

PETERSEN, FLYNN & DINSMORE, INC.

Investment Advisers

Value in Volatility

Winter 2012

While full of sound and fury, the US stock market finished 2011 essentially where it began. The S&P 500 Index was up a paltry 2% on the year – with the entire gain coming thanks to dividend payments – but that positive return made us the best house in a very tough neighborhood. Given the events of the year – from the earthquake and tsunami in Japan to the ongoing sovereign debt crisis in Europe – it is not surprising that the world's equity markets generally finished lower. In our view, opportunities are being created, particularly in the emerging markets, where high-growth countries such as China, Brazil and India declined by more than 20%.

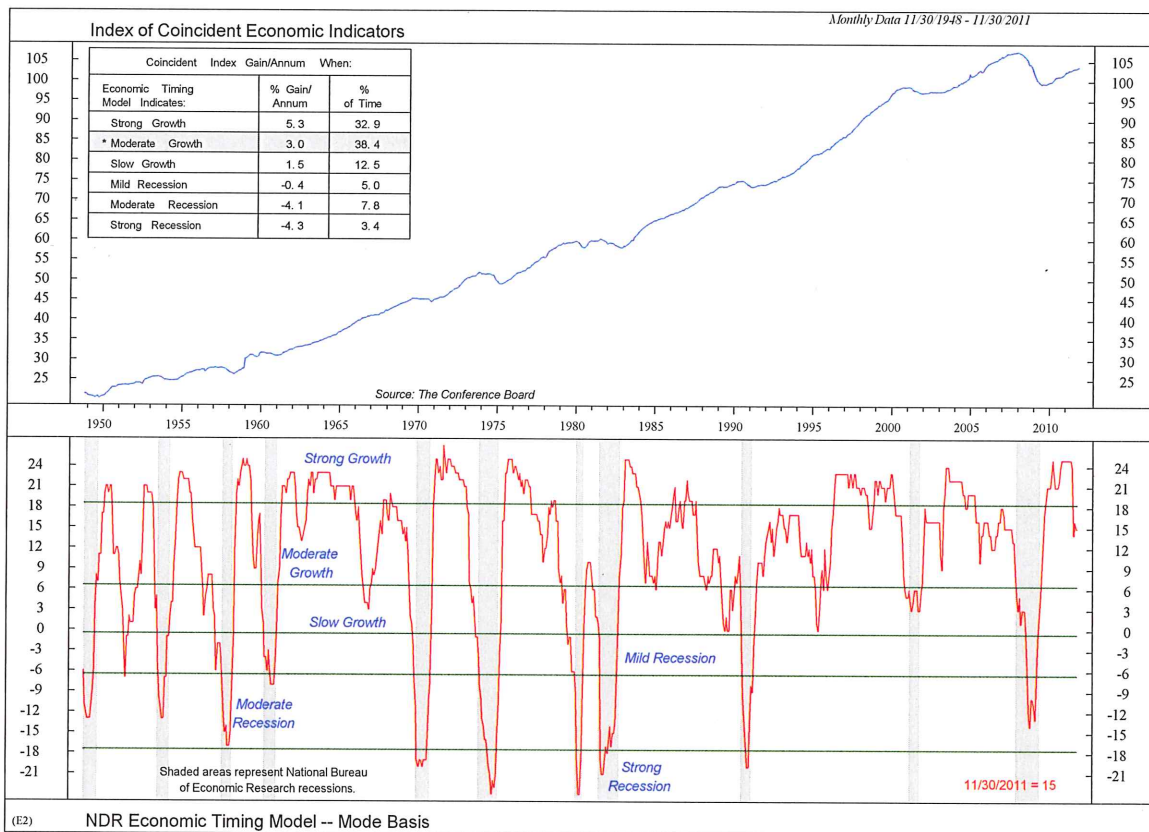
Market Returns by Country

<u>Country</u>	<u>% Return</u>
USA	+2%
Indonesia	+1%
UK	-2%
Australia	-7%
S. Korea	-8%
Spain	-9%
Switzerland	-9%
Canada	-12%
Singapore	-14%
France	-15%
Germany	-15%
Colombia	-16%
Japan	-16%
Norway	-16%
Russia	-18%
Hong Kong	-20%
Italy	-20%
Mexico	-20%
China	-22%
Brazil	-23%
India	-24%
Chile	-25%
Israel	-31%
Austria	-33%

