Sheffield Investment Management, Inc.

QUARTERLY REVIEW & OUTLOOK

Fourth Quarter, 2012

We're introducing a new, eye-friendly look to our quarterly letters and occasional interim letters. We hope you find it appealing, and we invite your comments.

IN THIS ISSUE:

1. **World Events Commentary**
   - ***Fiscal Cliff: Opportunity Missed***
2. **Investor Education**
   - ***Thank you, Vanguard***
3. **Market Performance Analysis**
4. **Investment Highlight**
   - ***AMT***
5. **SIMI Operations**
   - ***Meet Matt Sloan***
   - ***New Web Look***

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QUARTERLY REVIEW & OUTLOOK is presented by **Sheffield Investment Management, Inc. (SIMI)** to its clients, prospective clients, their associated advisors and interested parties

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1. WORLD EVENTS COMMENTARY

Since our last quarterly letter, there have been a number of important and favorable milestones for markets which may improve the investment outlook for 2013, particularly by the second half of the year. Unfortunately, most of these items have been given very little attention in the media relative to the incessant coverage of the fiscal cliff concerns and political theater generally. So let's begin this letter by considering the growing list of economic positives which are breathing fresh life into global markets:

- Japan has elected a new government under Prime Minister Shinzo Abe (ah-bay). The Prime Minister has promised an aggressive reflationary effort to stimulate Japan's economy. Investor enthusiasm for Abe's policies has resulted in Japanese stocks recently rising to a 2-year high.
- The Federal Reserve has changed the metric by which it will continue to hold down interest rates. Now the Fed says rates will stay at current levels until unemployment declines to 6.5% and inflation expectations are in the 2.5% range. This shift means that investors can now adjust their portfolios as economic events unfold rather than wait on Fed pronouncements of policy changes.
- European finance ministers have taken another significant step towards stabilizing their banking sector by agreeing upon a framework by which the European Central Bank will take operating control over approximately 6,000 banks across the 17 member countries. This action brings Europe one step closer to a true financial union and will break the connection between distressed banks and sovereign health.
- China's change in leadership during December has brought optimism to Chinese stock markets based on expectations of improving corporate profitability and massive new infrastructure spending. China's economic recovery is showing signs of acceleration which is anticipated to have a positive ripple effect across all of Asia's stock markets as well as in global commodities markets.
- Greece received a significant bailout (€44 billion) payment coupled with another structured debt default in which its government repurchased additional amounts of its outstanding sovereign debt at approximately 30 cents on the dollar. Additional restructuring benefits regarding other Greek debt were also concluded. Moody's recently *raised* Greece's credit rating one notch and gave it a stable outlook.
- There has been an extension of the timetable set by European banking authorities for the banks to reduce their financial leverage. This development is important for international finance as the European banks are major lenders throughout the world's emerging markets.

- In general, European authorities are moving away from their prior harsh austerity mindsets towards a more pragmatic structural reform to their debt markets and entitlement programs. European stock and bond markets have reacted very favorably.

Our observations about these and other favorable trends should not be interpreted as an "all clear" signal for risk assets. There are, as always, many evolving economic and political concerns around the world that have the potential to wreak havoc on generally improving global economic trends. So, our present investment approach is to allow the stock allocation within your portfolio to gradually increase towards the higher end of your Investment Policy Statement asset range as we watch for market confirmation of growing global economic strengths.

As 2013 begins, U.S. stocks continue to offer superior return *potential* compared to bonds. Furthermore, global equities in general, and European stocks in particular, are at generational lows on a valuation basis, vis-à-vis U.S. stocks. We are in the process of gradually increasing your foreign stock exposure relative to your U.S. holdings. As you will see in the section of this report titled "Thank You, Vanguard", valuation is the single most important determinant of future stock market performance.

The Fed has made it clear that it will keep interest rates at current levels throughout 2013 and probably through 2014 as well. Inflation expectations remain well contained. Therefore, unless you are willing to earn no return for probably the next two years while losing purchasing power to inflation, today's best investment choices remain 1) U.S. and foreign stocks, 2) U.S. corporate bonds, and 3) select foreign bonds. Gold should be a good holding place for money as central banks continue their reflation efforts, but its price has been drifting lower during the fourth quarter – perhaps reflecting rising investor optimism towards global stock markets.

Based upon conversations with clients throughout the year it's clear that the level of angst is no lower today than where it was when we began 2012. Yet, equity markets moved irregularly higher throughout the year, interest rates remained extremely low and inflation (as officially measured) has been very modest. We expect more of the same in 2013 barring actions of extreme stupidity by politicians. Moderate stupidity can probably be accommodated by investment markets and we will all muddle through.

