

January 2012 Commentary

The U.S. stock market, even with its lackluster performance this past year, outperformed almost all global markets in 2011. (The Jamaican and Trinidadian stock markets were actually the place to be, with both up about 25%!) After declining significantly in 3Q 2011 amidst political dysfunction at home, a debt crisis in Europe, and weakening growth worldwide, the S&P 500 had a return of 11.82% during the fourth quarter. For the year, the S&P 500 had a total return of 2.11%, although many broad market indices were down for the year. During 2011, gold reached an all-time high before retreating at the end of the year, and yields on U.S. Treasuries declined to historic lows despite a downgrade by Standard & Poors.

Portfolio Thoughts

In 2011 as a whole, we observed continued strong earnings growth in your portfolio companies. However, despite solid results, mounting economic fears caused significant volatility in equity prices at certain points during the year (e.g., August and September). In our minds, this was a case where the stock appreciation of your portfolio companies lagged their earnings growth. One of our basic investment philosophies since the firm's founding in 1976 has been that stock performance is highly correlated with growth in earnings over the long run. When the trend lines diverged in August and September, we decided to add to positions and to initiate new positions where cash was available in your portfolios.

2011 was one of the more volatile years for the market in recent history. However, for all the daily, weekly and monthly volatility in 2011 and the resulting investor unease, U.S. markets were actually little changed for the calendar year. 2011 marked the smallest price change (+0.31%) in the S&P 500 index (ex-dividends) since 1970. We recognize that volatility often concerns clients (very understandably), but we continue to try to use the volatility to your advantage to add to or initiate positions in companies whose valuations become more attractive to us during such periods. In particular, although we are bottom-up investors, the investments in your portfolios in 2011 have been consistent with the themes of technological innovation, food and energy production to feed and fuel a rising global middle class, and demographic trends in the U.S.

Market Thoughts

In statistical terms, tail risk is a form of portfolio risk that arises with the possibility that an asset or investment will move more than three standard deviations from the mean. In more everyday terms, tail risk is the risk of an economic or financial collapse of some sort that will decimate asset values.

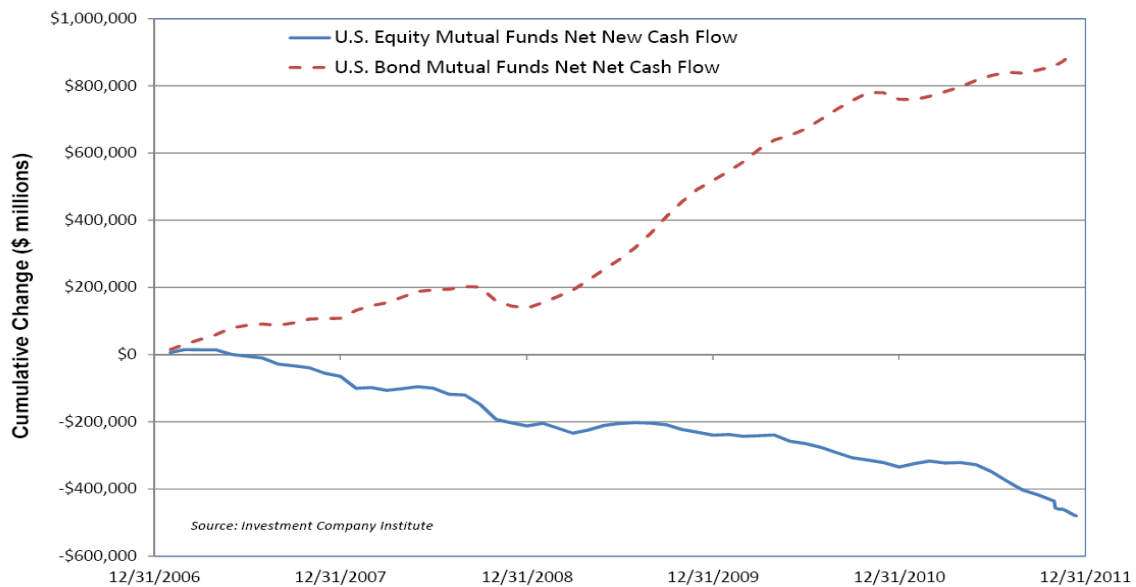
We have noticed in recent months that many professional investors and market commentators seem to be very concerned about risk and are protecting against it by staying cautious on stocks and continuing to recommend buying bonds. We appreciate that tail risks to the market will always exist, and they can never be fully discounted. There are risks related to the European debt crisis (and the threat of multiple sovereign defaults), the possibility of a double-dip recession in the U.S. or a global recession, budget deficit issues in the U.S., and geopolitical uncertainty with respect to countries like Iran and North Korea. There are other tail risks that most investors cannot imagine today because they are very low probability

events. We recognize that any of these risks could result in a pronounced market downturn; however, it seems to us that the market has been thinking about these types of issues for months (or years) and has been discounting them to some extent at least. In contrast, when Lehman Brothers collapsed and the financial crisis ensued, few investors and market commentators discounted tail risks before or during the collapse. Investors seem to be more focused on risks now, and in our minds that is a good thing. An environment of pessimism and worry about the market can lay the foundation for a market advance over time and is much more conducive to positive returns than an environment of optimism or exuberance.

