Greatmark Investment Partners
January 2013

Partner's letter

We had a great year

2012 was a great year for you, our investing partners. Our equities were up 15% on average compared to a price gain of 13% for the S&P 500 and 7% for The Dow Jones Industrials. Our fixed income investments rose 9% on average marking yet another strong year of gains. Greatmark began 2012 with $173 million under active management and ended the year with $208 million under management. Our investing partners had $21.8 million of total return (*growth/interest/dividends*) for the year. It truly was a great year.

Our premise coming into the year was that the string of strong corporate earnings would continue. If you will remember, in 2011 earnings grew 17% but the market was flat. We felt like the market would play "catch-up" in 2012 and indeed that happened. S&P earnings look to have grown about 10% in 2012 and as we said, the market rose about 13%. For the past two years, earnings are up 29% while the "price" is only up 13%. That gap between the underlying earnings and the value of the market remains wide and could be the fuel that will drive the market in 2013.

If earnings are up almost 30% in two years, why isn't the market? We believe the market has been overly focused on what *could* go wrong rather than the positives. 2012 was a year full of worries and many of the gloomiest predictions never materialized. The economic recovery has continued. Earnings have not collapsed. Profit margins, which many said couldn't go any higher, have continued to expand. Europe did not implode. Iran and Israel didn't go to war. China's real estate bubble didn't pop and Congress came to "some" resolution on the fiscal cliff.

This fear has reduced the valuations investors are willing to place on stocks. Since 2003, S&P earnings have grown 92% while the index is up only 28%. Since 2007, earnings are up 28% while the index is down 3%. In 2003, the S&P traded for 20x earnings and in 2005-2009, the market traded for an average of 16.5x earnings. Today, the market trades for 13.5x earnings. Investors just aren't willing to "pay-up" for stocks. For long-term investors like us, this lower risk valuation is a huge positive. Our great companies are very inexpensive vs. historic norms.

Investors do not trust the stock market

One of the greatest costs of the 2008 financial crisis is that it scared investors in a depression-like way. Our grandparents lived through the Depression and many of us were taught valuable lessons from them. In the same way, this generation of investors nearly "lost it all" in 2008 and having clawed their way back are now rightly ultra-conservative and skeptical.

The bubble-like flow of money into bond funds continued in 2012 and investors continued to pull money out of stock mutual funds. Since January 1, 2009 (*at the pinnacle of the financial crisis*) investors have withdrawn $300 billion from stock mutual funds. During this period of time, the S&P 500 is up 64%. In 2012, with the S&P up 12%, investors pulled $125 billion out of equity funds. It is illogical except that Mom and Pop America don't trust the stock market and they are voting with their wallets.

They do trust the bond market which is nearing the end of a 20+ year bull run. Since 2009, while pulling $300 billon out of stocks, they have poured $1 trillion into bond funds. Yes…trillion with a "T". 10 years ago, the 10-year Treasury was paying 5.0%. At the lowest point in 2012, the yield had fallen to 1.4%. With yields falling that much, prices staged a huge rally. But at 1.4% and investors putting another $1 trillion in, how much lower can yields go? Not much. The yield ended the year at 1.9%.

We think Mom and Pop America is a contra-indicator on this one – sort of a *"do the opposite of what the crowd is doing."* Remember back to the stock market bubble in the late 90's. From 1997 to 2000, investors put nearly $900 billion into stock funds chasing the run-up in performance. The market peaked in March of 2000 but that year, more than $300 billion came into stock funds. The "crowd" only started net withdrawals from stock funds in 2002, the year the market made a bottom.

We watch investor behavior. The crowd does not "buy" this market and that, in a perverse way, gives us confidence this rally can continue. We think 2013 will see a shift in this phenomenon with bond fund flows cooling and investors starting to buy equity funds. However, it will likely be a gradual, multi-year shift. Bond funds will continue to get money even as prices start to fall. Remember what stock funds did in 2000.

We will start to get nervous as the tide fully shifts and equity funds are once again attracting $10-20 billion a month of new money. That is a few years off in our estimation. When Mom and Pop America decide stocks are the place to be (*probably at prices even higher than today*), then we'll likely see high price/earnings valuations and Greatmark will be on the defensive.

Largest holdings…

We had a good year among our largest holdings and most still look very attractive to us…

15 Largest Holdings	Dividend Yield	Price Change YTD	Price/Earnings vs. 2013 EPS
AFLAC	2.7%	+ 23%	7.5 x
Johnson & Johnson	3.4%	+ 7%	13.0 x
Intel	4.2%	- 15%	10.9 x
General Electric	3.6%	+ 17%	12.5 x
Microsoft	3.4%	+ 3%	8.3 x
Bank of America	0.3%	+ 109%	12.3 x
Home Depot	1.8%	+ 47%	18.2 x
Cisco Systems	2.8%	+ 9%	10.5 x
Coca-Cola Company	2.7%	+ 4%	17.1 x
Target	2.3%	+ 16%	12.6 x
Emerson Electric	3.0%	+ 14%	13.7 x
United Parcel Service	3.0%	+ 1%	14.9 x
Medtronic	2.4%	+ 7%	11.2 x
Chevron	3.3%	+ 2%	9.1 x
Walgreen Co.	2.9%	+ 12%	10.7 x
TOP 15 HOLDINGS	**2.8%**	**+ 17%**	**13.0 x**
S&P 500	2.1%	+ 13%	13.1 x

On this list, Home Depot, UPS and Coca-Cola appear expensive. Coke has historically carried a higher valuation than the market – one we believe is warranted. Home Depot has had a great run and we trimmed our position this year. UPS appears a tad expensive but earnings have been held back by the slow global economy. We think UPS is fairly valued given the earnings growth ahead of it.

