PEKIN SINGER STRAUSS
ASSET MANAGEMENT

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Dear Client,

"The first panacea for a mismanaged nation is inflation of the currency; the second is war. Both bring a temporary prosperity; both bring a permanent ruin. But both are the refuge of political and economic opportunists."

-Ernest Hemingway-

The stock market last year can best be characterized in one of two ways. First, "lots of ups and downs, but not much to show for it." This refers to the fact that stocks were more volatile last year than in all but a handful of years since 1950; yet, for all of the market's gyrations, the S&P 500 Index ended the year unchanged (up 2.1% after dividends). Volatile stock markets, like 2011, are a reminder that when it comes to forecasting, the stock market can make fools of even the most astute observer.

Another characterization--"more than enough drama"--refers to the fact that risks to investors in 2011 were seemingly everywhere. Between upheavals in the Middle East and North Africa, natural disasters in Asia, sovereign debt crises in Europe, disappointingly tepid economic growth, and various credit rating downgrades, there was no shortage of forces vying for investor attention and contributing to the volatility of stocks.

The year began with the stock market showing good strength, buoyed by investor optimism about the prospects for a strong economy. By the end of April, the S&P 500 Index had increased 8%. But then, investor concern surrounding the solvency of European banks and governments grew. Around the same time, Congressional deadlock over raising the debt ceiling caused investors to fear that the U.S. Government could end up in technical default of its debt. The result was that the market dropped 18% from its peak in the spring to its bottom on October 3rd. At that point, the stock market was down 10% for the year. While little of substance changed over the final months of 2011, the market rallied and, as mentioned, ended the year basically where it began.

In effect, a large part of what we experienced last year were bouts of panic interspersed with periods of relief, much of which was driven by fragments of news and sometimes mere rumor. While often unsettling in the short-term, as a general rule, we view volatile markets as opportunities to put capital to work at attractive prices.

The swings were as great as they were in 2011, in large part, due to the impact of excessive financial leverage in the industrialized nations of Europe, but also due to the impact of excessive financial leverage in Japan and the U.S. as well. With leverage, small changes, one way or another, have an amplified result, and, the greater the leverage, the more exaggerated the result.

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The Math of Private Debt Leverage

We believe this issue of debt leverage is the linchpin for much of what ails the world we live in today; if you would, please bear with us—

> *Hypothetically—if you are a bank with $2 of assets, $1 of debt, and $1 of net worth, a decline in asset value of 10%, while clearly a hit to your net worth, likely is manageable. Using this assumption of a 1:1 debt-to-equity ratio, the use of debt or leverage is not overly burdensome. After the loss, you have $1.80 in assets, $1 of debt and 80 cents of net worth.*
>
> *But, if you have $10 of assets along with $9 of debt and your net worth is still $1 and you suffer an asset decline of 10%, it could be your financial ruin. With a 9:1 debt-to-equity ratio, the loss reduces your assets to $9 and eliminates all of your net worth. The use of an excessive amount of leverage, in this instance, has put you firmly on the path to financial insolvency.*

This math also applies to the balance sheets of corporations and of individuals, where debt-to-net worth is the appropriate measure of leverage. The amplified nature of leverage explains the housing bust, the U.S. credit crisis of 2008, and the current European banking crisis. Another more recent casualty of leverage, MF Global, a commodities broker and investment bank with a debt/equity ratio of 40:1, invested heavily in European government debt obligations. When the prices of those bonds declined and erased its thin layer of capital, MF Global quickly went bankrupt.

The crisis in Europe is as much a banking crisis as it is a sovereign debt crisis. Many of the largest banks in Europe are employing debt/equity ratios of 30:1 or more, and an unhealthy portion of their assets are invested in the sovereign debt issues of Greece, Italy, Portugal and Ireland, which just a few years ago were considered risk-free credits. The math we described above would suggest that the net worth of many of these banks has been wiped out or nearly wiped out.

The Math of Government Debt Leverage

For governments, one of the most important metrics of leverage is the amount of a country's public debt in relation to its annual output—Gross Domestic Product (GDP). Generally speaking, debt-to-GDP ratios that approach 1:1 become concerning, while ratios greater than 1:1 create significant default risk. As debt-to-GDP ratios rise, periods of low or no economic growth result as more and more income is diverted to making interest payments. In the current situation, emerging market countries are not the ones with the high debt levels; rather, it is many of the developed countries of the world which have poor and deteriorating balance sheets.