Historically, equity markets have performed well when “climbing a wall of worry” – whether it be economic or political risks or a combination of both. Stock prices have tended to perform better after the perceived risks have been discounted. Stated differently, when investors have already acted on their fears by liquidating equities, the context has been created for future appreciation. As the old maxim goes, buy the fear, and sell the greed.

A corollary to these “wall of worry” thoughts is what we have observed in flows into and out of U.S. domestic equity mutual funds and fixed-income mutual funds.

Investors Have Greatly Favored Bonds Over Stocks



While there have been several short periods of interruption or reversal of the overall trend of flows out of U.S. equity funds and into U.S. bond funds, the powerful trend has been plain to see. Over the past five years, individual investors have redeemed more than \$400 billion of domestic equity funds while contributing more than \$800 billion to low-yielding fixed-income funds. The swing is more than \$1.2 trillion since early 2007. While some of these flows may be attributed to deliberate allocations from domestic to global equities and some may be attributed to an aging demographic that is more suited to fixed-income securities, much of the phenomenon is a reaction to perceived risk. Many investors, for the time being at least, do not want to deal with the risk of U.S. equity markets. Between the 2008 financial crisis, the “flash crash,” the Madoff scandal, the insider trading scandals and the overall volatility,

investors have little appetite for equity risk. If these investors come back to the equity market, they would likely come back slowly over time and represent a potential longer-term source of strength for equities.

2011 overall was a year of flattish stock performance and strong earnings growth. Therefore, assuming we are not about to witness another recession in 2012, U.S. equities are more attractively valued today than one year ago. There are simply more earnings per dollar of market value than there were a year ago. One overall sanity check we have done recently is a comparison of the broad market today versus the period back at the beginning of 1999 (thirteen years ago) when the S&P was trading very close to the same level it was trading at the end of 2011. The S&P 500 has made no headway in thirteen years, while the economy, valuation and interest rates are all more supportive of stock prices than they were back in 1999. Real GDP is up by more than half since the start of 1999, EPS for the S&P 500 has almost doubled, the S&P 500 P/E ratio has fallen by almost half, and interest rates are much lower today than they were back then (Source: FactSet Research Systems Inc.).

While the market was significantly overvalued in 1999 (and the tech bubble was about to pop), the least that can be said based on this information is that valuation is much less a concern today. We are citing this data not as a reason to be bullish but to put the equity market in a broader perspective. The market will likely go through weak patches in 2012, when uncertainty abounds about the Euro's future, political developments and fiscal imbalances in the U.S., and global economic growth. We believe that some of the uncertainty will be resolved one way or another as the year goes on. We also ask ourselves what kind of fundamental support underlies the market and how these underpinnings compare to thirteen years ago when the market was at a similar level. We believe the footing is firmer now than it was then, which can limit downside risk somewhat and can provide the support for market appreciation over time, especially if uncertainty dissipates.

Firm Update

We thought it might be helpful to update you on where the firm stands at the end of 2011 – what has changed over the last few years and what remains the same. As usual with D.F. Dent and Co., much more remains the same than has changed, though the bullet points below might focus on the changes.

- ❖ No personnel changes in 2011, either among investment professionals or portfolio assistants;
- ❖ Still 100% employee owned;
- ❖ Still the same investment style;
- ❖ Added new financial, economic and company-specific information software;
- ❖ Successfully upgraded client accounting system and trading platform in 2010 and 2011, enhancing our ability to serve our clients;
- ❖ Introduced the DF Dent Midcap Growth Fund (DFDMX) as our second mutual fund, with a midcap focus. It follows the DF Dent Premier Growth Fund, with an all cap focus, which was introduced in July 2001; and
- ❖ Upgraded our company website: www.dfdent.com .

We appreciate the confidence you have placed in D.F. Dent and Co. and are conscious of the responsibility which you have entrusted to us. We continue to work diligently on your behalf.

This commentary can be found on our website (www.dfdent.com). We encourage you to refer to our website for other information about our firm and our investment products, including our new mutual fund, the DF Dent Midcap Growth Fund (DFDMX).