

APRIL 12, 2011

*“Life is a kind of Chess, with struggle, competition, good and ill events.”*  
- Benjamin Franklin



***Dear Investor,***

What does it mean when the stock market melts *up*, at the same time there is an actual nuclear melt-*down*? How do stocks gain sharply in value when we just opened a third simultaneous war? When oil is over \$100 per barrel? When there is a looming un-fundable debt hole in the balance sheet of the world's superpower? Or an even worse fiscal crisis in Europe? These are hard questions to answer, but ones that investors today need to consider.

At Spears Abacus, we ponder these macro conundrums, but remain true to our bottom-up approach of fundamental security selection. So a further question is how do we build a portfolio from the bottom up when the top (in the form of the overall economic and political environment) may literally be coming down upon us? The answer is to avoid paralysis and despondency through careful (and flexible) analysis of available information.

Let's first examine the current state of the economy. Since bottoming out in February 2010, the U.S. economy has added a net 1.5 million jobs. Real GDP has just surpassed the previous peak and is expected to grow at 3.1% this year. Savings rates have increased and personal income in the fourth quarter of 2010 is now 2% above its 2008 peak. Government measured inflation remains tame at 2.1%, interest rates are low, and the stock market measured by the S&P 500 index is up 96.0% (104.5% with dividends) from its March 9<sup>th</sup>, 2009 low, yet we believe it is not unreasonably valued. The emerging market economies continue to expand with inflation-adjusted growth in China this year expected at 9.5%, in Brazil at 4.1% and in India at 8.0%. Over 100 million people worldwide are expected to enter the consumer economy this year which creates real global capital at a time when, to many, it seems we have expended all of our capital. In other words, there are tangible signs of progress.

There is also a growing list of challenges. The projected U.S. federal budget deficit for 2011 is \$1.48 trillion, which would leave us after this year with a projected national debt of \$10.4 trillion (public debt) or \$14.4 trillion (total debt). When you include our unfunded entitlements (Social Security, Medicare, Medicaid), our liabilities may approach \$60 trillion. State governments are also in poor shape. Europe has public debt equal to 74% of its collective GDP, Japan 225%. Inflation-adjusted median income has been stagnant for over a decade and our trade deficit, one measure of competitiveness, totaled \$496 billion in 2010. Even in the emerging markets, challenges are growing. Most notably, the Gulf States and Middle East continue to be unstable. Inflation in India is now running over 9%, China has its own inflationary pressures and political challenges and Russia and Brazil continue to struggle with political inefficiencies and corruption.<sup>1</sup>

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<sup>1</sup> Data sourced from the US Bureau of Labor Statistics, the US Treasury, the Congressional Budget Office, the US Bureau of Economic Analysis, the Central Intelligence Agency and Bloomberg.



Delving further into the topic of government deficits, we believe that they do not become an acute problem as long as the confidence that supports them remains in place. Unfortunately the spell has been broken, confidence is lacking, and deficits now positively do matter. They will be progressively harder to fund and sustain and this will have real consequences, many of which are unknowable and perhaps contradictory.

Governments may enter a paradox where they are forced to raise interest rates to attract capital to fund debt. At the same time, higher interest rates increase their costs to fund existing accumulated debt and a negative cycle develops. Higher interest rates also tend to reduce economic activity and to increase the private cost of capital. Reduced spending by governments, a response to budget considerations, further reduces economic activity. Governments (whose debt is denominated in their own currency) may even try several forms of “printing money,” which in turn lead to higher rates and inflation. This inflation may actually “solve” governmental debt problems, but at the cost of devaluing currency and public confidence. We believe this deficit paradox, combined with the ever-present issue of oil (as discussed in our interim letter) are the most important themes determining economic health over the next several years or more. Whether the outcome is reduced government spending, higher taxation, increased inflation or higher interest rates we must collectively pay the price for our past growth which was borrowed from the future.

