

PORTFOLIO REVIEW & STRATEGY

The fourth quarter of 2011 could have been aptly described in two words – “never mind.” Following sharp declines in most equity markets in the third quarter on global recession fears, investors piled back into cyclical sectors and higher-risk asset classes on better-than-anticipated domestic economic data. Europe’s ongoing financial troubles continued to cause volatility, and China displayed further signs of a slowdown within key construction, lending, and manufacturing sectors. Yet worrisome headlines from the world’s key export economies were not enough to derail rallies fed by improved balance sheets and profit margins, sales rebounds in housing, retail, and auto sectors, continued low interest rates, subdued inflation, and generally upbeat forecasts from corporate managers.

Final data showed S&P 500 stocks posting a total return of 11.8% in the 4th quarter, but only 2.1% for all of 2011. Cyclical industries outperformed other sectors during the 4th quarter, with Energy and Industrials stocks both gaining more than 15%. Materials issues rebounded 14.7% and Consumer Cyclical saw a nearly 12% gain. Financials participated in the rally, gaining an average of 10% for the quarter, but remained the worst-performing sector for the year, down more than 18% for the full year. The U.S. dollar Index rose slightly in the quarter, which helped push gold prices down 5%.

Summarizing the wide divergence of performance in 2011 was difficult, but the data suggests investors placed their bets on two related trends: recession fears and falling rates. The sharp decline in banking-related stocks in 2011 derived partly from fears that Europe’s liquidity crisis would directly impact the profits of American banks, and partly from concerns that regulators would pressure banks to de-lever further and curtail once lucrative trading and fee-generating activities. Though we significantly underweighted the financial sector in 2011, we nevertheless kept careful watch on bank balance sheets looking for signs that credit was being slowly injected back into the economy.

With interest rates taking a surprising dip in the second half of the 2011, fixed-income investments went on a tear. Long-dated U.S. Treasury and municipal bonds soared in price, with some bonds soaring more than 25% in a matter of weeks as the 10-year Treasury yield fell from 3.5% to below 2%. Utility stocks, often viewed as bond proxies, likewise surged in price, and finished the year up 15%, making the group the best-performing equity sector. As the year closed, Utilities exhibited stretched valuations, and we are wary of adding these stocks to portfolios. So-called “defensive” sectors (Health Care and Consumer Staples) benefited from recession fears, finishing the year well ahead of the S&P 500 with reduced volatility. Their high dividends and stable cash flows make them solid choices for clients needing low-volatility growth.

Our general thesis in 2011 could have been described as “long the private sector; short the public sector.” The best valuations, the best balance sheets, and the best prospects for growth clearly resided in quality public companies, which we will continue to overweight for growth-oriented clients. Conversely, the most stretched valuations and the poorest balance sheets are lodged within developed national governments, whose prospects we would rather not try to forecast or rely upon in 2012.

ON-LINE NEWSLETTER NOW AVAILABLE

You can now receive future newsletters via email. By joining our email mailing list, you will also receive periodic bulletins regarding events and news stories that shape our investment outlook and strategy. Please email us at astarkey@naplestrustcompany.com.

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Co-Chairman

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Vice Chairman

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Dear Investors,

Every Thursday morning, The Naples Trust Company's Asset Management Committee meets to discuss investment strategy and how current events may be affecting the securities we own in client portfolios. These interactive sessions connect our four offices audio-visually and provide an opportunity to participate in substantive discussions with our investment professionals. Clients, as well as prospective clients, attend regularly to gain insight into how we preserve and enhance our clients' assets. We believe transparency – knowing what you own and why you own it – is an important and distinguishing characteristic of The Naples Trust Company.



You are welcome to attend our Asset Management Committee meeting by calling 239-774-4000 to learn why The Naples Trust Company is uniquely suited to help you accomplish your personal investment objectives.