The other thing that is different about leverage between governments and individuals/companies is the way that default occurs. An individual or a company defaults by not making an interest payment or a principal repayment. However, as noted by Ernest Hemingway, countries typically default by debasing their currency to more easily pay back their debts. In 2005, when talking about the sustainability of the U.S. Social Security system, Alan Greenspan famously said-- "We can guarantee cash benefits as far out and for whatever size you like, but we cannot guarantee their purchasing power." In this telling statement, he was alluding to the particular way in which countries tend to default on their financial obligations.

A country with a high debt/GDP level has two ways to reduce that ratio and improve its financial situation. The first is to reduce the numerator of the equation, which is the level of debt. This

usually involves painful and politically unpopular cuts in government spending or increases in taxes, otherwise known as "austerity measures." The second is to increase the denominator of the equation, GDP, through a combination of real economic growth and inflation.

Japan: With Europe's debt woes so much in the news, there has been little focus on Japan, but Japan is perhaps the most leveraged industrialized country with a high debt-to-GDP ratio (of 2.33:1) that will likely be a drag on the country's prosperity, perhaps for decades. In addition to having to contend with its high debt, Japan's aging, no-growth population will weigh heavily on the country's ability to grow GDP. Giving recognition to its excessive leverage, Moody's recently downgraded Japan's credit rating to Aa3. In addition, the International Monetary Fund warned that Japan's debt level was unsustainable and a threat to the financial stability of the world. That Japan is able to finance its public debt has been due to the unwavering (to date) appetite for government debt by domestic investors. At some point, Japan will have to take steps to reduce its debt/GDP ratio; nobody knows when that will be, however.

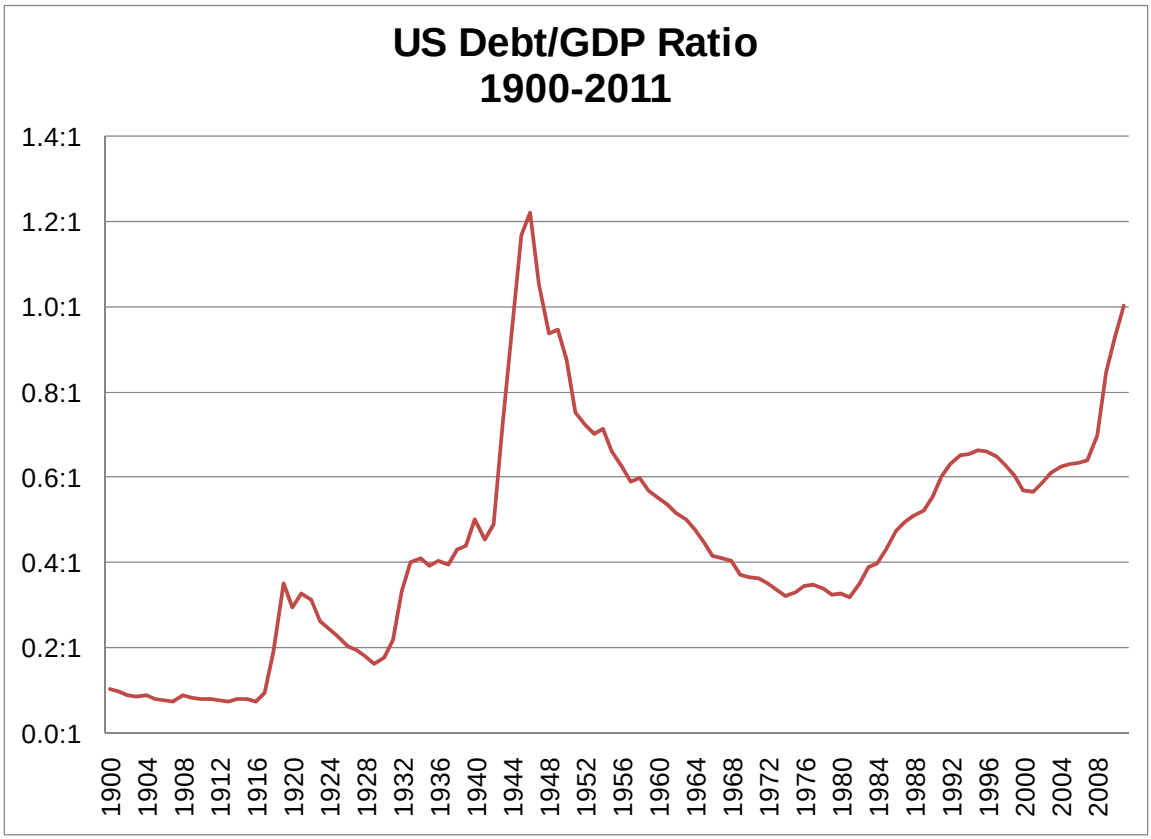
Europe: The Euro-Zone, as a whole, may not be as leveraged as Japan, but the recent down-grade by Standard & Poor's of several European nations debt ratings is yet another reminder that fiscal restraint is needed. Portugal, Italy, Ireland and Greece all have debt-to-GDP ratios greater than 1:1 and clearly have an immediate need to de-lever. (Debt-to-GDP for the European Union as a whole is about 0.8:1.) In 2012 alone, Euro-Zone countries have $1.3 trillion of debt coming due; whether these countries will be able to refinance this debt and at what cost remains to be seen.

