To: East Coast Asset Management Clients and Interested Parties

From: Christopher M. Begg, CFA – CEO, Chief Investment Officer, and Co-Founder

Date: January 12, 2012


Market Summary¹

<table>
<thead>
<tr>
<th></th>
<th>S&amp;P 500</th>
<th>MSCI AC World Index</th>
<th>MSCI Emerging Markets</th>
<th>MSCI EAFE Index</th>
<th>Barclays Aggregate Bond Index</th>
<th>Gold – $/Troy Oz</th>
<th>Crude Oil</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price</td>
<td>1257.60</td>
<td>1182.59</td>
<td>916.39</td>
<td>1412.55</td>
<td>1682.87</td>
<td>$1,563.70</td>
<td>$98.83</td>
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<tr>
<td>12/31/2011</td>
<td></td>
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<tr>
<td>2011</td>
<td>2.11%</td>
<td>-4.98%</td>
<td>-18.37%</td>
<td>-11.67%</td>
<td>7.69%</td>
<td>10.06%</td>
<td>8.15%</td>
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<tr>
<td>Q4 2011</td>
<td>11.82%</td>
<td>7.74%</td>
<td>4.44%</td>
<td>3.40%</td>
<td>1.15%</td>
<td>-3.71%</td>
<td>24.79%</td>
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<tr>
<td>2010</td>
<td>15.06%</td>
<td>12.67%</td>
<td>19.04%</td>
<td>8.38%</td>
<td>7.00%</td>
<td>29.52%</td>
<td>15.15%</td>
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</tbody>
</table>

On behalf of our entire team at East Coast, I want to extend to you and your family our sincere wishes for health and prosperity in the new year. Although we would love to start the year reporting that the equity market turbulence is behind us, we are expecting volatility to persist. Continued deleveraging of the global economic system coupled with heightened political inputs will fuel fear of the unknown. Our best absolute performance years have rarely been born out of a cheery consensus, thus this prognosis may not result in anemic returns. While an emotional “all clear” sign remains elusive for investors, we are finding the environment attractive for purchasing equity of competitively entrenched businesses.

We observe a general misclassification between uncertainty and risk. Looking forward, we also anticipate the general perception of “risk” versus “risk-free” assets will change. Central bank intervention to mitigate the effects of the inevitable deleveraging cycle will raise the cost of capital and compromise the value of paper currency. We expect this could be a disappointing realization for those seeking long-term shelter in cash and bonds. We will share some insight on these observations in this year-end letter.

Let’s take a moment to review 2011. Equity markets rebounded in the fourth quarter, with the strongest returns in the US with an 11.8% recovery in the S&P 500 versus a more muted appreciation overseas with a 7.7% increase for the MSCI World Index. For the calendar year

¹ The S&P 500 Index, the MSCI All Country World Daily Total Return Index, the MSCI Emerging Markets Index, MSCI Europe Asia Far East (EAFE), and the Barclays Aggregate Bond Index are representative broad-based indices and include the reinvestment of dividends. These indices have been selected for informational purposes only. East Coast’s investment strategy will not seek to replicate the performance of these or any other indices.
2011, the US was the only place to hide from the volatility brought on by Eurozone uncertainty. While the S&P 500 logged a positive 2.1% return for the calendar year, the foreign indices including MSCI World, MSCI EAFE, and MSCI Emerging Markets were in the red, giving up -4.9%, -11.6% and -18.3% respectively. The Barclays Aggregate Bond index registered a positive 7.6% calendar year return and gold moved 10% higher.

Attached with this letter, you will find your year-end portfolio summary including a detailed performance report.

**Plain Truth – Embracing Certain Uncertainties:**

The uncertainties that pervade the global economic landscape have many asking the same questions and voicing similar concerns. For every two steps forward out of this economic crisis there is inevitably one step backwards. We observe the psyche of market participants to be confused and frustrated. Investors want to know the truth. The illusion of prosperity created by a leveraged economic system has been exposed. The world is now rebalancing from the excess capacity brought on when credit was freely used by consumers, governments and corporations. Investors who were unprepared for the bubble that was forming feel duped, and citizens who are out of work or underemployed are angry and scared.