Warm Regards,

Adria D. Starkey
President

Richard A. Botthof
Vice Chairman

THE
NAPLES TRUST
COMPANY

3003 Tamiami Trail North, Suite 201 • Naples, Florida 34103

Phone: 239.774.4000 • Toll Free: 866.953.0070

Fax: 239.435.3719

Website: www.naplestrustcompany.com

Email: astarkey@naplestrustcompany.com

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MARKET WATCH

First Quarter 2012

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CURRENT OUTLOOK

2011 ended with more questions than answers for long-term investors. A year that started off with an encouraging upward trend for equity prices and a downward price trend for fixed income securities ended with just the opposite as both domestic and international issues increased uncertainty as well as caution. 2012 promises more of the same in our opinion, as the Presidential elections at home, the growth trajectory of emerging markets, and the Euro-land drama abroad all come into clearer focus. Ultimate asset valuations will depend importantly on all of these issues.

The ongoing headwinds from deleveraging in Europe and the United States seem to favor slow growth at best and something far more challenging at worst. We have mentioned in the past our concern regarding the growth outlook once the fiscal and monetary stimulus brought on by the 2008 financial crisis was removed. The attempted withdrawal of the stimulus is seen in the United States in terms of 10-year deficit reduction proposals that will eventually be put in place. It was seen in the emerging markets in terms of higher interest rates biting into growth. And most profoundly it is seen in the Euro-zone in terms of forced austerity in order to prevent the dissolution of the monetary system in that part of the world.

Recent signs of a sustainable rebound in economic growth in the United States, as well as monetary easing now coming to the emerging markets, offer some “silver lining” to the continued dark cloud of the European morass. Improvement in the fiscal condition of both the United States as well Europe will depend heavily on a resumption of growth. Given the recent level of sovereign debt interest rates in many of the European countries, financial and political leaders must come to some important decisions in the next few months in order to continue funding their deficits. Unlike the central bank actions in the United States since 2008, the European Central Bank has neither the flexibility nor credibility to embark on a massive liquidity effort to shore up the banking system. At the same time international banking authorities are demanding increased capital, which only serves to make normal banking operations even more problematic.

So, what is our Current Outlook? We expect more headline-driven volatility in all asset classes until these questions are finally answered. While we expect a lively contest for the White House this year, we do not expect any major legislative initiatives or meaningful addressing of the long-term deficit issues until 2013. Economic growth in the United States will probably be closer to 2% than 4%, and inflation should not be an issue for the foreseeable future. Short-term interest rates should stay unusually low for the next 2 years while corporate profits worldwide should be modestly higher this year compared to 2011. Commodities and precious metals will have a difficult time heading higher with austerity as the buzz word. With low short-term interest rates and an upward sloping yield curve, concentrating on bonds in the intermediate term range seems most prudent. Only those equities that offer reasonable valuation and well above-average revenue and profit visibility seem appropriate given our outlook—especially those that are returning some of those profits to shareholders in the form of dividends.

Relative valuations for equities are at historically low levels. While some may argue that uncertainty levels are also at unusually high levels, we believe this is less of a problem and more of an opportunity for long-term investors. We continue to focus on owning those assets where the risk/reward equation is substantially in our favor. We are not being fearful—just careful.

THE QUEST FOR YIELD

By maintaining an aggressively accommodative monetary policy stance, the U.S. Federal Reserve continues to influence very low rates for **U.S. Treasury securities** across the entire maturity spectrum. With two year rates barely above zero, ten year notes below 2%, and thirty year bonds below 3%, treasury investors can hardly be expected to keep up with even modest inflation levels. **In this era of extraordinarily low interest rates, what can investors do to increase the income or cash flows from their investments?**

The very highest rated **investment grade corporate bonds** are currently only yielding slightly higher levels than treasury rates. However, by moving down the ratings spectrum a few notches, we are able to build diversified portfolios of investment-grade issues with yields materially higher than Treasuries. We are, of course, wary of extending maturities and locking in current low rates for extended periods, and we are careful not to concentrate risks in a few sectors.

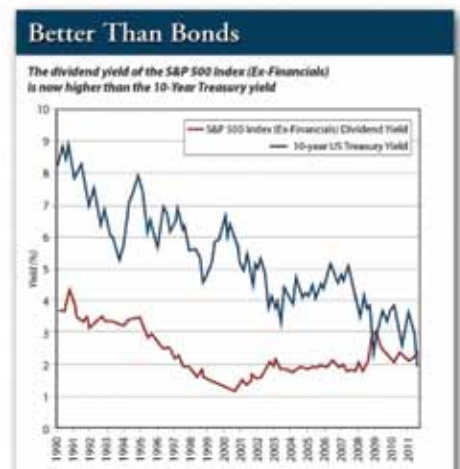
Municipal bonds are a decent alternative for investors in higher income tax brackets. With current fears of state and local government financial stress, taxable equivalent yields can compare favorably with corporate bonds for high-bracket investors. However, munis are no longer the bargain they were earlier this year.

