PHILOSMITH

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December 2012 - Market Outlook

Our year-end 2012 performance was up 18.9% nicely ahead of the 13.4% performance of the three-index benchmark against which we measure performance. The fourth quarter gain of 4.0% was in line with the benchmark. Our performance was the result of good returns by the majority of the holdings bolstered by strong gains of several of the larger holdings. Overall performance was only slightly offset by below-average performance of a few of the smaller holdings.

Our results reflected continued strength in core insurance holdings, particularly specialty property casualty stocks. All sub-sectors in property casualty: primary, specialty, personal lines, commercial lines, and reinsurance showed gains. The stock performance follows the upswing in premium rates reported in most lines of business. There is also continued optimism about the upward trend of property rates after Superstorm Sandy. At the same time, pressure to increase casualty rates is ongoing in the face of low interest rates. Neither the result of the U.S. presidential election nor the anemic growth of the economy has negatively impacted insurance stock performance in a significant way. Title insurance stock performance, up almost 70% on average, was extremely strong. The title companies have benefitted from record low interest rates, which have allowed many homeowners to refinance existing mortgages and have drawn new home buyers back into the market.

The Portfolio

Specialty property casualty insurers account for 35% of our holdings. Hiscox and HCC were our top performing specialty insurers. London based Hiscox was up 27.6%. Hiscox is well positioned to not only deliver strong underwriting results, but also capitalize on growth initiatives. HCC's stock performance follows its strong operating performance. HCC's industry leading expense advantage coupled with excellent loss ratios should allow for continued above-average performance down the road. Horace Mann was up 32.1% resulting in the strongest positive impact to overall performance. The company, focused on the teacher market, continues to reap the benefit of a strategy to improve underwriting profitability while gaining market share. Our returns were also enhanced by special dividends from RLI and W.R. Berkley.

Asset Managers, roughly 9% of our holdings, had above-average performance in an improving stock market. We believe these companies will continue to gain market share going forward.

Outlook and Strategy

The property casualty market is in the early stages of a market upturn. We hold some of the highest quality companies and the real competitive advantages held by these companies will translate into above-average growth and profitability. The holdings in the portfolio are undervalued relative to intrinsic value. Property casualty stocks, for example, continue to sell for tangible book value or less. These valuations give us continued optimism.

Performance through December, 2012