, as well as prosper when the market upswing gains momentum. In the larger property casualty sector, we added two new positions of note in 2011. One company is a niche player that has been making strong headway in a large market where it has competitive advantage. The other is a large Bermuda based insurer and is one of the strongest global insurers. We have also added positions with certain title insurers which are the most profitable and fastest growing companies in the group. Title insurance company growth is directly tied to home sales, home prices and premium rates. We believe all three of those drivers are likely to improve over the long term. However, over the near term real estate markets are likely to be volatile.

We continue to hold quality companies that have competitive advantages in their markets. The newer holdings are of similar guild. We continue to believe the portfolio is undervalued relative to intrinsic value. Property casualty stocks, for example, currently sell for tangible book value or less, which is well below the long term average of 1.4. We believe a strengthening economy, rising premium rates, and hopefully less volatility will, at a minimum, allow a return to long term average valuations. The ability to focus on companies with sustainable competitive advantages will lead to excellent long term price appreciation in the stocks we hold.

If you have questions regarding the financial services sector, or would like to discuss our investment approach, please contact us at the phone number below, or visit our website. (www.PhiloSmith.com)

Performance through December, 2011