The rest of the portfolio is fairly valued, if not cheap, given its quality and earnings strength. AFLAC is very attractive and will resume buying back stock this year and despite Bank of America's big gain in 2012, we continue to think the stock is worth $20-25 – more than a double from here. BofA will also start buying back stock this year and will likely give its dividend a significant boost. Microsoft, Intel and Cisco – our 3 big tech holdings – are cash cows, very cheap and are aggressively repurchasing shares.

This is why we remain bullish for the long-run. Great companies are not expensive. Our 15 largest holdings are very high-quality businesses paying a 2.8% dividend while trading at a market multiple. They should continue to grow their dividends and give us a steadily increasing cash flow. They look exceedingly better than the proposition of investing in government bonds for the next 10 years paying 1.9%. We think 2013 will mark the beginning of a turn as investors start to shift out of bonds and into high quality dividend paying stocks. We are well positioned.

"Patient, long-term investing"
We repeat this mantra over and over for a reason. We think it is incredibly important to remember our call. You don't pay us to find one "hot" stock after another. That's a good thing because we have no ability to do so! Greatmark can build you a solid investment portfolio with a long-term horizon and whether you are 40 and building wealth or 65 and focused on preserving wealth, we think having the mindset of a patient long-term investor will serve you well.

To illustrate our point, Kohl's is a stock we've owned before, sold and have recently started selectively adding back to portfolios. We may well buy it across the board in 2013. Kohl's is a very well-run retailer that has, for the most part, built-out their store base. They've struggled to grow earnings of late but they have a proven management team and a long history of success. Kohl's is not "sexy". We're not looking to hit a grand slam with Kohl's. It is a very good company that is cheap. They pay a 3% dividend and trade for just 9x this year's earnings. Since they have slowed their new store openings, Kohl's is throwing off a lot of excess cash. They have used that to pay a good dividend and to aggressively buy back their stock. The buybacks are the catalyst that intrigues us. Since 2005, Kohl's has retired 32% of their total shares. They bought back 14% of the shares last year alone and management just announced a new 3-year buyback that will retire another 35% of the shares based on today's price. If successful, KSS will have retired an amazing 2/3 of their share base in just 10 years and we should see a corresponding explosion in earnings per share growth.

We cannot predict when the market will recognize the value in Kohl's and so far, we've got a loss in the shares we have purchased. Greatmark tries our best to think long-term and make solid investments that will bear substantial fruit over the next 3-5-7 years, not necessarily the next 3-5-7 months. We sleep well at night owning a great business with strong cash flow and a growing dividend. The challenge is to remain patient and not jump at the temptations that will come our way i.e. selling Kohl's to jump on some hot new stock. This worked for us on AFLAC a few years ago and on Bank of America last year.

Warren Buffett framed very nicely what we are trying to say – *"If we live another 20 years, we're going to have a dozen good years, a few terrific years and a few terrible years. We don't know which order they'll come in and it doesn't matter. Coca-Cola was founded in 1886 and it went through wars and depressions and there probably was not a good time to sell Coke. Overall, we stick with really good businesses. We're tempted to buy companies we understand and know where they'll be in 5-10 years. That's easier to do with a Wrigley's than it is with a technology company. I've missed some boats but I don't mind missing boats that I don't know how to Captain. I don't have to understand everything, I just have to be right at things I do. Tom Watson of IBM said, "I'm no genius but I'm smart in spots and I stay around those spots." I don't have to be right on dozens of things – just a few."*

2013 outlook

We come into 2013 facing a series of unique challenges – having "conquered" the fiscal cliff, we now face an even bigger debt ceiling battle in the coming weeks. Fourth quarter 2012 and first quarter 2013 earnings will be challenged by the global slowdown. Taxes are going up and the first costs of Obamacare are hitting the system. We still face big problems in Europe and it is the first year of the Presidential cycle – historically the lowest return year of the four-year cycle.

On the positive side – company balance sheets remain very strong and the US consumer has significantly deleveraged. The huge drop in interest rates has enabled businesses, municipalities and households to refinance and significantly reduce debt costs. Household net worths have largely recovered and consumer confidence is at a 4-year high. Importantly, home prices are rising and building activity is ramping up. The housing and auto sectors are huge components of job growth and 2013 should see a further strengthening in both key sectors.

We came into this year in a mode of caution. We are very confident in the next 3-5 years – especially if Washington can reform the tax code and employ some spending controls – but the short-term issues give us pause. We probably want to get past the debt ceiling debate before we can turn more constructive on the market.

The companies you own are, for the most part, great businesses run by capable managers with a proven history of success. They navigated the oil crisis, rampant inflation and sky-high interest rates of the 70's. They came through the crash of 1987, the recession of 1991, the dot-com bust and the financial crisis of 2008. We are confident they will navigate the current issues in Washington and the European debt crisis.

Our companies are strong and we invest in companies, not markets. They are aggressively buying back their shares and should increase their dividends yet again in the coming months.

Greatmark has learned to focus on our niche and avoid the things we can't do well. We try to stick to our knitting. We keep our strategy fairly simple – buying really good businesses when we get an opportunity to buy them cheap as a long-term owner. Lastly, we try to think defensively by asking *"what could go wrong?"* and trim back our big winners to harvest gains and lessen portfolio risk.

This isn't an easy business but you make it a delightful one. We come to work every day blessed by the opportunity we have to serve you. Thank you for your confidence and trust.

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