For this year-end update, I have highlighted the top seven areas where we are focusing our efforts. The list is portfolio and economic specific and includes change agents that we need to understand to extract opportunity or protect against tail risks. These broad views represent how and why we are allocating portfolio capital. The penultimate goal of our investing efforts, and I believe all investing, is to protect and compound capital (JOC)\(^2\).

Toward this objective of compounding, we can succeed if we seek the truth in three areas when researching an investment. We need to determine the investment’s internal rate of return (IRR)\(^3\), understand our margin of safety (MoS), and synergize the critical data points that will drive the success of the investment (H4)\(^4\). If we are successful at determining these factors we can compare investments against one another and build a merit-based portfolio. An investment has merit when it has both an attractive expected rate of return (IRR) and a high confidence assessment garnered from the insights into MoS and H4. The following formula captures this objective: \(\text{JOC} = \text{IRR} \times (\text{MoS}+\text{H4})\).

In pursuit of truth, being intellectually honest about what we do not know or that which is unknowable are both critical to success. I find more people tackle this problem in reverse, pretending to know things that can’t be known and in doing so build dangerous convictions based on false assumptions. Socrates’ famous paradox, “the only true wisdom is to know that you know nothing,” has always served as a reminder that we should constantly challenge our conclusions and more importantly those of the consensus.

\(^2\) JOC = Joys of Compounding discussed in detail in “Joys of Compounding – Revisited.”
\(^3\) Internal Rate of Return (IRR) discussed in detail in “Unified Theory of Investing.”
\(^4\) H4 – finding the critical data points was discussed in detail in “Finding Longitude – H4.”
I find the Arts can be a guiding body of knowledge to study in pursuit of truth. Great artists have a keen ability to conceptualize nature and humanity. Ernest Hemingway wrote in his memoir, *A Moveable Feast*, that when he was having difficulty writing he would remind himself of the following: “All you have to do is write one true sentence. Write the truest sentence you know.”

In the fine arts, paintings can be one of the greatest expressions of truth. Artists that have created enduring masterpieces refined their expressions to find the true essence of their subject; a still life, a portrait, or a landscape. Since human emotion contributes to mis-pricings, I believe the ability to synergize the truth of man-made systems gives the investor a true competitive advantage.

Below you will find a description of our seven broad views, and how we are expressing them in our portfolio today. To reinforce the fact that most of the uncertainty facing the world is the result of cycles of human nature, I have chosen a masterwork to demonstrate the timelessness of the topic. We feel an investor equipped with a process and philosophy to synergize truth will not be fooled by illusion and can move towards a goal of protecting and compounding wealth.

**Broad Views:**

1. **Deleveraging - Embracing Certain Uncertainties** – “*Certain Uncertainties*” – C. Vincent:

   By avoiding investments where the future is unknown, investors are paying a heavy price for perceived certainty. The investor’s tool kit must be equipped to address a range of uncertain outcomes.

   The survival behavior of fight or flight is not a positive attribute for investing. I believe people confuse the threat of danger with the fear of the unknown or simply uncertainty. **Risk and uncertainty are two very different things.** Uncertainty is the existence of more than one possible outcome. Measurement of uncertainty is giving probabilities to a range of those possible outcomes. Think probability distributions – the bell shaped curve for example.

   Risk is the state of uncertainty where some of the possible outcomes have an undesirable result or a significant chance of loss. Thus, the measurement of risk is assigning odds and measuring the magnitude of loss based on probabilities.

   There are uncertainties that exist in our portfolio that range from marginally positive to significantly positive outcomes. Based on multiple scenarios, some macro-economic and some specific to the investment, the expected returns will vary. We attempt to avoid those investments where there is even a slight probability of permanent loss of capital. We feel we can mitigate volatility, which we do not necessarily define as risk, by adhering to a value discipline and purchasing securities with a margin of safety. It is important to note that not all volatility is worth the return we would surrender to reduce it.

