CLARK & STUART, INC.

Investment Counsel

Investment Comment
December 31, 2011

Dear Friends,

At the start of 2011 we listed several risks to the global economy and financial markets. These included the European sovereign debt crisis, slower economic growth in developing countries, and ongoing deterioration of U.S. government finances. These issues weighed on investors throughout the year and triggered a 20% decline in the S&P 500 Index between late April and early October. The market benchmark finished 2011 with a strong fourth quarter rally and a total return of 2.1%. However, the three critical risks listed above are still in place. We anticipate another roller-coaster ride for stocks in 2012 – and we are prepared.

For 18 years our clients have placed their trust in an investment approach which is firmly rooted in the belief that stock prices will, over the long term, reflect the business performance of the underlying companies. We have executed this strategy by emphasizing companies with long-lasting competitive advantages in lower-risk businesses. Also, our bottom-up approach spreads investment risk across 15-20 separate and unique decisions. This approach has served our clients well during periods of significant global uncertainty. This was true in 2011. We believe it will be true again in 2012.

Widespread fear of another recession also contributed to the sharp decline in stock prices noted above. In our last report (September 30, 2011) we argued that economic recovery in the U.S., though sluggish and fragile, was still intact. In fact, the U.S. economy accelerated modestly during the year as gross domestic product (GDP) increased 0.4%, 1.3% and 1.8% in the first three quarters. Steady improvement of the labor market, signaled by lower unemployment claims and higher monthly job creation, suggests that the pace of recovery increased again in the fourth quarter.

On several occasions we have noted three critical variables which drive stock prices in the short term: (1) monetary policy and liquidity conditions, (2) corporate profits and (3) the outlook for sustainable economic growth. Throughout 2011 the Federal Reserve continued its support for the economy with unconventional policies and exceptionally low interest rates. With the unemployment rate at 8.5%, and inflation under 2%, monetary policy will remain easy in the year ahead. Profit growth, however, has decelerated to a mid-single-digit pace after several quarters of strong double-digit gains driven by rising profit margins. The key determinant of profits going forward will be the economic expansion. *Because the U.S. economy is growing at an anemic pace, it remains vulnerable to external shocks. Among several risks which might de-rail the U.S. economy, the one we fear the most is still the European crisis.*

The European debt crisis escalated in 2011 -- spreading from Greece, Ireland and Portugal to the larger economies of Italy and Spain, and morphing into a liquidity crisis for the European banking system. In December the European Central Bank, which had made the drastic mistake of raising interest rates earlier in the year, finally took aggressive steps to support the banking system with unlimited long term loans. Still, the economic damage has been done. The inability of large European banks to secure adequate funding throughout 2011, the losses incurred on their holdings of government debt, and the imposition of higher capital standards have, taken together, created a credit crunch. Europe is already in recession (though no official declaration has yet been made) and it may be a very bad recession.

The U.S. economy is somewhat insulated from the European recession, but it is not immune. Exports to Europe are only 2-3% of total U.S. GDP. Still, U.S. companies with operations in Europe will incur some pressure on their sales and profits. Moreover, the *indirect linkages* between Europe and the U.S., through global trade and the financial system, are significant. European banks are among the largest lenders in the developing countries of Asia, Latin America and Eastern Europe. Also, as demonstrated in 2008, the complex web of relationships among financial institutions includes many risks that are unknown or underestimated until they are fully exposed in a crisis.

The origins of the European crisis are numerous and complex. The fundamental problem is that several countries' economies are simply not competitive. According to the U.S. Bureau of Labor Statistics, manufacturing unit labor costs in the U.S. *declined* steadily from 2000 through 2010. In France unit labor costs *increased* 50%. In Italy, they *rose* 100%. Higher government spending, funded by rising debt, papered-over the loss of competitiveness -- providing unsustainable support to failing economic models. Austerity, the policy imposed by European leaders, focuses on the symptoms and not the fundamental problems. Austerity also strengthens the forces of recession and, thus, exacerbates the current crisis.

The failure of European leaders to pursue the hard work of structural reform (of labor laws, tax regimes, pension programs) holds important lessons for politicians *and investors* in America. The "Occupy" movement in the U.S. has much in common with protestors on the streets of Europe. If politicians in the U.S. also continue to avoid the hard work of reform (of spending, taxes, entitlements), then America's government bond market may also, eventually, have something in common with the bond markets of Italy or Greece.