Examining all of these scenarios may make observers feel very similar to Joshua, the anthropomorphic Pentagon computer in the 1983 movie *War Games*. At the end of the movie, Joshua begins to play a series of tic-tac-toe games quickly realizing there is never a winner – all games end the same. He then begins simulating nuclear war, soon discovering the theory of mutually assured destruction, and that “winning” a nuclear war is impossible. He ends with the line “A strange game. The only winning move is not to play. How about a nice game of chess?”<sup>2</sup>

We do believe our task is akin to a chess match in which gross exaggerations, quick conclusions, and dogmatic thinking end very badly. We believe the economic (and political) environment is more nuanced than can be understood or summarized in a sound bite – and if there is an unavoidable endgame the timing is unpredictable and the ultimate consequences uncertain. Upside surprises exist in parallel with downside risks. Flexibility in approach is an asset to be cherished.

With this backdrop, let’s briefly summarize our current portfolio thinking. Market crashes generally follow periods of irrational exuberance. Likewise, irrational pessimism leads to great opportunities. The question most on our minds is which actions to take during this period of perfectly *rational* pessimism?

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<sup>2</sup> *War Games*, starring a young Matthew Broderick and Ally Sheedy, was one of the earliest movies to focus on computer hackers. David Lightman (Broderick) accesses what he believes is a computer game, but is actually the pentagon computer that was recently given control of the nuclear arsenal. Chaos ensues as the stars race to prevent the nuclear Armageddon they themselves triggered. Eventually they convince the computer of the illogical path of nuclear war and thereby the movie preaches both against computerization and nuclear weapons – as well as being somewhat entertaining.

## Equity Portfolio

The first quarter of 2011 was another solid one for our portfolios, both on an absolute and relative basis. The quarter was not without volatility, but a near 6% gain in any quarter is certainly satisfactory.

As we have discussed in the past, the level of the overall market is much less important to our process than the specific opportunities we are able to identify. Currently, and more so than any time over the last four years, we own a portfolio largely based on idiosyncratic opportunities. That is to say, we own companies that have very specific opportunities with catalysts to increase their values, apart from general economic growth and stability. In fact, this past quarter our portfolios experienced the highest level of turnover activity in years, much for this reason. We discuss the specific holdings in the appendix, but quickly review our portfolio thoughts and actions below.

In our fourth quarter letter and our first quarter interim commentary we discussed our worries about large firms who may experience rising input costs at the same time that they are facing more competition and an inability to increase prices. This was a driving force behind our first quarter sales of Nestlé and Unilever. By way of example, the Chinese government purportedly recently warned Unilever against further “rash” price increases – and they abided. During the first quarter we also decided to sell long time holdings Time Warner and Disney. Both operate “hit driven” businesses affected by potential technology shifts. More importantly, both stocks have been excellent performers during the recovery and we felt their current prices more than reflected reasonable optimism.

During the quarter, several of our current holdings experienced strong gains based on idiosyncratic factors we had identified as value drivers, and not just market momentum. Hologic gained on the back of an important new product approval and launch, Aon gained on an improved pricing environment in property and casualty insurance, IMAX rose sharply on the announcement of a further large deal in China and Williams rose shortly after our recent purchase due to an announced capital restructuring. Other strong performers included DC, St. Jude, and Western Union.

New purchases in the quarter are discussed in the appendix and continue our theme of seeking companies with specific catalysts to increase value, whether it is new product innovation and adoption at small cap Caliper Life Sciences or restructuring and margin improvement at large cap Federal Express.

Microsoft was again among the weakest performers in the quarter. We continue to examine our investment case and believe the potential opportunities to enhance the value of the business are being ignored by investors. In fact, we recently increased our position in The BeeHive Fund.

We also added further to our positions in Broadridge and Thermo Fisher Scientific while reducing our investment in CVS/Caremark.

## Concluding Thoughts

We have been relatively bullish for two years. As the market recovers and the risks discussed above persist, we are now turning more cautious. Careless strategies, as well as disciplined ones, have benefited from a stimulus induced recovery cycle. The headwinds are now beginning to blow and we believe it is even more imperative to have a thoughtful and disciplined process in managing portfolios.