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As a result we are finding very compelling “certain uncertainties”. We are also finding, and avoiding vehemently, a number of investments where risk of permanent loss of capital is material and a risk of negative real-rate of returns are likely.

The global economic system is in a period of deleveraging. This deleveraging requires us to devise a playbook that will be different than one that may have been used over the last thirty years. While our fundamental cornerstones of compounding (ascertaining attractive IRR’s with confidence around MoS and H4) remain the same, the difference lies in how the economic system will work in light of the excessive debts accumulated during the credit binge.

I explained in last quarter’s letter that there will be a prolonged period where governments will need to cut spending, increase taxes and print money. The budget debate will be great political fodder for our election and higher taxes to the wealthy are likely imminent. However, the bulk of the block-and-tackling will be done by money creation here in the US, the Eurozone and in Japan. The inflationary effects of these activities will have negative consequences for long-term bonds and developed-world paper currencies.

We are favoring the positively skewed “certain uncertainties” of the equity of competitively entrenched global businesses which we define and discuss as compounders. We own and continue to buy these businesses at attractive IRRs. We also continue to find mis-pricings in the equity investments of our transformation and workout categories. For liquidity, we are using short-term bonds and a modest amount of cash. We continue to maintain a gold allocation which we have viewed as an attractive alternative to some of our fiat-currency money market assets.

This concept “uncertainty” was highlighted in Walter Isaacson’s biography of Steve Jobs. During the creation of the iPod Shuffle, Jobs told his engineers to get rid of the screen. When the engineers responded perplexed, Jobs predicted that users looking for a smaller device would not need to navigate, but rather if they were not in the mood for a particular song they’d simply skip ahead. Jobs was correct, and the Shuffle was another huge hit for Apple. The ads read “Embrace uncertainty.”

“I’m as proud of what we don’t do as I am of what we do.”

Steve Jobs – (1955-2011)
2. A “Fair Wind” for Certain High Quality/Mis-Priced Equities - “Breezing Up” – W. Homer:

When we turn off of the global macro noise and look at the merit of the businesses we own and that are available for purchase, we are optimistic about the future. Our compounders, defined as businesses with very large moats that protect the favorable economics their position affords them, are attractive at current prices.

We have approximately two-thirds of our long-equity positions attributed to compounders. Representative holdings in this category are: Berkshire Hathaway, Becton Dickinson, Colgate Palmolive, Express Scripts, Google, Johnson and Johnson, Lab Corp, MasterCard, Nestle, and Transdigm.

Beyond attractive compounders, our equity portfolio is represented by a number of attractive mis-pricings in our transformation and workout category. Currently they account for about one-third of our long-equity portfolio. Representative holdings in these two categories are: DirecTV, Fairfax Financial, General Motors, National Oilwell Varco, Union Pacific, Waste Management, and Willis Group Holdings.

In Q4 2011 we added two new core positions to our portfolio. The first purchase was a basket of large-cap global technology companies which we are implementing through a sector level exchange traded fund (ETF). With this basket trading at less than 10x earnings we feel there will be a mean-reversion to a more appropriate valuation. Historically the competitive advantage in the technology industry, even for great businesses, can be fleeting so in this case we have chosen to diversify away some stock-specific risk by executing this opportunity by way of the ETF.

The second position purchased was a financial services company whose share price has been battered by weakness in the financial sector and current earnings disappointment. While the share price has come down in line with many banks, this institution has very little exposure to mortgage loans and housing weakness. They do however have a sustainable, competitive advantage in providing safe keeping for household wealth. Their earnings have been hurt significantly from this prolonged period of low interest rates where they cannot earn normal fees on money markets and interest spreads on bank deposits. They are growing client assets at a 4 – 5% rate as they continue to take share of the industry. We conclude there will be nearly $2 billion of incremental earnings power in the business when the Fed Funds rate normalizes. With trough operating income near $1 billion and the business available for purchase at $15 billion, we feel we are buying a growing business at close to a 20% normalized free cash flow yield.