An interesting contrast between investor fixation on shorter-term political issues and a longer-term focus on perceived investment opportunities is illustrated by a recent Bloomberg article describing the current investment activities of Mr. John Fredriksen. The article points out that Mr. Fredriksen is a Norwegian shipping magnate with a net worth of $13.2 billion, who "manages the world's largest fleet of supertankers, the most valuable deep-water drilling company and an armada of about 128 other vessels that carry minerals, grains and liquefied gases".

From his vantage point in the midst of Europe's financial and political turmoil, Mr. Fredriksen sees longer term opportunity. So much so, in fact, that he is making the biggest wager of his 68 years by investing $7 billion in about four dozen new vessels to transport liquefied natural gas, gasoline, propane and other fuels. His decision to forge ahead at this time, he says, is based more upon the plunging prices of vessels rather than economic and petroleum growth forecasts, which he says are *too uncertain to be useful*. In the article, Fredriksen says that he believes the tanker market is very close to the bottom and, "I like to be a buyer at the bottom. This is the game."

Do you see parallels to our style of investing? We also believe it is counterproductive to try to synthesize tens or hundreds of variables, none of which will have a highly predictable outcome, into "the" correct course of investment action. Investors quickly drown in the permutations, only to arrive at indecision

The level of investors' **angst** is no lower today than it was when 2012 began.

with a comment such as "I'll wait for the investment picture to become more clear before committing cash to the stock market". Instead, SIMI's contention is to invest more heavily in a particular asset class when prices are attractive based upon valuation metrics and to reduce exposure, or even avoid those asset classes that exceed reasonable valuation tests.

Today our philosophy recognizes that stocks offer reasonably attractive long term return potential while bonds offer elevated risk due in many cases to negative real returns and Federal Reserve manipulation. Cash continues to be a money losing proposition from a purchasing power standpoint. This situation is anticipated to remain so well into 2015 under current Federal Reserve economic growth assumptions.

Fiscal Cliff: Opportunity Missed

The January 1 agreement reached by Congress and accepted by the President is a disappointment to the American people. It consists of some tax increases with most of the burden falling on higher income earners, a fix to the alternative minimum tax yearly escalation, no entitlement cuts and a two month postponement of various automatic spending cuts. Not one word about economic stimulus or enhancing U.S. global competitiveness! Our politicians have kicked the can down the road once again. The stock market's January 2 robust rally is mystifying as the country's fundamental imbalances have not been addressed, stimulus has been reduced, all taxpaying Americans will have 2-3% less spendable cash, and the long term budget picture and debt problems will not be improved. Congress' and the President's inability to work together did actually have a slightly positive outcome. They could have crafted a much worse deal than what we got. Perhaps that's why global stock markets reacted favorably.

Fortunately, manufacturing and housing continue to gain momentum in our low interest rate, low energy cost environment, and signs of an improving global growth environment should help pull the U.S. economy along as well. We continue to muddle through, which is not an unfavorable climate for further stock market gains.

2. INVESTOR EDUCATION —

Thank You, Vanguard

In October 2012, Vanguard published on its website a research study titled: *Forecasting Stock Returns: What signals matter and what do they say now?*

This article offers a valuable contribution to investor knowledge regarding how well of various commonly used indicators can be relied upon to determine future longer term stock market returns. Here are some highlights of Vanguard's research.

First, long-term stock market returns are not consistent. A chart of rolling 10-year returns for the periods ending December 1935 through December 2012 is presented in **Figure 1** (Page 4). It reveals significant return volatility, from highs of around 20% per year to periods of negative 10-year returns such as those most recently experienced for the 10 year periods ending 2008 and 2009. The chart illustrates the uselessness of the factoid that the average long term return of the stock market during the past 75 years is 10% per annum.

Figure 2 (Page 5) presents a wake-up call for investors who seek clues to future stock market performance from various well known metrics. For the period from 1926 through 2011, there have not been *any* metrics that can be used with confidence to predict 10-year ahead real (after inflation) returns. As if that isn't bad enough, Vanguard's study reveals that it is even *more difficult* to predict 1-year ahead real stock market returns!

The metric with the greatest explanatory power – that is, having the highest predictability for future returns – is the Price/Earnings ratio. Vanguard considers

Figure 1. Long-run equity returns vary over time, but are they predictable?

