CARMICHAEL CAPITAL INC.

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2012 Year-End Review
"Fiscal Cliff Dweller"

Several years ago my family and I made our way from our home in the steel canyons of Manhattan to the rocky canyons of the wild American west. Some of the most amazing sights we saw were the dwellings and cities carved into the sides of the cliffs in Mesa Verde, Colorado near the four corners area. Almost 1,000 years ago the Anasazi people decided that it was better to live in the face of a cliff than on the flat, open land above. Although many have speculated as to the reasons they chose such a challenging place to build their abodes (defense mostly), it seems to have worked pretty well for them, at least for about 100 years. They could farm the land and hunt game on the mesa tops, then retreat to their well-guarded homes at night or during an attack. Then the water dried up, or the game left, or the land became depleted from over-farming, and the Anasazi left the safety of their cliff-face homes to join their relatives in Arizona or New Mexico, and left those beautiful structures behind to be discovered by cowboys some 600 to 700 years later.

I thought about those cliff dwellers when we were being pummeled recently with news stories about the expiration of tax cuts, the automatic cuts in government spending, and the dire consequences it would all have for the economy. It was a real problem and a real danger, but disaster was not the only possible, or even the probable outcome of the situation. In fact, last quarter there were at least three major stories being trumpeted in the media that would lead you to believe that you should abandon any investments and head for the hills. First, an Obama victory in the presidential election was supposed to sink the stock market. Second, the parties in congress were so entrenched in their opposing views that they couldn't possibly reach an agreement and the economy would fly off the fiscal cliff like Thelma and Louise in their 1966 Thunderbird convertible. Third, we might not even make it to the end of the year because the Mayans supposedly predicted the end of the world with the end of their calendar on December 21st. Oddly enough, none came to pass. It reminds me of the old saying about betting on the end of the world; it is usually a good thing to bet against because it doesn't happen very often.

In our previous quarterly letter we mentioned that the most important development on the short term would probably not be the election, or the fiscal cliff, or the Mayan apocalypse, but the Federal Reserve's revealed policy to "ease to infinity." With aggressive and vocal support from the creators of the supply of dollars, and with signs of a slowly improving economy, the equities markets held up through the doomsday scenarios and did pretty well in 2012 as a whole. The Dow Jones Industrial Index rose 7.26% while the broader S&P 500 Index gained a little over 13%. With interest rates at record lows, and with seemingly little room to go lower, US Treasury bonds fared much less well with the Barclays iShares 20 year ETF falling by a fraction of 1%.

So, our economy appears to be on the mend, albeit slowly and begrudgingly. Our stock positions range from equities in stable businesses with high dividend yields to those whose businesses are more cyclical, but which may benefit disproportionately during an economic recovery. We have maintained our core "value" positions in pharmaceutical and consumer good companies that still pay us better than long term government bonds would. Stocks like Bristol-Meyers, Merck, Abbot Labs, Pfizer , Proctor & Gamble, Pepsico, Verizon, and AT&T to name a few, have moved up very slowly but very nicely while paying a good dividend all the while. More recent acquisitions like AIG and Corning appear to be cheap stocks in solid companies that are working their way from being hated to being loved again (and the love always seems to come *after* the price has risen significantly, not before). Our positions in energy stocks have been stable while those in precious metals have declined somewhat with the recent cycle down in the price of gold and silver. The real estate market has started to recover and that has boosted the price of stocks such as Fidelity National Financial and Ocwen Financial. GDP is expected to grow a couple percent this new year and Europe seems to be hobbling along.

One thing that the last few years should have taught us is that investing by the headlines is a very bad idea. You would have sold (low) at every perceived crisis and bought every time things looked better and stocks were higher. This is why so many people get "whipsawed" and often lose badly by making big "all or nothing" bets. Long term results are dependent upon long term trends, and they take a while to develop, as well as to reverse. Although the spectacle of two ladies flying a doomed Ford across a canyon is a compelling cinematic sight, digging into the rock in the side of the cliff is a better example of the ingenuity and adaptive behavior that we humans seem to possess in quantity. And we will continue to adapt as the problems we face unfold in front of us.

Although things have gone relatively well in the face of those high-profile and much-hyped dangers, we want to remain aware of the fact that the market has rallied and investors are feeling more confident. As market prices rise, investors tend to become more comfortable and often seem unaware that the risk/reward ratio is usually rising as well. A good investment at $20 per share may be a rank speculation at $40 per share. There are more high-profile problems awaiting us in the months ahead, with the federal debt ceiling being one. For these and other reasons we recently took a profit on our entire position in Yahoo stock after the euphoric "relief rally" that started the new year helped lift the stock close to our value target. We may re-enter the position if the price drops to a level representing a compelling bargain, but until then we are happy to book the profit and wait for the next opportunity.

Enclosed are your year-end portfolio reports and statements. You won't have to file your tax returns for a while yet, but we also enclose your realized capital gains reports so that you will have those figures as soon as possible. We would be glad to save you the trouble and send that information directly to your tax preparer if you just give us the word. Always feel free to give me a call if you would like to discuss or change your investments, strategies, or asset allocations.

As always, we appreciate your confidence in us and we will do our best to make 2013 a successful and productive year for you and your investments

Best regards,

Claude Carmichael CFA