Abbott Laboratories (56.23)

Abbott Labs is the largest holding for most of our clients. A sharp decline in the stock price in early 2011 provided an opportunity to increase positions at very attractive prices. By year end the stock had posted a strong recovery – appreciating 17.4% for the year. With a dividend yield well above 3%, Abbott provided a total return of 21% in 2011.

On October 19, 2011 Abbott announced that it would split into two companies before the end of 2012. The pharmaceutical business, which accounts for about $18 billion of Abbott's $40 billion annual revenue, will become a separate yet-to-be-named company. The remainder, a diversified medical products company, with strong competitive positions in cardiac devices, diagnostics, nutritionals, and generic pharmaceuticals, will retain the Abbott name. Separation into two companies, with distinct investment identities, reflects a long-standing priority of Abbott's management – increasing the value of the company for its shareholders.

In an earlier report (January 2010) we reviewed the contribution of Humira, an injectable biologic medication, to Abbott's sales and profits. Humira limits the body's production of tumor necrosis factor (TNF) – a protein which causes inflammation. Thus, Humira is approved for treatment of several chronic inflammatory diseases: rheumatoid arthritis, psoriasis, psoriatic arthritis, ankylosing spondylitis, juvenile arthritis and Crohn's disease. Sales in 2011 were close to $8 billion – 20% of total company revenue and 45% of the pharmaceutical business. Approvals for additional indications (e.g. ulcerative colitis) are expected and Humira's patents do not expire until 2017 in the U.S. and 2018 in Europe.

The decline of Abbott's share price early in 2011 was triggered by concern among Wall Street analysts and investors that new anti-TNF medicines, available in oral formulation, could provide strong competition for Humira before its patents expire. A pill is clearly more convenient than an injection, but clinical studies of the oral alternatives have *not* demonstrated incremental efficacy. Established anti-TNF medications like Humira and Remicade (from Johnson & Johnson) have a long track record efficacy *and safety*. Also, the anti-TNF market is still dominated by chemical-based drugs which affect many areas of the immune system. In contrast, biologic medications, which are derived from human genes, target specific components of the immune system. At present, only 20-30% of patients with rheumatoid arthritis or Crohn's disease are treated with biologics. Therefore, even if new and more convenient drugs are approved over the next few years, sales of Humira should continue to grow as biologics continue to take market share from chemical-based drugs.

Later this year shareholders will receive shares of the new pharmaceutical company in a tax-free distribution. The two companies will pay dividends equal to the Abbott annual dividend. Management has indicated that the pharmaceutical business contributes a slightly greater share of total profits (about 55%) and the contributions to cash flow are roughly equal. Still, we expect investors to assign greater market value to the new Abbott Labs.

Investors always factor the impact of patent expirations into the valuation of pharmaceutical stocks well in advance. Obviously, the patent expiration of Humira will be a critical consideration at some point in the next few years. In the short term, however, patent expirations of other Abbott drugs will cause total sales for the new pharmaceutical company to be relatively flat in 2013 and 2014. Whether or not the new company can re-accelerate its growth rate after 2014 depends on new products currently in research and development. The company has several new products with high potential as treatments for Chronic Kidney Disease, Multiple Sclerosis, Parkinson's, and Hepatitis-C.

In contrast, the new Abbott Labs will be a well-balanced company with each of its four businesses accounting for 20-28% of revenue. Also, these businesses generate almost 40% of sales in the faster growing health care markets of developing countries. *Thus, the new Abbott will retain the reliable and sustainable financial characteristics which have been the hallmark of the company for many years.* Indeed, we expect Abbott to increase its dividend next month for the 40th consecutive year.

By spinning-off the pharmaceutical business, Abbott is isolating a significant business risk -- the patent expiration of Humira. Investors will make a separate judgment of the business risks, the growth potential, and the intrinsic value of the pharmaceutical business. Clearly, the headwinds to growth are well defined for the pharmaceutical company. However, the business will also generate substantial free cash flow over the next few years – courtesy of Humira. Consequently, other large drug companies may view Abbott's pharmaceutical business, and its new product pipeline, as an attractive acquisition target *after* the separation.

Finally, Abbotts' Chairman and Chief Executive, Miles White, architect of the separation, will remain with Abbott. Mr. White is only 56 years old, yet he has been CEO of Abbott for over 13 years. It is highly unusual for a CEO (at any age) to purposely make his company significantly smaller. Mr. White's willingness to put the interests of shareholders, employees, and patients ahead of his own ego is a rare demonstration of humility at the highest levels in corporate America. Investors in Abbott Labs can look forward to many more years of steady profit and dividend growth with the company in the hands of Miles White.

