

FOURTH QUARTER COMMENTARY

Los Angeles, January 15, 2012

Dear Fellow Investors:

Investors can be forgiven for wondering whether 2011 was the purest distillation yet of what has become of modern stock markets: all volatility and no return. Whether it was the wild daily 4% swings the stock market saw in August or the steep 19% drop in the S&P 500 from June through September, investors saw big changes in market prices, yet the S&P 500 ended the year practically where it began, with dividends providing a small positive total return.

The outstanding performer in 2011, in a long-running encore, was US government bonds. The 10-year US Treasury bond, which began the year offering an already low 3.3% yield, delivered a whopping 15.5% total return (based on the iShares Barclays 7 – 10 Year Treasury Bond Fund). The yield dropped to 1.9% by year end.

This rally came despite an

onslaught of news that appeared to have quite negative implications for US credit obligations. There was the mid-year news that Standard & Poor's--still the most widely recognized credit rating agency despite some major fumbles during the last cycle--was downgrading US credit from its triple-A perch. There was also no evidence of willingness or ability by the political class to tackle head-on the nation's deep fiscal problems (and plenty of evidence to the contrary).

Diversified bond funds tended towards returns in the mid to high single digits, as corporate bonds and shorter duration bonds did well, but not as well.

The laggards in 2011 were nearly everything else: international stocks especially, but also small cap stocks and commodities. The en vogue buzzwords on Wall Street are "risk-on" and "risk-off." 2011 was a "risk-off" year where riskier assets fared worse and safer assets fared better.

Large Cap Value Summary

The fourth quarter delivered a sharp rebound from the summer selloff, with the typical Bristlecone Large Cap Value portfolio up about 12.9%, after fees (see page 5 for complete performance information). Other than the two quarters in

2009 when the market was pulling itself up off the floor, this was the largest quarterly gain since 2003. The portfolio slightly outperformed the S&P 500 (up 11.8% including reinvestment of dividends) in the period. For the full year, the average



Large Cap Value Summary

NEW INVESTMENTS:

NONE

INCREASE IN EXISTING INVESTMENTS:

HEWLETT PACKARD

REDUCTION IN EXISTING INVESTMENTS:

NONE

INVESTMENTS SOLD:

JP MORGAN

Large Cap Value portfolio ended flat after fees, lagging the S&P 500, which was up 2.1%. It did slightly better than the average Large Value mutual fund, which was down 0.75% according to [Morningstar](#).

We made just two trades during the quarter, content mostly to let play out the changes we had made during the summer downturn when we took advantage of lower prices to increase four positions (Bank of America, Cemex, General Dynamics, and Intel) and introduce one entirely new position (Hewlett Packard). Although, we didn't time the purchases perfectly, most of these additions looked good by the end of the year (Bank of America was the major exception). For most investors, buying when everyone else is selling is psychologically nearly impossible to do. Yet, history shows that, for long-term investors, it is a more rewarding strategy than contributing to the panic selling.

During the quarter, we sold long-time holding JP Morgan. We became more concerned that the European debt crisis could negatively impact JP Morgan, which is very active overseas and in derivative markets. This concern may seem a little counter-intuitive, since JP Morgan held up better than nearly all other big banks during the 2008 – 2009 financial crisis. The company was nearly a model of prudence (or at least more prudent than most) going in and smartly opportunistic picking up distressed assets during the crisis. This allowed JP Morgan's stock to deliver positive investment returns during our ownership.

But among US banks, JP Morgan is the most highly exposed to foreign sovereign debt and derivatives markets, and it is nearly impossible for the outside observer to accurately gauge the risks they are taking.

The company participates in highly complex transactions, the outcomes of which are frequently dependent on unknowable factors and potentially unreliable counter-parties. A reported net exposure of \$1 billion to Italian sovereign debt, for example, could result from owning \$100 billion in Italian bonds with \$99 billion hedged via credit default swaps issued and guaranteed by increasingly shaky European banks.

JP Morgan will likely navigate through the current European sovereign debt crisis ably, but we felt there were other opportunities available without the same level of potential downside risk.

Our other trade during the quarter was to increase our investment in Hewlett Packard. Although the stock was slightly more expensive this time than our initial purchase (we prefer to average down), we still feel the valuation is very compelling. Shortly after our initial purchase, the company settled on Meg Whitman as the new CEO. While we might have preferred an outsider (she was already a director of the company), Whitman is clearly capable and had a mostly solid track record at eBay.

She has already made some key capital allocation decisions that we think bode well for the future. The company had been contemplating the



Large Cap Value Summary

separation of its personal computer business, a large division that is less profitable and slower-growing than its other businesses. In the current market environment, it is very unlikely the company could have received full value for the business, so we concur with the decision to keep it for now. Whitman also announced that the company would not pursue any major acquisitions, instead focusing on returning money to shareholders. These decisions begin the process of restoring investor confidence in the company.

Another key portfolio event during

the quarter was the offer by Martin Marietta Materials to purchase Vulcan Materials. Vulcan has been decimated by the downturn in construction activity and Martin Marietta seized the moment to step in. While we believe the current offer still undervalues Vulcan, it is one example of a catalyst that prevents assets from staying too undervalued for too long. Another recent example was Google stepping in to pay a large premium for Motorola Mobility earlier in the year. Large share repurchases, which many of our holdings undertook this year, can serve as a similar check against low valuations.

What Should Investors Do?