High yield bonds (below investment grade) can offer a significant improvement in yield, yet careful selection and diversification remain important considerations. While yields can be several percentage points higher than high grade corporate bonds, resale prices can and do fluctuate to a higher degree, therefore investors should have a more equity-like time horizon of at least a few years.

Dividend paying stocks are highly attractive today, with many companies' equity yielding more than the same companies' investment grade bonds. This higher level of dividend yield versus bond yield is not typically the case, and many of these same companies have stable cash flows and strong financial structures that enable them to not just pay but to regularly increase the dividends they are paying to their shareholders. Unlike bondholders, equity holders benefit both from receiving a growing dividend stream as well as any additional price appreciation stemming from retained earnings and increased profitability trends.

Alternative income investments are a lesser known alternative for generating income. There are a variety of investments that encompass this category including: master limited partnerships (MLPs), real estate investment trusts (REITs), and trust preferred shares. Again, careful selection, appropriate diversification, and ongoing active monitoring are essential, as is an equity-like time horizon. Highly attractive income yields can be obtained. The Sanibel Captiva Trust Company has recently introduced a separately managed Alternative Income Portfolio in order to fulfill a significant need in this area.

In this highly challenging economic environment, meeting or exceeding reasonable yield objectives, while carefully managing risk can be difficult. Success is also unlikely to be accomplished with a single strategy rather than a carefully implemented combination of the above alternatives.



STAYING THE COURSE

One of the hardest things for a financial advisor is watching clients deviate from their long-term plan and make emotional decisions in times of market stress. When Wall Street has one of its periodic nervous breakdowns, we do our level best to empathize with clients and counsel the importance of not acting out of fear – but sometimes we don't succeed, and clients insist on selling.

This is a painful experience for us when it happens, because “going to cash” when asset values are depressed has truly pernicious effects on long-term portfolio returns. First, the sales generate less cash than they would in a less-stressed environment for equities. Second, clients often do not want to put the cash back to work in equities until after asset values have rebounded substantially.

Here's a real-life example of the drag on returns this can create. On average, our core Growth Equity approach has generated approximately 11% annual returns over the past three years. However, the subset of our clients who requested that we sell out some or all of their equities at times we felt were inopportune have, on average, experienced returns of about half that level. Five percentage points per year really adds up over time – in just three years, a \$1,000,000 account compounding at 11% is worth \$1.37 million, while an account compounding at 5% is only worth \$1.16 million. So, the real-world price of fear over a three-year period for a \$1,000,000 account has been \$200,000. Over a longer time horizon, and multiple market cycles, that price is obviously much higher.

“Attempting to forecast whether the market is at a peak or in a valley—and whether to buy or unload stocks as a result—is a waste of time. I don't know anyone who has been right more than once in a row.”

PETER LYNCH

In a perfect world, all investors would stick to their investment plans and avoid this kind of damage to long-term portfolio returns. But since we know the world is imperfect – and that falling markets can create very strong emotions that are hard to set aside – we are working hard with our clients to help them stay focused on their long-term asset allocation.

One way we are doing this is by being upfront with about volatility. While we believe U.S. equity valuations are very attractive right now, the odds of substantial headline risk over the next year from the evolving Eurozone situation are quite high. If Greece, for example, were to exit the Eurozone – a reasonably likely occurrence – equity markets globally would take a nasty short-term hit. Although such an event would have little impact on the long-term intrinsic value of most companies in our portfolios, it could prompt a fearful market atmosphere that would encourage inopportune selling. By recognizing and discussing this possibility ahead of time, we hope to have less emotional conversations should such a market drop occur.

A second tactic we are using for less risk-tolerant clients is holding above-normal amounts of cash as a buffer against potential volatility. This “cash and courage” strategy served our clients well during the 2007-2009 period, and while we do not expect 2012 to be as unpleasant as the global credit crisis of a few years ago, we believe that having extra cash on hand will help clients “stay the course” if markets become stressed.