



Broadleaf Partners, LLC

The Year in Review December 20, 2011

At the end of every year I like to take a look back at the year that was and share some thoughts on what worked, what didn't, and how we see the future. To be sure, there are still a few days of trading left this year – and by the standards of the past few months – any call on the full year's returns is without a doubt, premature.

Regardless of how things end up, I think it would be safe to declare this year as uninspired at best and to borrow from the NFL, concussed at its worst. In spite of multiple brain bruising changes in direction in the second half of this year, investors have been dished up a full year loss of 1% through Friday of last week in perhaps the stock market's version of a 7-3 ballgame.

Multiple spearings to the head from Europe and domestic politicians have been responsible for the heightened state of anxiety on the field, and investors are now far more worried about where the next unexpected hit may come from than keeping their eyes on the ball. Given the punishing nature of the last few years, such anxiety levels can be understood, but might likewise prove misplaced.

On the domestic front, the news has actually made a positive tick upwards, with leading economic indicators improving and in recent weeks, unemployment claims breaking down to new lows. Corporate profits continue to surge, with companies raising dividends and buying back stock at a record pace. China has clearly slowed, and while there is a heightened fear of a hard landing in recent weeks, the country has far more policy tools at their disposal to achieve a soft landing than the rest of the world today.

Typically, stocks have been better buys than sales when policy moves are biased towards easing and leading economic indicators have been improving. To the frightened and concussed, such views may sound silly and unintelligible, but for an investor, the awareness of such a predisposition remains key.

With regards to the Broadleaf Growth Equity Portfolio, this year's retrospective is more difficult than normal. While I'm used to looking at past mistakes and successes in hopes of gaining wisdom about the future, I also know that in this extreme environment of volatility, this week's conclusions can pose a danger of becoming next week's mistakes if I fail to discern wisely.

Through August, the Broadleaf Growth Equity portfolio was holding its own with the markets and while our absolute returns were indeed uninspiring, they were nevertheless ahead of the S&P 500 and leading our peer group. The period since August, however, has been a different animal, and while our returns have remained

uninspiring, we've lost ground to both the S&P 500 and our peer group. While I know this will happen from time to time, I still can't stand it and if I knew how to spear something with my helmet, I would.

Most of this recent period of underperformance has been related to individual stocks rather than our sector bets, consistent with our longer term source of outperformance. In our portfolio, individual stocks have accounted for roughly 90% of our excess returns over time, even in a market where individual stock returns have become extraordinarily correlated.

Over the past five months, we experienced losses or left money on the table with Netflix, Green Mountain Coffee and Diamond Foods. Fortunately, our sell discipline protected us from more severe losses in the portfolio and in Netflix case, our clients still earned strong absolute and relative returns throughout the ownership period.

In our mind, there was no doubt that the competitive environment has been increasing for Netflix and as a result, we haven't regretted selling. With regards to Green Mountain and Diamond Foods, the issue was a little beyond our control, as the accounting practices at both companies came under scrutiny. While our judicial system presumes innocence until proven guilty, capitalism is far less merciful, shooting first and only asking questions later.

In my book, if a company's accounting comes under question, the management will too, and likewise, the stock's valuation. Green Mountain and Diamond Foods were highly valued relative to their peer groups, but that argument alone, in my opinion, does not make a stock a sell. I've experienced far more gains from buying stocks that appear highly valued, than from companies whose accounting practices come under question.

Such investigations can take months or years to resolve, and unfortunately, additional questions almost always linger. Thankfully, accounting related questions on our portfolio holdings have been rare, and I can assure you that Mike and I have scrubbed the portfolio and have a smaller tolerance for any accounting practices that might appear aggressive.

In terms of what has worked for the portfolio, our view that the economy will grow slowly for as far as the eyes can see appears to have been on track, and if it weren't for the long term issues facing Europe and the near term slowdown in Asia, might actually have proven too conservative. As the year winds to a close, defensive, dividend paying stocks have been trading to new highs, while everything with a hint of cyclical or exposure to emerging markets has come under pressure.

While I have been a proponent of dividend growers as compelling substitutes to the fixed income market and offering a modicum of safety in an era of extreme stock price volatility, most of the stocks that share this factor have outperformed significantly in recent weeks and are bumping up against longer term resistance levels. Despite their allure, they have no doubt benefitted from increased anxiety this quarter and could likely be bought at cheaper prices. Unless a new dawn of growth is upon us, utility stocks have rarely been big price movers and when they have been, there have often been better opportunities elsewhere.

With regards to the future, we remain biased to a slow growth environment for as far as the eyes can see, an environment which continues to favor innovators. At the same time, with concerns about a slowdown in China emerging and Europe likely already in recession, the Economic Cycle may deserve some increased attention as a driver of alpha in the portfolio, particularly with a global monetary policy bias towards easing and leading economic indicators in the United State now improving.

While it is difficult to believe, several bank surveys and credit reports show that lending is starting to improve, which may foretell some healing in the credit cycle, a key ingredient of any hope for a more vibrant economic recovery. The U.S. industrial complex, in my mind, holds the greatest promise in the coming decade as a long term investment theme, not only as a function of our global competitiveness, but as a potential beneficiary of growing supplies of cheap U.S. natural gas. Similar to the semiconductor, natural gas may be a game changer in the world economy, unleashing a new source of productivity just as the world could use it the most.

Europe does have long term structural issues that won't be resolved anytime soon, but with anxiety at heightened levels, investors appear far too focused on where the next hit may come from than where the ball currently is on the field. If the ball continues to move downfield as it has in recent months, it will eventually capture the attention of more players on the field, providing an environment with a strong bias to the upside at precisely the time such thoughts appear silly.

Merry Christmas, Happy Holidays and Best Wishes in the New Year!

Kindest Regards,

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