Walgreen Company (33.06)

Walgreen posted outstanding results for the fiscal year which ended August 31, 2011. Sales increased 7%, net income rose almost 17%, and earnings per share increased more than 24% to $2.67. At mid-year the company increased its dividend by 28% to $0.90 -- the 35th consecutive annual increase. These results are due to a significant cut in the annual increase in new stores and greater focus on improving the profitability of 7,800 existing stores.

Walgreen opened 261 stores in 2011 – down from 388 in 2010 and 602 in 2009. The number of acquired stores also declined to only 36 -- versus 282 in 2010 when Walgreen acquired Duane Reade in order to gain a significant presence in New York City. Walgreen also closed 133 stores in 2011 – half as many as were opened. *Thus, the net number of new stores in 2011 was just 164 -- versus 550 in 2010 and 562 in 2009.* Not surprising, Walgreen's profit margins improved substantially last year. Gross profit margins increased 24 basis points (from 28.15% to 28.39%) and cost controls helped to lower the ratio of operating expenses-to-sales by 8 basis points. Most of these improvements flowed to the bottom line as the after-tax profit margin increased from 3.10% to 3.38%. In a business with very low after-tax profit margins, seemingly small increases have an enormous impact on total profits – especially on a revenue base of $72 billion.

Unfortunately, the company's financial progress has been ignored by investors over the past several months. Walgreen's common stock ended 2011 down 15% from its value at the start of the year and down almost 30% from its 52-week high ($47). The catalyst for the stock price decline was Walgreen's announcement last June that negotiations to renew its contract with Express Scripts, one of the largest pharmacy benefit managers (PBM), had been unsuccessful and that Walgreen would not be part of the Express Scripts network starting January 1, 2012. Walgreen had requested higher compensation for each prescription filled, while Express Scripts wants to lower payments. Recently, Walgreen offered to accept flat reimbursement rates. Express continues to push for lower payments. Walgreen management says that the rates offered by Express are below-market and that accepting such low reimbursements would have greater long term consequences than the short term impact on sales and profits from opting out of the Express network.

In 2011 Walgreen filled 819 million prescriptions. About 88 million prescriptions, representing $5.3 billion of revenue (7% of Walgreen's total), were paid/reimbursed by Express Scripts. Much of this lost volume can be offset by growth elsewhere. Indeed, Walgreen's total prescription volume increased 5.3% in 2011 -- following increases of 6.5% to 7.5% in each of the three previous years. Thus, management estimates the company will achieve 97-99% of its 2011 prescription volume in fiscal 2012.

A similar dispute a couple of years ago between Walgreen and CVS/Caremark was eventually (and quietly) resolved. A complicating issue in the current dispute may be the fact that Express Scripts is also attempting to acquire Medco Health Systems, another large PBM. The merger of Express and Medco has not yet been approved by government authorities. However, it appears that Express believes the combination with Medco will give it even greater clout in negotiations with Walgreen and, eventually, other drug retailers.

Walgreen currently fills 1 in 5 retail prescriptions – suggesting (as Express argues) that patients have many alternatives to their neighborhood Walgreen store. However, in some cities and towns Walgreen's market share is overwhelming and there are, in fact, few alternatives. Consequently, over 100 employers, health plans and other clients of Express have already changed pharmacy benefit managers or taken other measures so that the individuals and families they cover may continue to have access to Walgreen's pharmacies. A merger of Express and Medco, if consummated, will result in even more angry patients – prompting more employers and health insurers to reconsider their relationship with Express. We believe the dominant position of Walgreen in many markets was a key factor in the eventual resolution of the dispute with CVS/Caremark. The key point is this: failure to settle this dispute is harmful to both Walgreen and Express. Consequently, we believe the two companies will eventually settle their differences.

In the interim, Express is directing members of its network to CVS – the parent company of its rival PBM, Caremark. This, however, is clearly a short-sighted strategy; comparable to Coca-Cola insisting that athletic stadiums which serve Coke must also carry the products of Frito-Lay -- which, of course, is owned by Pepsico.

