

MARCH 8, 2011

*“Democracy don't rule the world, You'd better get that in your head;
This world is ruled by violence, But I guess that's better left unsaid.”*
- Bob Dylan



Dear Client,

As we have indicated in past quarterly letters, we plan to send periodic comments to clients and friends in addition to our regular letters when we feel there is a topic broadly, or specific to our portfolio, that may warrant additional comment. This marks our first of these interim communications and deals with the subject of price inflation in its various forms.

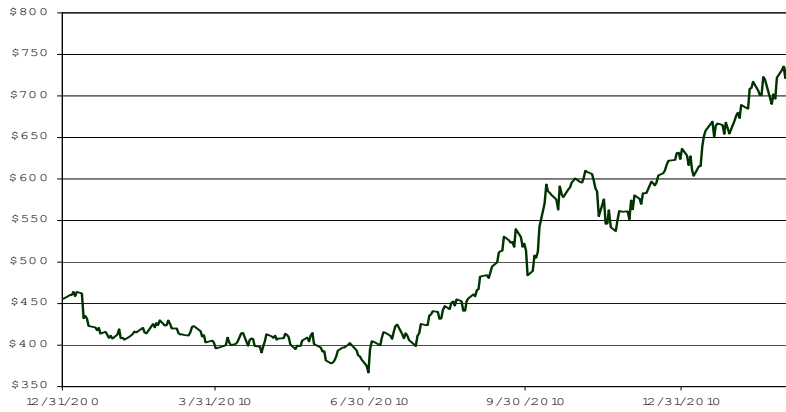
First, we would stress that our investment process normally focuses on business forecasts for individual companies, not on macroeconomic data. Our discipline starts with the notion that the world is and will remain uncertain. Every business is affected by economic growth or recession, but macroeconomic activity, deficits and GDP have less direct impact on long term stock performance than net profits and cash flow for the individual entity.

We have now had a sustained market advance for two years and we as a firm have stayed optimistic through the entire period. Simply, we felt that once the 2008-2009 crisis dissipated, economic conditions stabilized, and stimulus programs took effect that a favorable environment for corporate profits and ultimately stock prices would ensue. Over the two year period, there have been a number of causes for concern for the markets such as additional bank failures, commercial real estate losses, fear of a double dip recession, defaults on Greek, Irish or Spanish bonds, the oil spill, healthcare reform and deficits at all levels of government. Throughout, we remained aware and studious of macro events, but continued to see a building momentum in the profits of the businesses that we owned, and found share prices to be at compelling levels.

Recently, the specter of a particular type of inflation has caused us to raise our sense of alert. We are not yet at the point of decisive action, but we are concerned. This inflation is unlike that of the 1970's. Then, price increases quickly resulted in higher wages that in turn led to further price increases; and the spiral of inflation continued. Today, the U.S. has excess labor capacity and labor is still losing its bargaining power. We are also not experiencing, nor are we likely to experience, Weimar style inflation led by an uncontrollable or deliberate expansion of currency. Yes, the Federal Reserve has taken unprecedented steps to expand its balance sheet; but, as yet, they have simply increased bank reserves. Until banks expand lending (at which time the Fed will take some action, even if belated and insufficient), broad money supply growth will remain quite restrained.

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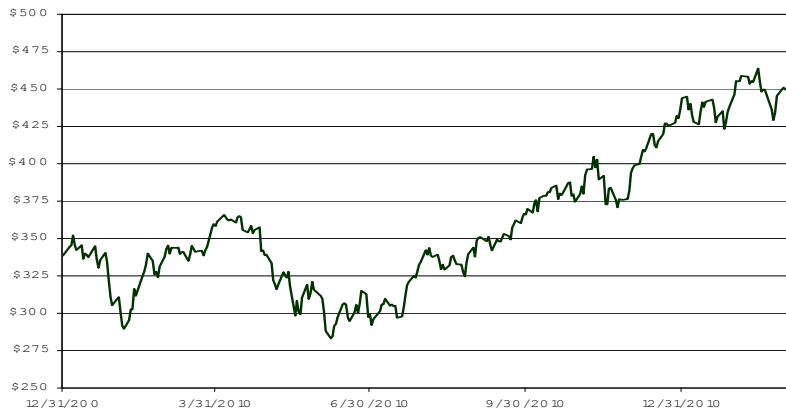
Recently, we have certainly seen global price inflation of food and other commodity prices. As an example, the following chart shows corn prices over the last year:



And cotton:



And copper:



There are multiple causes for these increases. Higher demand from a recovering economy and from emerging markets growth may be first. Harvest patterns, weather and production delays also play a part and financial speculation and even manipulation cannot be ruled out. Increasing input costs are squeezing profit margins for companies across many industries.

This commodity inflation has caused us to make tactical changes in our portfolio. Earlier this year we wrote about our sale of Nestlé shares and we recently completed the sale of Unilever shares. These sales were based partly on the expectation that inflated prices would not easily be passed on to consumers in competitive markets. (Also, because we found more interesting opportunities.) Still, we do not feel that this inflation will seriously threaten global economic health. Increased prices should bring about new production to satisfy the demand and commodity prices have always, and will again, regress to the marginal cost of production. The world has a surplus of food and shortages are more a result of structural inefficiencies and imbalances than a lack of supply. Furthermore, in much of the developed world, raw material and food prices are not dominant components of inflation indices. Labor and housing are much more important and they are still deflating.

Oil and energy price inflation, in contrast, is concerning to us. Since February 15, WTI crude has spiked nearly 20%. North Sea Brent, even more. The obvious and proximate cause is unrest in the Middle East and North Africa. With economic recovery still in a fragile state, further increases will have a detrimental effect on discretionary spending. As with past oil shocks, a sudden spike in energy prices can lead to recession and a global slow-down. In short, we agree with the consensus that Middle East and North African unrest raises the risk to the global economy and to equity prices.

Still, we did not author this note to simply agree with the consensus, and we believe it is too early to change course from our generally positive stance. We believe that the most likely case is for oil prices to vacillate with news from troubled areas, but for economic activity to continue to expand, supporting further gains in corporate profits and stock prices. Importantly, even a more negative scenario would not likely bring about another global panic and financial crisis as feared by jittery public investors. More likely, it would cause a recessionary environment, possibly negative for shares and business, but far from disastrous. Interest rates remain low and the stocks we own are reasonably valued for a conservative base case. Disruptions in oil supply may occur due to violence and uncertainty in governance, but no group thus far is threatening to stop shipping oil for money. We have had regime change before and we have experienced the Suez Canal crisis, the oil embargo, the Iran-Iraq War, the Kuwaiti invasion and various other coups, revolts, etc. These were economic disruptions, but most proved to be transitory. Longer term, the current global energy dynamic is unsustainable but change will be a gradual process that presents opportunities along with the threats.

As mentioned above, we have been shifting the portfolio from low margin businesses with commodity inputs, to higher margin businesses with better pricing power. Dylan's point is somewhat crass, but is appropriate given current events overseas. The lyric comes from his 1983 *Union Sundown* about the globalization and outsourcing of manufacturing. Since that time, democracy has spread, the world's markets have become wealthier, and the U.S. has replaced many, if not all, manufacturing sector jobs with higher skilled positions. We have even reduced the size of our dependence on oil, but clearly have not eliminated it.

In short, when we build our probability tree, we still find a positive future investment environment – but we are prepared to act decisively if circumstances deteriorate.

Sincerely,



William G. Spears



Robert M. Raich



James E. Breece



Paul F. Pfeiffer



Stephen H. Frank



John V. Raggio