“Look at nature, work independently, and solve your own problems.”

Winslow Homer (1836 – 1910)

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*This painting was painted just miles from our Essex office in Gloucester Harbor. Homer completed this to commemorate our centennial in 1876. This painting was a statement of optimism about the future of the United States as the young boy holding the tiller looks forward to the horizon, anchor on the bow, a brisk breeze filling the mainsail.*
3. **Inflation and Interest Rates - “Perspicacity” – R. Magritte:**

When NASA set out to recruit astronauts in the mid-1960’s, they wrote in their brochure that the quality they were most looking for was “perspicacity”, which is defined as someone “who is able to quickly pick out, from among the thousands of things he sees, those that are significant, and to synthesize observations and develop and test working hypotheses.”

Rene Descartes wrote in “Rules for the Direction of Natural Intelligence,” “we should totally focus the vision of the natural intelligence on the smallest and easiest things, and we should dwell on them for a long time, so long, until we have become accustomed to intuiting the truth distinctly and perspicuously.” Rene Magritte did an excellent job of visually explaining this quality in his self-portrait – he is looking at an egg but in turn painting a bird in flight.

I find these concepts helpful in thinking about the direction of inflation and interest rates. To provide perspective, the chart below highlights US CPI Inflation (orange) and the 10 Year US Treasury (green) over the last 50 years. In the deleveraging section we discussed how the printing presses would be a necessary tool to deal with developed world debts in a post-credit bubble environment. Most market participants are focused intently on the egg and painting the egg: the reality is that the market will require a higher cost of their capital in light of the amount of money that is being created.

We are finding value in businesses that will benefit when this trend reverses and are avoiding certain fixed income investments which would be negatively affected.

“Everything we see hides another thing, we always want to see what is hidden by what we see.”
Rene Magritte – (1898-1967)
4. **Emerging Market Consumer** - "Impression, sunrise" – C. Monet:

In the mid-1800’s, photography was introduced to the mainstream world, instantly changing the unique and competitive advantage of the artist. Up to that point, the artist was the one charged with capturing an image; the most skillful could capture likenesses with awe-inspiring perfection. The camera was a game changer for the artist and a game changer to their competitive franchise.

Artists were forced to evolve and improve their techniques. They sought to capture a greater sense of reality that even photography could not capture. As a result, one of the great art movements in history was born – the impressionist movement. Claude Monet with his "Impression, sunrise" is said to be the first painting to emerge from this era. Artists painted "en plein air," capturing light, color and an impression of nature that had never before been done.

In our lifetime, we are and will experience another such watershed event in the world with the emergence of the emerging market consumer.

The interconnectedness of the world is self-reinforcing. Envy is a much more powerful force than greed. Human nature is said to covet that which it sees every day and with today’s technology and social networking the world can see and covet prosperity at any time. This is a very powerful force and this power is now in the “hands of the people”.

Businesses with scale, product identity, and distribution into emerging markets will thrive. As an example one of our holdings, Colgate Palmolive, derives over 40% of their total sales from the emerging markets. Our holdings in Visa and MasterCard are poised to benefit as this emerging population is introduced to the benefit of debit/credit versus cash. Many of our high quality compounder businesses deserve the right to win business as this pipeline of greater and greater demand comes to market. This is the most certain way to play this uncertain consumer demand curve.

This “impression, sunrise” of the emerging market consumer is one of the most underappreciated change agents that will ultimately drive global economic growth over the decades to come, and help move the world economy beyond the deleveraging currently at hand. As the quote below suggests, when one studies the parts - the facts and the figures - the impression that emerges is often reality.

> "When you go out to paint try to forget what object you have before you - a tree, a house, a field or whatever. Merely think, here is a little square of blue, here an oblong of pink, here a streak of yellow, and paint it just as it looks to you, the exact colour and shape, until it emerges as your own naive impression of the scene before you."