We usually take this year-end letter as an opportunity to paint, with very broad brush strokes, a picture of market valuations, pointing out where we see opportunities and pitfalls. The current investment landscape remains a rocky one, lacking large obvious pockets of value. Nonetheless, we believe patient, long-term investors can find attractive areas for investment.

The US stock market began the year at about an average historical valuation (15x earnings). While prices stood still, 2011 was mostly a good year for corporations, which on average grew profits (S&P 500 operating earnings were up more than 10%, based on current estimates), increased cash balances, and bought back shares. As a result, the market

is now that much cheaper than it was this time a year ago. We are a little wary that corporate profitability is above long-term averages, so the US stock market is probably not quite as attractive as the current 13x – 14x price/earnings ratio might suggest. Still, we believe today's market offers a good chance for long-term investors to earn average rates of return. Larger, high quality, dividend paying stocks continue to look particularly attractive to us.

Bonds, on the other hand, are an area for greater concern. We noted in our November monthly digest that the 30-year period ending October 31, 2011 marked the first time since before the Civil War that bonds had outperformed stocks over such an extended period. Bonds are seen by



What Should Investors Do?

many as the ultimate safe harbor, but mathematical reality will set in sooner or later. Yields on 7 to 10 year US Treasuries below 2% offer little room for further price appreciation and little income to offset inflation. It would take very little upward movement in interest rates to wipe out the meager coupon.

Inflation, as measured by the CPI, was 3.4% in the twelve months ending last November. Since World War II, inflation has averaged about 3.7%. Clearly, with governments and consumers in a de-leveraging mode, there are reasons to expect economic growth and inflation to be muted in the near term. But to our eyes, the coupon from Treasuries today may not be enough even to account for inflation, meaning when the bond principal is returned it will be worth less in real terms, maybe materially less, than today's investment. Investors focusing on the rear-view mirror admiring the trailing three decades of rosy performance and low volatility for bonds need instead to look forward at the road ahead.

Bonds still play an important role in most portfolios, but we feel it is important to cast a wider net beyond just Treasuries in order to navigate the current low rate environment. To complement our stock investments, we are using bond funds whose managers have the latitude to invest in other areas of the fixed income market, like high quality corporate bonds or certain types of mortgages that offer higher current yields and should hold up

better in a rising rate environment. High quality stocks and bonds form the core of our diversified, balanced portfolios, for now and probably well into the future. That theme of casting a wider net, though, applies beyond just the stock or bond universe. The current low yields for bonds have created a need for investments that offer some combination of lower volatility than stocks, higher expected returns than Treasury bonds, and low correlations to equities. While there are alternatives available, too often in the past they have been inefficient due to high costs, short track records, or lack of transparency. One example that passed our review and that we've been using for over a year is the Arbitrage fund (ARBNX), a fund that invests in mergers and acquisitions. With caution, we are continuously vetting investment ideas that could fit that bill and you may see some of these become a part of your portfolio in the coming years.

Let us take this opportunity to thank you once again for being our valued clients for another year. We are driven to help you meet your financial needs and truly appreciate the chance to work with you.

Sincerely,

Jean-Luc Nouzille, CFA
David Fleer, CFA
Josh Graybill, CFA

Large Cap Value Composite Performance History through December 31, 2011¹

	Since Inception	10 Year	5 Year	1Year	4Q 2011
Cumulative					
BRISTLECONE	16.7%	8.6%	-22.8%	0.0%	12.8%
S&P 500	4.4%	33.2%	-1.2%	2.1%	11.8%
Annualized					
BRISTLECONE	1.3%	0.8%	-5.0%	0.0%	
S&P 500	0.4%	2.9%	-0.3%	2.1%	

¹ PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS. Performance quoted is that of the Large Cap Value Non Wrap Composite net of fees and may include estimates for the most recent quarter. Investment returns for the composite and the S&P 500 include the reinvestment of dividends and/or interest income. The Large Cap Value Non Wrap Composite contains fully discretionary, non-wrap large cap value accounts. The S&P 500 is a market value weighted index of 500 selected common stocks, most of which are listed on the New York Stock Exchange. It is widely recognized as representative of the equity market in general. Inception is April 1, 2000. The US dollar is the currency used to express performance. Bristlecone Value Partners, LLC ("Bristlecone") is a registered investment adviser founded on June 1, 2004. Prior to June 2004, the composite represents performance generated by the portfolio management team at a prior firm and includes wrap accounts. Bristlecone claims compliance with the Global Investment Performance Standards (GIPS®). A list and description of all composites and/or a presentation that complies with the requirement of GIPS is available upon request (clientservices@bristlecone-vp.com).

CAUTIONARY STATEMENT

One of Bristlecone Value Partners' principles is to communicate frequently, openly and honestly. We believe that our clients benefit from understanding our investment philosophy and process. Our views and opinions regarding the investment prospects of the portfolio are "forward looking statements," which may or may not be accurate over the long term. While we believe we have a reasonable basis for our appraisals, and we have confidence in our opinions, actual results may differ materially from those we anticipate. Information provided in this report should not be considered as a recommendation to purchase or sell any particular security. You can identify forward looking statements by words like "believe," "expect," "anticipate," or similar expressions when discussing prospects for particular portfolio holdings. We cannot assure future results and achievements. You should not place undue reliance on forward looking statements, which speak only as of the date of this report. We disclaim any obligation to update or alter any forward looking statements, whether as a result of new information, future events, or otherwise. Our comments are intended to reflect trading activity in a mature, unrestricted portfolio and might not be representative of actual activity in all portfolios. Portfolio holdings are subject to change without notice. Current and future performance may be lower or higher than the performance quoted in this report.