We believe Walgreen can still achieve flat profits in 2012 and, perhaps, a very modest increase. Ongoing improvement in Walgreen's non-pharmacy/front-end business (about 35% of sales) will help to drive further gains in profit margins at existing stores. Also, gross profit margins in the pharmacy business will be helped by the patent expiration of Lipitor. Profit margins are higher on generic drugs and Lipitor is the largest selling prescription drug of all time.

At current prices Walgreen's stock is valued at 12x *trailing* earnings per share and the dividend yield is 2.7%. We believe these valuations imply a far more negative view of Walgreen's future than is likely. In other words, the negative impact of the dispute with Express looks to be fully discounted in the price of Walgreen's common stock. Resolution of the dispute would likely trigger a solid recovery for the shares of Walgreen.

The New York Times Company (7.73)

One year ago we provided a lengthy analysis of the New York Times. We concluded that report with the key points supporting our investment thesis:

- *The New York Times newspaper is an iconic and enduring franchise whose high quality content endows the company with the ability to raise prices and gain market share at the same time.*

- *The company is in the early stages of transition from print-to-digital distribution – a substantially more profitable business model that will reach more readers and, therefore, enhance the value of the company as a platform for advertisers.*

- *Strong cash flow and the sale of non-strategic assets will improve the company's balance sheet, reduce its high-cost debt, and augment the improvement in operating profits that is already underway.*

Each of these statements was validated by the company's progress in 2011. Still, we were *not* surprised that the stock price did not keep pace. The Times is a company in transition *and transformation*. Investors are not likely to reward the company with a higher share price until its progress is obvious and entrenched.

The stock price was highly volatile in 2011 due to its low absolute price and Wall Street's emphasis on short term developments. High expectations surrounding the launch of The Times' on-line pay model drove a 19% increase in the company's shares early last year. Disappointing advertising sales triggered a 53% decline later in the year. The stock finished 2011 down 21% for the year. We took advantage of the price declines in August and September – purchasing the shares at prices less than the cost of The Sunday New York Times. Because of this volatility, our strategy has been to maintain positions for our clients which are smaller than average but still meaningful.

On-line subscriptions for the New York Times are off to a good start. At the end of the third quarter, less than six months after launching the pay model, The Times had 324,000 digital subscribers. In addition, the Times has more than 100,000 on-line users who received free-access to NYTimes.com through the end of 2011 under a program sponsored by the Lincoln division of Ford Motor Company. A significant number of these users are likely to remain as paid subscribers.

Home-delivery subscribers also receive free on-line access to the New York Times. Thus far, about 800,000 print subscribers have established linked digital accounts. Also, since the launch of the pay model last Spring the Times has experienced an *increase in print subscriptions* as well as *greater retention* of current print subscribers. Consequently, circulation revenue for the total company increased 3.4% in the third quarter. C*irculation revenue for the flagship newspaper, The New York Times, increased 6.2% in the third quarter.*

The company also took steps to improve its balance sheet in 2011. On July 1, 2011 the company sold more than half (390 units) of its 16.6% interest in Fenway Sports Group (i.e. The Boston Red Sox, Fenway Park, and cable TV channel New England Sports Network) for $117 million. This transaction implies a market value of about $93 million for the remaining 310 units -- which the company is looking to sell in whole or in part.

In August the company prepaid all its $250 million of 14.053% notes – three years early. These notes had been issued to companies controlled by Mr. Carlos Slim Helu, the wealthiest man in Mexico and largest shareholder of The Times. Annual interest savings will be over $35 million. Thus, by the end of September the company had lowered its long term debt from $990 million at the end of 2010 to $765 million. Net-debt (debt minus cash-and-short term investments) was reduced from $590 million to $502 million. Finally, in December the company sold its 16 local/regional newspapers for $143 million. These operations had contributed about 11% of total company revenue. Proceeds from this sale will help to lower net-debt even further.

In early December the company indicated that advertising trends have improved in recent months. Circulation revenues, which are more predictable and sustainable, are expected to continue growing at a low-to-mid-single digit pace. At the same time, operating costs, which fell 1.4% in the first nine months of 2011, are expected to decline at a low-to-mid-single digit rate in the fourth quarter. The combination of *increasing revenue and declining costs* obviously bodes well for the company's near term financial results. Also, sale of the local/regional newspapers, whose revenue declined about 7% in the first nine months of 2011, should help to expose the improving results of the flagship newspaper.

It is still too early to declare that the transformation of The New York Times Company is complete. Nevertheless, the financial and operating progress made in 2011, particularly the improving trend in circulation revenue, suggest that the company is near a turning point.