Higher inflation can allow companies with pricing power to increase profits, but stock valuations may become compressed. Higher interest rates appear likely and may reverse the nascent flow of capital into stocks back into bonds. While we believe our portfolio provides great value and a compelling defense against the various risks that are both known and unknown, we remain alert and believe now is the time for realistic caution.

As always, please let us know if you have any questions or comments.

Sincerely,



William G. Spears



Robert M. Raich



James E. Breece



Paul F. Pfeiffer



Stephen H. Frank



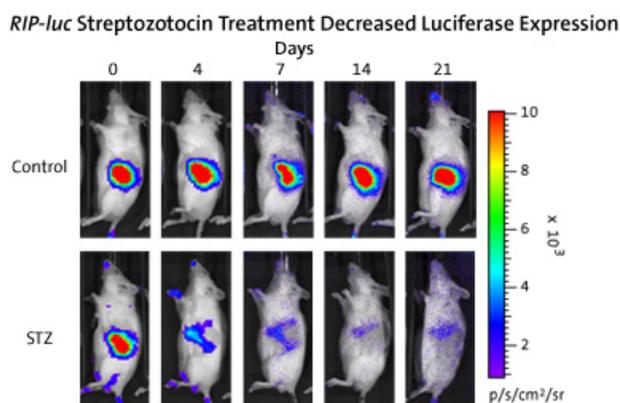
John V. Raggio

## Appendix

### Caliper Life Sciences

During the first quarter we made a small investment in Caliper Life Sciences. Caliper provides tools to researchers in fields including drug discovery, genomics, and proteomics. Products are segmented between imaging solutions, predominantly for preclinical drug discovery, and instruments utilizing Caliper's microfluidics technology to create a "lab on a chip." Both businesses enjoy sizable and growing installed bases and are supported by strong intellectual property.

The capabilities of Caliper's imaging products are remarkable and through the use of luciferase (the enzyme that enables luminescence in the abdomens of fireflies) and other fluorescent proteins their imaging systems enable researchers to study drug efficacy within a live animal model. In the below images even the novice eye can see the difference between the treatment group and the control group – in this case regulating the production of insulin.



We believe that Caliper's imaging system sales will continue to grow, but we are more excited about the potential for Caliper's microfluidics technology. Using chips that contain a network of micro channels that are less than a millimeter in width and depth, Caliper's instruments utilize pressure and voltage, along with optical readers, to perform experiments with a high degree of accuracy and reproducibility, while using a very small amount of sample. Current application of this technology is focused on laboratory DNA, RNA and protein analysis as well as sample preparation for next generation sequencing. We believe that continued adoption within these core markets will drive material future growth. However, we also believe that Caliper's technology is very well suited for molecular diagnostics and success in establishing the "lab on a chip" platform in this emerging market could potentially be game changing for Caliper.

Small companies with exciting technology are not uncommon, yet we rarely invest as they often present binary risk and do not satisfy our demand that investments carry a favorably asymmetric return profile. Caliper made our cut because of its installed base of proven and patent protected technology, because of its strong balance sheet, and most of all because of the company's disciplined management team that has been successfully executing on its plan for a number of years.

## **Federal Express**

Federal Express is a company well known to all with its pervasive FedEx envelopes and distinctive delivery vehicles a common sight. As Kleenex is to facial tissue, its name has become synonymous with express delivery. The company is well positioned to benefit from a number of positive long term trends, most notably the globalization of trade, the dynamic growth of developing markets and the increasing use of the internet as a shopping alternative with its attendant delivery service requirements.

In addition to favorable secular tailwinds, numerous factors point to a significant increase in operating margins over the next few years, including operating leverage as Express package growth continues to recover, the exit of its competitor DHL from the U.S. market (which will increase pricing flexibility), elimination of “catch up” compensation and pension expense growth, additional market share gains in the company’s ground transportation business and the restructuring of its freight operation, which lost money last year but is expected to turn profitable ahead of schedule beginning this quarter. Given our outlook for steady but not overly robust global economic growth, we believe the company’s prospects for reaching or possibly exceeding prior peak margins are good and that worries about rising energy prices and political unrest are at least partially discounted in the share price.