Source: Seeking Alpha

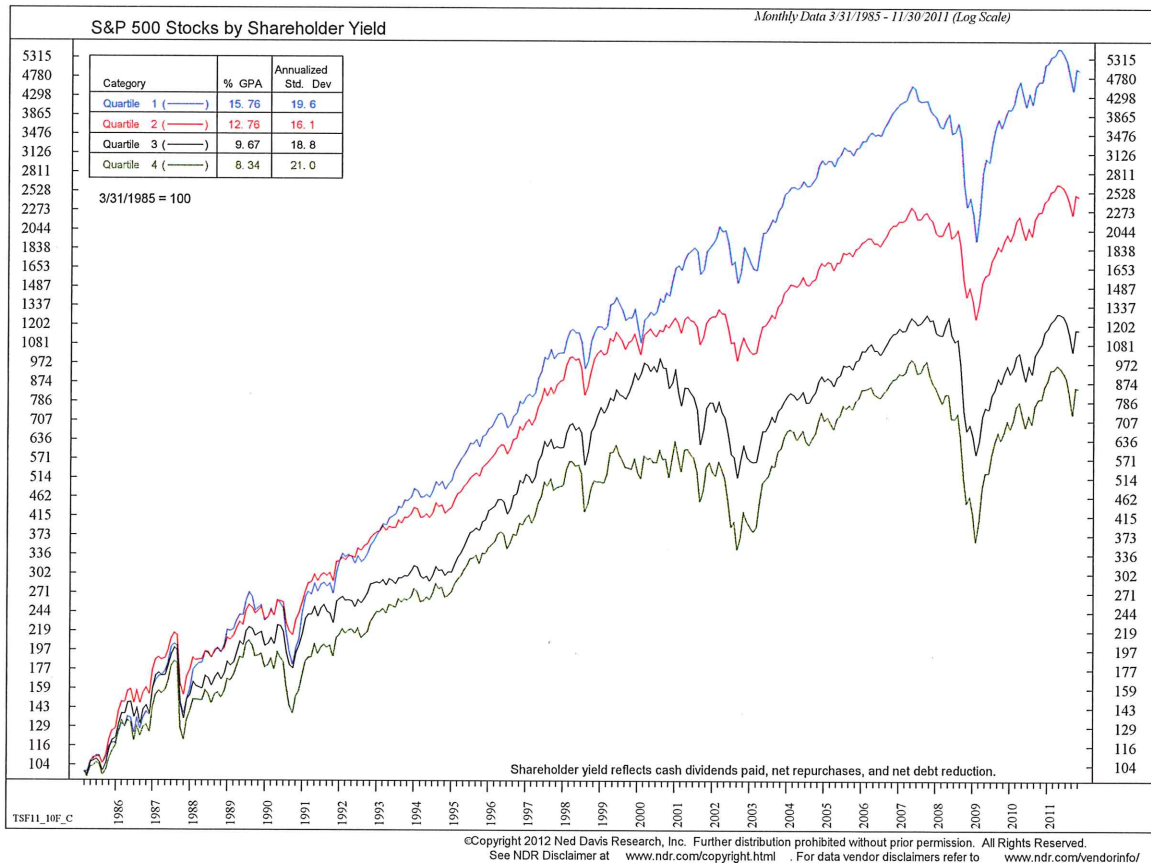
The economic turmoil in Europe will likely be a long-term headwind to global growth. Even if government leaders come up with a credible plan to extricate themselves from the current, acute phase of the crisis, many years of debt reduction lie ahead. Much like the US, years of paying down accumulated debts will mean a great deal of money spent in non-productive ways – every dollar spent on interest payments or debt reduction is one less dollar available for investment or consumption. The debt pay-down is clearly needed, but the process will mean slower growth and trade for years to come. Leading Economic Indicators in Europe, highlighted in our last letter, continue to point toward recession.

The resiliency of US markets in 2011 was largely due to persistent, though measured, improvement in our own economy. Earnings generally came in at or above Wall Street expectations, employment continued its gradual rise, and even the housing market showed some hopeful signs of stabilization. Leading Economic Indicators for the US suggest growth will continue in 2012, though at a slower pace than we saw in 2011.



Given these circumstances, we continue to believe the best opportunities lie with those companies that both pay a significant and growing dividend, and those that have exposure to the developing world, where internal growth is accelerating and sovereign balance sheets are far healthier.

The large, multi-national companies that do significant business in emerging markets are also the companies that have tended to put their shareholders' best interests first when it comes to the use of excess cash reserves. The chart below breaks down the S&P 500 into quartiles, ranking companies based upon an indicator known as shareholder yield. Shareholder yield measures cash dividends paid, net repurchases of company stock and net reduction of company debt.



Companies ranked in the top quartile of shareholder yield have outperformed all other quartiles over the last 25 years. In fact, the top quartile has beaten the bottom quartile by more than 7 percentage points per year – an enormous difference when compounded over time. While there are certainly no guarantees, history suggests that companies with strong balance sheets, a culture of returning cash to shareholders, and products that are in high demand in the developing world should be positive contributors to performance in the years ahead. We believe an added benefit of having tilted our portfolios toward these high-quality companies will be their ability to better-weather continued volatility, likely triggered by the crisis in Europe.

Fixed income markets continue to offer historically low yields, though we are starting to see some relatively attractive opportunities in the corporate and municipal bond markets. With all the money printing going on around the world, interest rates are bound to rise at some point. We have kept our bond maturities relatively short in an effort to position ourselves to take advantage of higher yields in the future.

Highly volatile markets like we saw in 2011, while not always great for the stomach, can often be beneficial to the wallet. By sticking to our disciplined approach of buying high-quality companies when their shares trade at reasonable prices, we can often take advantage of emotion-driven swings in the market. Given the difficult and on-going deleveraging process we expect around the world, further opportunities are likely.