Rolling 10-year annualized geometric returns of the broad U.S. stock market:
Periods ended December 1935 through June 2012

Summary: January 1926–June 2012

	Nominal	Real
Geometric annualized return	10.0%	6.8%
Arithmetic annualized return	12.0	8.8
Volatility	19.3	19.4

Note: The blue line represents the nominal geometric annualized return on the broad U.S. stock market over rolling monthly 10-year periods through the date shown. The tan line represents the real (or inflation-adjusted) return. See the Appendix for indexes used to represent stock market returns.

Source: Vanguard calculations based on the data sources listed in the Appendix.

two variations of P/E: either today's stock market price relative to the average of the last ten years' earnings, or the current market price compared to the past 12 months earnings. These two valuation metrics have been statistically determined to explain approximately 40% of subsequent stock market variability. That means that approximately 60% of the market's subsequent price action is not explainable by this best performing valuation metric.

Now, consider some of the popular metrics presented in **Figure 2** which have no demonstrated predictive capability:

- Consensus GDP growth rates
- Consensus earnings growth rates
- Corporate profit margins
- 10-year treasury yields.

It is remarkable that these items are among those causing the greatest discomfort among investors today as we all contemplate the future impact of the fiscal cliff on our portfolios!

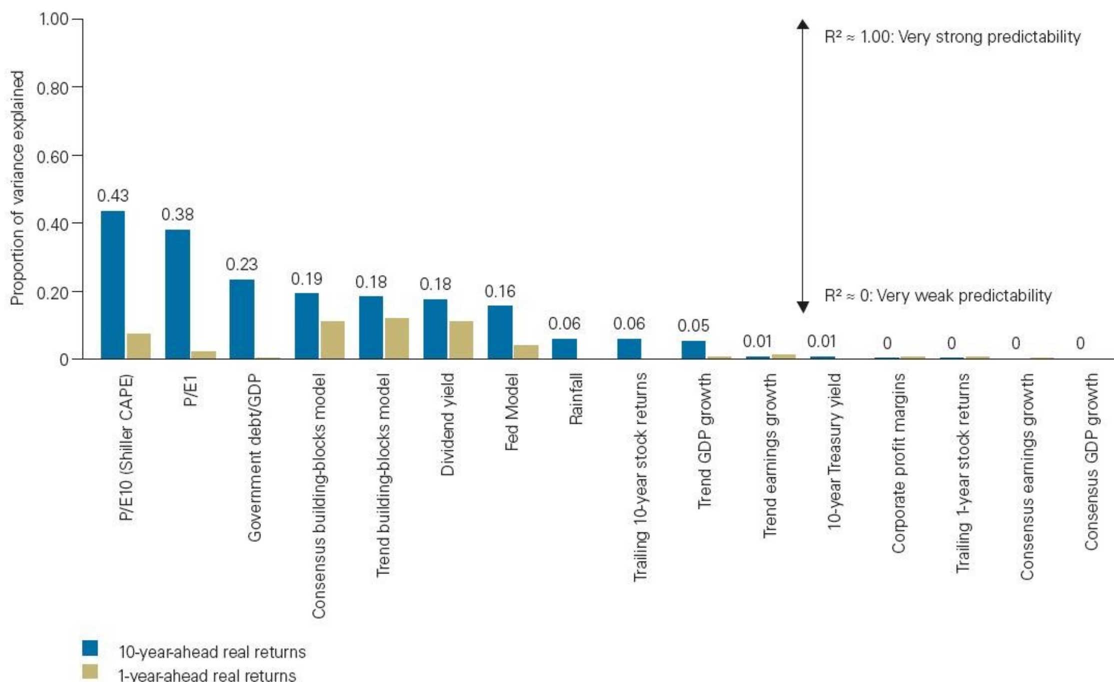
We also call your attention to the lack of predictive capability of trailing 10-year and trailing 1-year stock market returns on future stock market returns. Sadly, many investors still cling to the notion that the market downturn of 2008-09 is a reason to remain out of the stock market during the recovery period from 2010 to date. Behavioral psychologists call this the "recency effect" and it describes one of the reasons why so many individual investors do a poor job of managing their own portfolios.

Keep in mind that an entire industry has been built upon giving investors advice

Sadly, many investors still cling to the notion that the market downturn of 2008-09 is a reason to remain out of the stock market during the recovery period from 2010 to date.

Figure 2. Most popular metrics have had little or no correlation with future stock returns

Proportion of variance of future real stock returns that is explained by various metrics, 1926–2011



Notes: The bars display the R^2 of a regression model of 10-year-ahead and 1-year-ahead real annualized stock returns on each variable, fitted over the January 1926–June 2012 sample, with the exception of corporate profits, which are fitted for January 1929–June 2012 (because of data limitations). See the Appendix for further information about the data.