## **Williams Companies**

Williams Companies is composed primarily of two businesses, its oil and gas exploration and production operations and its ownership interest in Williams Partners (WPZ), one of the largest diversified master limited partnerships in the U.S. With respect to WPZ, Williams owns 75% of the limited partnership units and 100% of the general partner. We believed at the time of purchase that the company was not well understood due to its complexity and that the underlying value of its assets was far higher than the share price reflected. Further, we believed that it was increasingly likely that the E&P business would be spun-off, allowing investors to focus more clearly on the attractive growth prospects for the midstream gathering and processing operations and the natural gas pipelines.

Shortly after making our investment, the company announced its intention to separate the E&P business in two steps: a public offering of up to 20% of the shares in Q3 2011 and the subsequent spin-off of its remaining interest in June 2012. An initial 60% increase in its dividend to shareholders was also announced, along with plans for an additional increase in June 2012. While the shares have responded positively to this announcement, we believe there is still considerable upside potential from here.

*Spears Abacus BeeHive Fund Performance (Net)*

2009	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
The BeeHive Fund	-2.82%	-11.62%	7.51%	11.65%	4.43%	3.87%	5.17%	2.97%	2.00%	-1.31%	3.42%	4.37%	31.59%
S&P 500	-8.43%	-10.65%	8.76%	9.57%	5.59%	0.20%	7.56%	3.61%	3.73%	-1.86%	6.00%	1.93%	26.46%

2010	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
The BeeHive Fund	-2.87%	3.48%	4.59%	0.98%	-7.92%	-4.41%	5.38%	-3.75%	8.77%	4.97%	-0.47%	8.55%	16.90%
S&P 500	-3.60%	3.10%	6.03%	1.58%	-7.99%	-5.23%	7.00%	-4.51%	8.92%	3.81%	0.01%	6.68%	15.06%

2011	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
The BeeHive Fund	0.09%	4.57%	1.11%										5.84%
S&P 500	2.37%	3.43%	0.04%										5.92%

Annualized Since Inception (9/2/08)	
The BeeHive Fund	7.81%
S&P 500	3.78%

*Spears Abacus Municipal Bond Performance (Net)*

2009	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
SA Bond Account	2.32%	0.90%	-0.40%	0.71%	0.71%	-0.11%	0.86%	0.53%	1.71%	-0.62%	-0.24%	0.23%	6.74%

2010	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
SA Bond Account	0.66%	0.60%	-0.09%	0.59%	0.41%	0.33%	0.85%	1.38%	-0.33%	-0.29%	-1.26%	-0.87%	1.98%

2011	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
SA Bond Account	-0.31%	1.61%	-0.29%										1.04%

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The Fund performance information shown is for The BeeHive Fund, a series of Forum Funds, an investment company registered under the Investment Company Act of 1940 that is managed by SA. The BeeHive Fund seeks capital appreciation by investing in a concentrated portfolio of companies believed to have dynamic businesses with defensible market positions. The BeeHive Fund invests primarily in equity securities. Performance information for The BeeHive Fund is presented for 2009, 2010 and 2011.

The performance information set forth indicates the corresponding return of the Standard & Poor's 500 Total Return Index. The volatility of the S&P 500 Total Return Index (as well as any other index used by SA from time to time) may be materially different from the volatility of the The BeeHive Fund. In addition, the securities holdings in The BeeHive Fund differ significantly from the securities that are referenced in the index. The S&P 500 Total Return Index has been selected not to represent an appropriate benchmark to compare results but rather to allow for comparison to the performance of a widely recognized index. SA is not responsible for the accuracy or completeness of any information contained here that was obtained from or compiled by third parties.

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### ***SA Fixed Income Performance Information***

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