



Hemenway Trust Company^{LLC}

Third Quarter 2011 Report

Dear Valued Client:

The themes discussed in our second-quarter report continued to dominate investing in the third quarter of 2011. Concerns about slowing economic growth and the sovereign debt crisis in Europe encouraged investors to reduce risk. Equity prices were down across the board, with the Dow Jones Industrial Average down 12% for the quarter and the S&P 500 down 14%.

Elsewhere in the world, things were even worse. European markets were down 25% for the quarter. In spite of faster growth and generally stronger fiscal strength, emerging market equities also lost value, with the MSCI Emerging Markets Index down 23% for the quarter. Commodity prices were also lower, with the DJ-UBS Commodities Index down 11.3% for the quarter. Key commodities copper and oil were down 26% and 17%, respectively.

Investors flocked to lower-risk assets, particularly United States Treasuries. On a year-to-date basis, the 10-year Treasury produced a 12.15% return and the 30-year Treasury a 27.32% return. The S&P Municipal Bond Index returned 7.36% year to date. Riskier bonds underperformed, with the Barclay's High Yield Index down 1.4% on a year-to-date basis.

United States GDP, which grew 1.9% in the first quarter, slowed to a pace of 1.3% in the second quarter and is expected to grow at a similar pace in the third quarter. Slower economic growth again seems to be attributable to the weak housing market and high unemployment. Although the Case-Shiller Home Price Index increased in July for the fourth consecutive month, housing prices were still lower than they were a year earlier and are more than 30% below their 2006 peaks. Single-family housing starts were at 30-year lows. Unemployment remains stubbornly high at 9.1%. Reflecting these and other trends, consumer confidence remained low, according to the Conference Board.

The European sovereign debt issues continued to overhang the market. European governments and international agencies have not yet reached a long-term solution. The possibility of a default on sovereign debt has also heightened concerns about the stability of European banks and insurance companies, which are exposed to sovereign debt. Some fear that the crisis will spread to the U.S. and other countries in the same way credit concerns spread around the globe in 2008. At a minimum, economic growth in Europe has stalled.

In the quarter we also witnessed the messy resolution of the debt-ceiling issue between Congress and the president. The way the compromise was reached did not inspire confidence. The debt-ceiling debate was followed by Standard and Poor's downgrade of the U.S. sovereign debt. The downgrade did not lead to higher interest rates. In fact, investors increased their purchase of U.S. Treasury bonds, which are still seen as the least risky investment. However, the two events seemed to contribute to the dour mood of investors.

The quarter was also characterized by extreme volatility in the stock and bond markets. The VIX index of the Chicago Board of Options Exchange, which measures volatility, spiked in August and remained elevated for the rest of the quarter. Prices of equities moved up or down by 1% or more on many days during the quarter. The price and yield of fixed-income investments were also volatile. The yield on the 10-year U.S. Treasury bond dropped from 3.164% on July 1 to 1.992% on September 30, with day-to-day changes of 10 or 20 basis points a common occurrence.

Third Quarter 2011 Report (continued)

Looking ahead, the question is whether the economy will continue to lose steam and, perhaps, slip into a recession or will regain momentum and begin to grow at a less anemic pace. Recent statistics suggest some reason to believe that growth will continue, but at a subdued pace. The Institute of Supply Management's Manufacturing PMI Index stood at 51.6 in September, up a point from 50.6 in August. The Manufacturing PMI has grown for 26 consecutive months. The Non-Manufacturing Index was at 53.0, down from 53.3 in August but still indicating growth. New orders and backlog were both up in recent months. The Conference Board's Leading Economic Indicators continue to be positive, with an increase of 0.3% in September. Retail sales, a key indicator of consumer spending, have been surprisingly strong. The decrease in the price of oil during the quarter is also a positive development. These indicators all suggest that the economy continued to grow in the third quarter and may be able to sustain growth. However, there is little evidence to suggest that the pace of growth will get beyond 1% or 2% annually anytime soon.

The Federal Reserve continues to attempt to stimulate economic growth. At its September meeting, the Financial Management Oversight Committee (FMOC) agreed to buy \$400 billion of longer-dated U.S. Treasuries over the next six months, replacing a similar amount of shorter-dated Treasuries on its balance sheet. The FMOC also indicated that it would reinvest the proceeds of mortgage-backed securities in other mortgage-backed securities rather than in U.S. Treasuries. Both moves are designed to encourage economic growth by reducing long-term interest rates.

The earnings of U.S. companies continue to be quite strong, in spite of the subdued economic environment. Standard and Poor's projects the earnings of the S&P 500 in 2011 to be just under \$100 and projects 2012 earnings of \$111.29. Although earnings estimates have been reduced for the third and fourth quarters, the decline in equity prices from April 29 to the present has been primarily a result of a reduction in price/earnings multiples rather than a reduction in earnings. With stock markets at reasonable valuations, there could be a strong move up if earnings come through as expected and significant progress is made to solve the European debt crisis. On the other hand, if earnings do not come through as expected, we could see further contraction in valuations, as the "e" in "p/e" declines along with the "p."

The quarter illustrated the value of balance between safety and risk. With interest rates on bonds at historically low levels, it has been tempting to reach for yield at the cost of taking on more risk. However, in the third quarter, the safest investments, high-quality bonds, performed the best. They not only provided ballast to portfolios to counter the loss of value in equities, but provided superior returns. They rewarded investors for sticking to allocations to high-quality bonds as part of a balanced investment portfolio.

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