INVESTMENT STRATEGY
JANUARY 2012

The year 2011 should be known as the year of volatility. After rising 8.4% to start 2011, the S&P 500 Index fell as much as 19% through October, and then rallied through year end to finish flat overall. During the second half of 2011, the markets swung wildly as traders reacted to news emanating from Washington and Europe. Volatility peaked in August, which included four consecutive days when the Dow Jones Industrial Average alternated up and down by more than 400 points. Such an event has never happened in the history of the stock market. During August, share prices changed an average of 2.2% each day, the most for any August since 1932. From September onward, the average daily price change has been 1.3%. By comparison, the 50-year average daily change before the collapse of Lehman Brothers in 2008 was only 0.6% per day.

Why has the stock market been so volatile? Certainly the sovereign debt crisis in Europe was the catalyst for much of the volatility. However, it is hard to make the argument that this crisis alone has warranted record volatility. What is apparent from the past six months is how dominant short term trading has become. Short term trading is normally the domain of investment banks and hedge funds, but over the past few years the explosion of programmed computer trading is likely a large contributing factor. Actually, programmed trading makes up an estimated 50-70% of the daily trading volume in today's markets! We do not know for certain the entire reason for the heightened volatility, but we do know that over the past 60 years the average holding period for stocks has consistently declined from more than five years to only months today. This means that the average portfolio has more than a 200% turnover rate on an annual basis. In comparison, our average turnover is roughly 15-25% per year.

Regardless of the reason for this volatility, it is very important to review the past year to gain perspective on which investments and investment strategies worked and which investments failed during this unusual period. Traditionally, fast-trading hedge funds and investment banks benefit during volatility because they claim to jump in and out of investments at opportune times. However, these traders do better in trending markets (markets that move in one direction or the other). The sharp back and forth actions of the market over the past few months left most hedge funds negative for the year and caused many investment banks to miss earnings expectations due to poor trading results. In general, high levels of trading activity proved to be detrimental during 2011 because of the extremely unpredictable market swings. Despite many pundits claiming otherwise, a well executed 'buy and hold' strategy is not dead.

TV pundits have also been adamant that viewers must be invested internationally because of the superior economic growth rates in emerging markets. In retrospect, 2011 may turn out to be the inflection point away from emerging market investing. Emerging markets performed

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exceptionally well over the past decade as $70 billion of investor funds flowed into Brazil, Russia, India, and China. However, these four markets suffered outflows of $15 billion in 2011. As a result, the Chinese market finished down 21.6%, the second consecutive year the Chinese market finished negative. Despite strong economic growth, Brazil was down 18.5% and India declined 22.6%. The mature European markets also faired poorly in 2011 as countries imposed austerity on their populations. The Bloomberg Euro 500 Index, comprising the 500 largest European companies, was down 13.2% during 2011. Even Germany, the strongest economy in Europe, saw its market drop 15.4%.

So which investments did work during this period of heightened volatility? As one may expect, investments that consistently display below average volatility. More specifically, large high-quality U.S. companies that pay significant and rising dividends outperformed. Traditionally stable defensive sectors such as healthcare, consumer staples, telecom, and utilities, performed very well. Meanwhile, the more volatile cyclical sectors lagged considerably. We also saw the continued out performance of U.S. Treasury bonds. Despite record low yields, an unbalanced budget, and trillions in debt, U.S. Treasury bonds remained the favored refuge for nervous global investors.

Despite recent out performance, we believe the large high-quality segment of the market will continue to outperform over the next few years. These low-volatility investments should become even more appealing as a result of the traumatic market movements in recent memory. In addition, the record low yields on corporate and government bonds are not going to change in the near future. This requires investors to focus more attention on gaining additional income from their equity holdings. Meanwhile, these market trends should only be reinforced by the largest demographic shift in history as the baby boom generation transitions into retirement and will naturally seek safer, income producing assets.