Claude Monet (1840 – 1926)

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7 This phrase was expressed in Henry David Thoreau’s *Civil Disobedience* written in 1849. “After all, the practical reason why, when the power is once in the hands of the people, a majority are permitted…” The proliferation of smartphone technology into the hands of a large emerging market demographic will continue to be a driving force of change.
5. **Eurozone Consequences** - “*Abduction of Europa*” – Rembrandt:

How can we be bullish on equities considering Europe? Are we being lured into complacency by a bullish delusion of what might transpire? Will the spillover effects drive the global economy back into a deep recession? We have carefully looked at the Eurozone situation and have solicited input from experts who specialize in the region. We have assigned probabilities and a range of outcomes to various scenarios. The distribution provides us with some insight into the range of uncertain outcomes and the probabilities of true risk.

As explained above, the global deleveraging process is acutely affecting the US, Eurozone, and Japan. The central bank solution to the debt burden for all three indebted regions will be austerity, taxing the wealthy and printing money. In the case of Europe there is an immediate need to print money to save the Eurozone. If they are unwilling to do so the worst case scenario may take place; the Eurozone could break apart. The different degrees of how much money they print will have scaled effects on the economic recovery and inflation. Too much and they release significant inflation, too little and we will see bank failures and sovereign defaults.

While a break-up of the Eurozone is a low probability outcome, it is also not zero. Even with some of these dire forecasts, we estimate that the most uncertain outcomes from these valuations give us a range of estimated returns between anemic single digit returns to healthy double digit returns over a multi-year holding period. When we stress test our own holdings, we do not see a major downside earnings revision or multiple adjustments from the businesses we own, particularly from current valuations.

We continue to monitor this situation closely and we have been looking carefully in the region for opportunities. We have added to some of our European-non bank holdings prudently. We will keep you updated on changes to our thought process as we digest more information during the first quarter.

> “...Practice what you know, and it will help to make clear what now you do not know.”  
> Rembrandt – (1606 - 1669)

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8 Europe derives its name from the Greek goddess Europa. Rembrandt’s depiction tells the story of how Zeus, enamored with Europa, decides he wants her for his wife. He transforms himself into a tame white bull and mixes in with her father’s herd. As Europa and her attendants are gathering flowers, she is persuaded by the bull. She eventually joins him where he wades into the sea and swims to Crete where his true identity is revealed.

This irony is not lost on us when we think of the Eurozone and how some of their 17 constituents were deceived by the prosperity that leverage could bring. The bull has now revealed itself and they realize they have been abducted, swimming in debts they cannot escape, and facing the reality that economic consequences may be, among other things, their freedom. The future of the Eurozone rests now in the hands of a few politicians; where Europa eventually became the first queen of Crete, the various outcomes that will occur in Europe are less regal.
6. Jobs and Housing - “Noon: Rest from Work (after Millet)” – V. van Gogh:

We are ten months away from a US presidential election. President Obama took office just as the US economy was sailing into an economic perfect storm. Unemployment and underemployment has persisted, as it generally does when an economy deflates from a period of unsustainable leveraged growth.

The lion’s share of the job losses have come out of the housing industry which directly and indirectly affects many people and businesses. We have and will continue to see job losses coming out of the banking industry as financial service companies continue to be dealt mortgage and earnings losses from the Fed administered zero percent interest rate regime.

Until we work off the excess capacity of homes, jobs will not return to these sectors. While the statistics are not perfect, we estimate there are 2.5 million surplus homes in this country. We have approximately 1 million new families that come into the market each year willing to buy these homes. We are currently building about 500,000 new homes each year, so we are sopping up approximately 500,000 homes which equates to about 4-5 years until we use up excess inventory. We have many bank-owned homes that will be foreclosed on and sold which we refer to as “shadow inventory.” This is the skeleton in the closet for the banking industry.

For these reasons, we remain cautious on many financial institutions that have mortgage loan exposure. While banks and related businesses have favorable valuations, the uncertainty that exists around losses remains negatively skewed into the risk category.