There is a clear need for these European nations, along with Spain and Belgium, to reduce their debt/GDP levels. Yet, austerity measures are resisted, sometimes violently, by those dependent on government programs. Also, much of the debt of these countries is held by highly leveraged, essentially insolvent European banks, as we described above, which limits "debt-default" as a viable option. A healthy banking system is fundamental to a healthy and growing economy. Further complicating resolution of the issue is the fact that member countries of the European Union do not have the option today to depreciate their currency as they are unable to print money.

Policy makers in Europe have been trying to address Europe's problem of excessive leverage. As of this writing, however, beyond making some ultra-low interest loans to Europe's large "zombie" banks, very little has gone beyond the talking stage. The fragmented political structure of the European Union is a complication that may not have been fully thought through when the common currency was created.

FYI—while some of the companies we are invested in on your behalf conduct a significant amount of business in Europe, our direct exposure to the securities (bonds and stocks) of the leveraged European banks and governments is negligible. We have, however, purchased a number of securities that are denominated in currencies other than the U.S. dollar, such as the, the Norwegian Krone, the Canadian dollar the Swedish Krona, etc. We have done so in the belief that the U.S. dollar would depreciate against the currencies of these countries with stronger balance sheets.

United States: The U.S., itself no paragon of financial rectitude, presently has a debt-to-GDP ratio of slightly more than 1:1. The graph below shows the public debt/GDP ratio of the U.S. from 1900-2011.



As you can see in the graph, this is not the first time the US had a public debt-to-GDP ratio of 1:1 or more. The enormous cost of waging World War II caused our debt/GDP ratio to reach 1.2:1 by the time the war ended. At that time, the private sector was substantially under-leveraged following first the Depression, when debt was generally viewed as somewhat foolhardy, and then subsequently the war effort, which limited private consumption, resulting in forced savings. Therefore, private consumption was in a good position to increase GDP growth in the 25 years following the war. To support the rising levels of consumption, consumers initially turned to their accumulated savings and then subsequently increased their credit usage. This private sector consumption was an important driver of GDP, as was the rate of inflation, which also was markedly higher than it has been in recent years. At the same time, government spending declined with the end of the war, while the highest marginal tax rate was above 80%. As a result, by the mid-1970's public debt-to-GDP had declined to 0.3:1.

Over the next three-plus decades, however, as a result of increased government spending and lower tax rates, the debt/GDP ratio increased to 0.7:1 by 2008. The impact of the financial crisis of 2008 and the accompanying recession, coupled with the government's policy response to both issues over the past three years, pushed the debt-to-GDP ratio to the present 1:1. **Just briefly, both the private sector and the public sector of the U.S. were in a long-term leveraging cycle from the mid-1970s to**

the present, and that leveraging cycle was a major driver of GDP growth. At the current level of private and public sector debt, this cycle has ended and is now set to reverse.

The obvious most pressing concern is Europe's debt burden, but policy makers in the U.S., can no longer ignore the need to de-lever either. They face the task of having to choose one or more of three options. None are especially attractive.