From a valuation standpoint, high-quality companies are still positioned favorably. As you may remember, in our January 2011 investment strategy we presented an internal study comparing 30 of our largest multinational holdings with the S&P 500 Index (market average). Last year the table showed that despite being cheaper than the market, these 30 holdings generated higher profit margins, had faster sales growth, and provided larger dividends. The following is an update to that study with a few companies substituted as a result of changes to client portfolios during 2011. You will see that these major holdings now have an equal valuation with the S&P 500 Index, but still generate much higher profit margins, sales growth, and dividend yields. As a reference, high-quality companies have historically traded at a 10-15% premium to the market over the past 60 years due to their higher profitability and safety.

COMPANY NAME	P/E 2011	DIV YIELD	NET PROFIT MARGIN	REVENUE 5 YR AVG GROWTH		COMPANY NAME	P/E 2011	DIV YIELD	NET PROFIT MARGIN	REVENUE 5 YR AVG GROWTH
3M COMPANY	13.0	2.7%	14.1%	4%		HOME DEPOT	15.4	2.8%	5.1%	-7%
ABBOTT LABS	11.2	3.4%	18.3%	11%		HONEYWELL INT'L	12.2	2.7%	7.6%	0%
ACCENTURE	14.0	2.5%	8.0%	5%		IBM	12.4	1.6%	14.3%	1%
AFLAC	6.5	3.1%	13.4%	9%		INTEL	10.2	3.5%	24.3%	6%
BB&T	10.6	2.5%	12.8%	9%		JOHNSON & JOHNSON	12.5	3.5%	20.8%	2%
BRISTOL-MYERS	17.5	3.9%	18.0%	2%		KIMBERLY-CLARK	14.0	3.8%	9.0%	3%
CARNIVAL	12.1	3.1%	9.2%	4%		KRAFT FOODS	14.8	3.1%	7.2%	9%
CHEVRON	8.2	3.0%	10.8%	-1%		MEDTRONIC	11.1	2.5%	21.8%	7%
COCA-COLA	16.9	2.7%	18.7%	10%		MICROSOFT	9.5	3.1%	31.9%	7%
CONOCOPHILLIPS	8.6	3.6%	4.4%	1%		PEPSICO	14.4	3.1%	10.4%	13%
DISNEY (WALT)	12.9	1.6%	11.2%	2%		PHILIP MORRIS INTL	15.0	3.9%	26.2%	---
DOVER	11.8	2.2%	9.7%	1%		PROCTER & GAMBLE	15.9	3.1%	12.9%	1%
EXXON MOBIL	10.1	2.2%	8.5%	0%		STRYKER	12.1	1.7%	17.2%	7%
GENERAL ELECTRIC	11.4	3.8%	9.4%	-3%		VERIZON COMM	15.7	5.0%	5.7%	4%
HARRIS CORP	7.0	3.1%	9.0%	7%		WALMART STORES	12.2	2.4%	3.4%	4%
30 COMPANY AVG	**12.3**	**3.0%**	**13.1%**	**4%**						
S&P 500	**12.3**	**2.1%**	**9.3%**	**1%**						

For the stock market as a whole, Wall Street forecasters are pessimistic on 2012 which has historically been a very positive sign for investors. Specifically, forecasters expect a 6.4% gain in the S&P 500 Index this year, the smallest expected gain since 2005. This year's performance will continue to be significantly affected by the ongoing debt crisis in Europe. The most likely scenario is for Europe to slowly work through their problems and over time regain investor trust. If Europe remains stable, it will likely result in double digit gains in U.S. equity markets. However, there is a slim chance the European debt crisis unwinds, oil prices skyrocket, or another unforeseen event arises. Due to the fragile state of the global economy, any significant shock to the system could result in a renewed recession and lower market indexes a year from now.

Regardless of how events play out, we believe the best choice for long term investors is to be positioned in the high-quality segment of the market. This strategy provides investors with the greatest return potential for the level of risk. Large, high-quality companies offer substantial returns in an advancing market while providing far more protection if the market deteriorates. Additionally, they provide above average dividends that are becoming increasingly sought after by income-starved retirees. Due to the major trends covered in this letter, there should be a number of tailwinds for the high-quality, dividend paying segment of the U.S. market for the next 3-5 years. As a result, we believe our clients are positioned to benefit next year and beyond by owning a portfolio of the greatest and most recognizable names in business.

Truly Yours,

Keating Investment Counselors, Inc.