Source: Vanguard analysis based on the data sources listed in the Appendix.

based upon many of these metrics as well as others, all of which we believe are virtually worthless in terms of their investment market predictive capabilities.

We believe this Vanguard study validates our investment philosophy of setting long-term investment objectives, designing portfolio strategies to achieve those objectives and then using market valuation levels as a principal metric for fine tuning your portfolio's asset allocation. This philosophy is presented in your Investment Policy Statement.

At the end of its analysis, Vanguard concludes that because the future is unknowable, investors should use a "probabilistic framework" to create a distribution pattern of future market returns. An example of this approach could be stated as follows: "Based upon the current level of the stock market's one year trailing earnings P/E, there is a 24% probability of the market generating 10-year average future returns between 4-8% per annum."

We believe Vanguard's research provides valuable lessons to investors who wish to determine what their future returns may be. We disagree, however, with Vanguard's answer to the riddle because the framework upon which their conclusion is based is virtually useless when one is trying to establish long term numerical return objectives. It is better, in our opinion, to simply recognize that returns will vary significantly over time, and that future market returns will be lower if P/Es and other valuation metrics are high when an investment is made, and vice versa. In this manner both we and our clients avoid a false sense of precision associated with future statistical analysis outcomes. To summarize, the future is unknowable. Any attempt to determine a statistically accurate future return is folly. Garbage in, garbage out.

3. MARKET PERFORMANCE ANALYSIS

Asset Allocation

During the first half of 2012 we kept clients' equity positions at or below the midpoint of their allowable range as the crisis in Europe, fear of China "hard landing" and the political turmoil in the U.S. had us in a reduced risk mode on your behalf. Beginning in the third quarter, and continuing throughout the fourth quarter, we allowed stocks to increase as a percent of total portfolios given our perception of an improving environment for risk taking.

Cash

Money market funds and short term treasuries offered zero return for the year. The Federal Reserve's clearly stated intention of holding short term interest rates at zero to encourage investor risk taking is expected to continue through all of 2013 and well into 2014 under present economic growth scenarios.

Equities

At least in this asset class the story has greater interest. Domestic and global markets had robust returns for the year although the fourth quarter was a period of heightened angst in the U.S. due to fiscal cliff concerns. If we were to divide the world up into developed markets versus emerging, the performance prize would go to emerging markets, which on a global basis had a total return of approximately 18%.

We have commented in past quarterly letters that Eurozone finance ministers continued taking a series of steps to strengthen their economic union and restore confidence to their banking system. Their efforts were rewarded during 2012 in both their stock and bond markets. Interest rates fell, the price of insuring against sovereign and bank defaults fell and interest rate spreads between the highest and lowest grade bonds declined. MSCI has created an index of stocks from the 17-member European Monetary Union. That index generated a total return of 24% for the year which represents significant out performance relative to the rest of the world. Investors who did no participate these high risk markets could not expect to earn a return commensurate with the MSCI All World Index.

Fixed Income

U.S. interest rates continued their multi-year pattern of decline until the beginning of the fourth quarter. That's when markets became aware of a change in perceptions in favor of the reemergence of global growth projected to occur during the latter part of 2013. Treasury rates, in maturities ranging from 2 years to 30 years, have begun to creep higher, with the trend continuing to date in the new year.

One of the key pieces of economic information now is the monthly employment report. Should these numbers begin to increase above the 145,000 – 155,000 level, the long awaited bond bear market may begin in earnest as markets will be looking for the Fed to scale back on its bond purchasing programs.

Gold/Commodities

Gold has not reacted as we had expected during 2012 given aggressive monetary easing around the world and negative real yields across many countries. Its safe haven status appears tarnished in the face of the generally rising global stock markets and reduced perceived market risk. We have trimmed all clients' holdings to 4% of total portfolio value after recent higher levels in the 6-7% range. Gold experienced a roller-coaster year, but did manage to post a 12-month gain of 7% in spite of a fourth quarter decline of almost 6%.

Industrial and agricultural commodities had a lackluster year, experiencing neither significant increases nor decreases. The same could be said for oil, down approximately 7% for the year and, (SURPRISE!) the U.S. dollar which was flat for the year against a basket of other global currencies. It's interesting to think back over the course of the year at the extreme levels of negativity towards the dollar and all the reasons why it would be crashing at any moment. The truth is markets don't care what journalists, talk show hosts, economists, politicians or pretty much anyone else thinks about anything. Markets will do what they will do.