1. The U.S. government can ***default*** on its debt obligations by not making interest or principal repayments. Given that the U.S. alone holds the world's reserve currency and can print its own money to buy its own debt, we view this as a highly unlikely outcome.
2. The Government can opt for ***austerity measures*** by cutting spending and/or raising taxes. This option was discussed at length by policy makers just before the government debt ceiling was raised last summer, but after watching the political charades, it is clear that significant austerity is currently viewed as an unpalatable option.
3. They can flood the system with ***printed money*** in an attempt to ignite the economy and depreciate the dollar. If inflation can cause GDP to grow faster than our debt grows, then the debt/GDP ratio will decline.

This brings us to the concept of ***Financial Repression***. Financial Repression is a term used to describe a set of government policies most recently described by Carmen Reinhart and M. Belen Sbrancia in an IMF paper called "The Liquidation of Government Debt" whereby the government caps interest rates, finds sources of directed lending from captive domestic groups (such as banks and pension funds), and implements capital controls. It is adopted by policy makers because alternatives 1-2 above imply a painful adjustment and are politically hazardous. Option 3 is the most feasible option, but its chances of success are likely to be highest if combined with other supportive measures.

Why is Financial Repression necessary? In the United States, if the Treasury's borrowing costs were more historically normal, say 4% on the 10-Year Treasury bond instead of slightly less than 2%, our budget deficit would be a whopping $300+ billion (20% plus) higher than it otherwise would be. (Due to the political impasse in Washington, there is no budget for the current year; consequently, more precise estimates cannot be made.) Adjusted for the rate of inflation, the "real" yield for investors who own the 10-Year Treasury is decidedly negative, thanks to a policy of interest rate caps on the part of the Federal Reserve Board. Unsurprisingly, the Federal Reserve has announced that it intends to keep a lid on interest rates at historically low levels through at least mid-2013.

Will money printing combined with Financial Repression work to reduce the debt/GDP ratio without runaway inflation? It's hard to know. If creditor nations, such as China, are willing to continue to own Treasury bonds and rely on the dollar as the world's reserve currency, it could work, eventually. The issue, as mentioned, is how long will foreign creditors be satisfied with a negative real rate of return on their foreign reserve holdings, and, particularly so if their own economies weaken.

Thus far, the Financial Repression measures that have been imposed have given the markets a certain surface stability. To use Hemingway's words, money printing has worked as a temporary panacea for the U.S., although general prosperity is declining. Unfortunately, the stability may only be the result of the fact that debt accumulation has slowed and the days of reckoning have been delayed. The more important problem is that debt continues to grow at a faster rate than GDP, which means that the debt/GDP ratio is actually worsening.

In the past, sovereign debt, as a supposedly risk-free asset class, was the bedrock of our financial markets against which all other investment options were measured. The consequence of decades of sovereign debt build-up has made investing commensurately riskier, and the process of creating sensible investment strategies has become more challenging. It also means that political uncertainty has become a more important variable for investors to address.

None of this is news—but what is new is the magnitude of government debt in the industrialized nations of Europe, the United States and Japan, and also new is the reality that policy options are narrow because of politics.

As always, as your investment managers, we remain vigilant in our search for opportunities where we perceive the risk to be modest and the return potential to be well above average---all the while seeking to protect the real (inflation-adjusted) value of your capital. How the year ahead will unfold is anyone's guess. Much will depend on how the central banks of Europe, Japan, the United States and perhaps China (as the world's largest creditor nation) react to the slow (or no) growth economy and how they deal with the pervasive debt in the system. While constantly tweaking our investment strategy, we feel good about the positioning of our client accounts as we enter 2012. We continue to play defense with the expectation that the business environment will remain relatively stagnant, but we also are relatively well prepared should inflation accelerate.

Last, we are pleased to announce that Brandon Hardy has become a stockholder of Pekin Singer Strauss, effective January 1, 2012. Brandon's responsibilities for a number of years at the firm were as Portfolio Accounting Administrator, but as the years unfolded, he successfully transitioned into the area of Portfolio Manager. Brandon served our clients well in past years, and we are excited to have him do so in the years ahead as a fellow stockholder.

In closing, we thank you for your confidence and support of our efforts and will endeavor to earn it in the years ahead.

Sincerely,

Rick Singer, CFA | Ron Strauss, CFA | William Pekin, CFA

Josh Strauss, CFA | Adam Strauss, CFA | Brandon Hardy