We are hearing the beginning of some creative programs being initiated by the current administration to mitigate this reality. They believe if these programs can reduce housing inventory levels then possibly unemployment rates will drop and loan losses will improve.

James Carville hung a sign in Bill Clinton’s Little Rock campaign headquarters that read “It’s the economy, stupid” during President Clinton’s 1992 successful bid to unseat George H.W. Bush. This election will be focused more on jobs rhetoric.

“Exaggerate the essential, leave the obvious vague.”

Vincent van Gogh (1853 – 1890)
7. **The “Sinnerman” versus The Protestor** - “Son of Man” – R. Magritte:

Time Magazine’s person of the year choice of the “The Protestor” was further evidence of just how impactful a year it has been for change. The individual has been empowered in the name of humanity.

Overseas we witnessed the Arab Spring and how civilians assisted by technology could band together and topple a dictator. Here in America the protestor is angry at the “faceless businessman” who pushed our financial system to the brink of collapse, blaming him for the joblessness that persists today.

During the leveraging of the economic system too many people, including corporate executives, politicians, regulators, and credit agencies, were lured to “bite into the forbidden apple.” They envied the fruits of what others were enjoying just as Adam and Eve envied wisdom when they ate from the Tree of Knowledge.

The fact that many of these leaders were caught red handed with no consequence justifies protestor frustration. The sun is setting on the period where leverage, greed and envy led to mistakes. The sun is rising on a period where people learn to do more with less. We view the period ahead for our country and for the world as promising. We believe corporate and government leadership are being judged by their humanity, prudence, and virtue and not just on progress at the expense of others.

Charlie Chaplin was famous in silent films before he uttered words on screen. Those words were worth waiting for when he wrote and spoke the famous “Great Dictator Speech” in 1940. This excerpt of the speech captures the essence of the protestor’s voice; “Greed has poisoned men’s souls – has barricaded the world with hate; has goose-stepped us into misery… We have developed speed but we have shut ourselves in: machinery that gives abundance has left us in want… The misery that is now upon us is but the passing of greed, the bitterness of men who fear the way of human progress… Let us fight for a new world, a decent world that will give men a chance to work, that will give youth the future and old age security…”

We believe different themes and investment opportunities will emerge in an era of deleveraging. We will source businesses that will deserve the right to win in this paradigm- selling products and services that are in harmony with changing demand patterns. More importantly, we need to exit businesses not willing to adapt as their existence will be compromised.

“There are more valid facts and details in works of art than there are in history books.”

Charlie Chaplin - (1889 - 1977)
Organizational Updates:

Laura Mok – Operations Associate: We welcome Laura to East Coast as an Operations Associate working closely with our Director of Operations Jane Bolger and Operations Associate Lindsay Pollard. Laura will help address many of the operational and service issues that arise for our clients. She has been working on special projects for East Coast and we have been so thrilled with her work that we invited her to become a permanent member of our team. Laura brings over 20 years of experience in the financial services industry. Laura is a graduate of Barnard College. Laura has quickly become an invaluable member of our team and we look forward to introducing you in person during your next office visit or by phone.

Associate Research Analyst: We welcomed Brian Degnan to our team this fall. Brian is a recent graduate of Columbia Business School and earned his Bachelors from MIT and JD from the University of Florida. Brian recently returned to Massachusetts with his family and we are lucky to have him working with us while he continues to pursue full-time analyst opportunities.

ECAM Award: We made an announcement prior to year-end that we awarded our 2011 ECAM Award to the “Horizons for Homeless Children” and “New England Center for Homeless Veterans.” We look forward to assisting these charities with their mission in the year ahead.

We continue to manage your capital with the utmost prudence and look forward to meeting and talking with you soon. We greatly value your support and trust.

“I am progressing very slowly; for nature reveals herself to me in very complex forms; and the progress needed is incessant.”

Paul Cezanne – (1839-1906)

On behalf of the firm,

Chris

Christopher M. Begg, CFA
CEO, Chief Investment Officer, and Co-Founder