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We continue our practice of introducing various companies whose shares are widely owned across SIMI client accounts. This quarter we are placing the spotlight on American Tower Corporation

NYSE: AMT

americantower.com

4. INVESTMENT HIGHLIGHT: American Tower Corporation (AMT)

The world is becoming increasingly connected via the internet at rates which are difficult, if not impossible, to comprehend. Current estimates are that as of mid-2011, two billion people were connected to the internet, double the level of 2005. Current estimates call for 3 billion people to be connected by 2015.

Not only is there extraordinary growth in the number of users, but there is also an explosion in the number of internet connected devices per user. Cisco currently projects at least 15 billion network connected devices for 2015. This growth rate is taxing the ability of wireless data networks to provide adequate bandwidth capacity. 13D Research, for example, reports that mobile bandwidth scarcity is poised to get worse as smart phone usage explodes in the U.S and abroad.

One of the ways of dealing with the need for more bandwidth capacity is through expanding the number of cell towers in use together with increasing the intensity of their usage. This is where AMT comes into the picture. AMT owns and operates a portfolio of over 50,000 communication sites which are leased to wireless service providers. AMT provides the tower and the real estate upon which the tenants own, operate and maintain their own antenna, backhaul, and base station equipment. Approximately 22,000 of AMT's sites were located in the U.S. and 29,000 were located in Central and South America, India and Africa as of the end of the third quarter of 2012. Value Line reports that AMT is the largest tower operator in the U.S.

Tenants typically sign leases having initial terms of 5-10 years with multiple 5-year renewal periods thereafter. It is also typical for all leases to have annual price escalations insuring an increasing cash flow per leased site. Corporate revenue growth has averaged 14% per year during the past 4 years. AMT restructured itself as a REIT in 2011 and now pays out virtually all of its "profit" each year in order to avoid taxation at the corporate level.

AMT has a clearly defined growth plan fed by:

1. Continuing government auctions of wireless spectrums;
2. Growing consumer demand for wireless services; and
3. Increasing data usage.

Each of these elements necessitates additional network equipment to be added to existing towers of companies like AMT as well as the development of new cell tower sites. As a result AMT's revenue per tower site continues to increase at double digit rates.

SIMI OPERATIONS

Meet Matt Sloan

We are pleased to introduce Matthew A. Sloan, CFA, CIPM, who joined our firm on October 1, 2012. Matt serves in a Performance Analyst role here at SIMI.

A Georgia native, Matt earned his BS degree in Management from Georgia Tech in 2006, with a dual certificate in Finance & Accounting. Following graduation, he gained experience at SunTrust Robinson Humphrey and BlueCross BlueShield of Tennessee, where he performed analytical roles relating to investment banking, mergers & acquisitions, strategy and corporate development. Matt studied and took the various tests to become a CFA charterholder, which he attained in 2011. He went on to earn a Certificate in Investment Performance Measurement (CIPM), also awarded by the CFA Institute, later that same year.

Matt subsequently moved into a consulting role relating to performance verification, which is similar to auditing but within the investment management world. As a verifier, Matt worked with over 80 investment firms to ensure compliance with the Global Investment Performance Standards (GIPS®). He also consulted with these clients on their internal operational controls and performance measurement processes.

The GIPS standards were developed by the CFA Institute to ensure fair representation and full disclosure of investment performance, while “leveling the playing field” between firms in the way performance is presented. It has long been a goal of SIMI to position itself to claim compliance with the GIPS standards, both for the benefit of existing clients in our regular quarterly performance reporting, and in marketing our firm’s investment management services to prospective clients. Meeting the demanding standards for historical reporting, constructing composite track records, and comparing to appropriate benchmarks are all highly technical undertakings. Matt has joined SIMI with an initial mission to shepherd us through this important process.

Outside of the office, Matt enjoys playing golf, playing guitar/piano, and spending time with his wife Sarah Stuart and their yellow lab, ‘Belle’. We welcome Matt Sloan to SIMI, and we hope you’ll have an opportunity to meet him in connection with your future dealings with our office.

New Web Look for SIMI

SIMI is pleased to announce the recent update of our website, having launched a completely new look in late December. While much of the content is consistent with our prior web presence, we have introduced a new “*Spotlight on a SIMI Holding*” series, in which we present thumbnail sketches of companies whose shares are widely owned in client portfolios. We have plans for further revisions and enhancements in the months ahead. In the meantime, we wanted to invite our clients and other friends to visit and peruse the site’s new look (www.shefinvestment.com). Your comments and suggestions on the new look are welcome.