

der Mut zur Lücke (MIND THE GAP)

He began near Piccadilly Circus, in the center of London. He was headed to the newly opened Westfield Shopping Mall in Stratford, East London. The center was in development for nearly ten years, finally opening adjacent to what will be the 2012 Olympic Stadium, one year ahead of the Summer Games. It will become the largest shopping mall in Europe, both in size and sales. As we have an investment (in our International and Global portfolios) in the 50% owner of the project, Australian-based Westfield Group, one of the Aristotle analysts wanted to see the facility for himself. A guided tour with management had been arranged.

He found the entrance to the London Underground (“tube”) station at Piccadilly, “fought” with the automated ticket vending machine for a while, then descended what seemed like a 400-yard-long, steeply inclined escalator to find the train. The Underground was built to withstand the German bombings of WWII, resulting in what is mostly a very deep under the ground transit system. He found the correct train line, navigated the pathways to identify the eastern direction of travel and waited for the train to arrive. “*All Underground lines are operating a good service,*” he heard over the speaker system, interpreting that to mean the trains were running on time.

Sure enough, in two minutes a packed train arrived and the doors opened to accommodate the departing passengers. “***Mind the Gap***” he heard blasted loudly. Not really knowing to what that referred, he ignored the warning and fought his way onto the train. A few stops later, at Holborn, he needed to transfer to another line. “***Mind the Gap***” was blasted again as he exited the train. Navigating through the Underground maze, he found the “Central Line” train traveling east. Another short two-minute wait (“*much better service than the New York subways,*” he thought) and another packed train arrived. “***Mind the Gap!***” He boarded again. About 20 minutes and seven stops later, he arrived at Stratford Station (Zone **Three** on the system, perhaps the subject of a future edition of *The Essence*). The doors opened and, sure enough, “***Mind the Gap!***”

By now, the analyst had figured out the announcement at each opening of the train doors was a warning for passengers to be careful of the space gap that may exist between the train platform and the vehicle. The instructions were heeded.

He was on an investment trip to Europe, London being the first stop. Upon his return to Los Angeles from the trip, he recounted that “*I kept hearing the same phrase over and over, in different contexts. I wonder why?*” he asked. “***‘Mind the Gap’*** of the train at every tube stop in London. ***‘Mind the Gap’*** of the rickety taxi door in Rome. ***‘Mind the Gap’*** of each and every

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Jetway bridge upon entering airplanes.” Other than the literal meaning of the warnings, the analyst started to believe he was being sent a “message,” or some sign from “above” to interpret this constantly used phrase.

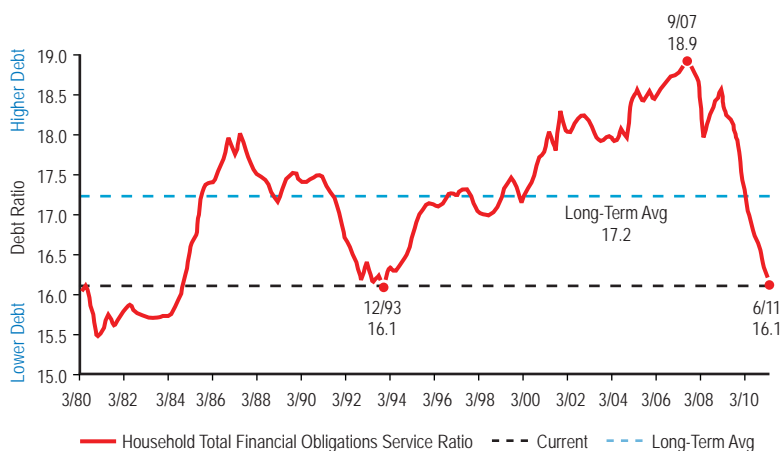
Then, in Munich, a fellow investor traveler offered her variant of the phrase and said, “*der Mut zur Lücke*. It’s similar to **‘Mind the Gap’** in English,” she said. “It’s a German expression that I recently heard used by an executive describing his business and management philosophy. The direct translation is... ‘the courage to admit when one doesn’t know something.’ Sometimes people translate it as ‘the courage to have a gap,’ as in a **GAP** of knowledge.”

Now our analyst knew what the message was he kept receiving. This was a lesson as useful in investing as it is in business. “*Know what you don’t know,*” he preached. “*Embrace the gap in one’s knowledge, never pretend to know everything, always account for the unpredictable and invest with the assumption that what can go wrong, very well might.*”

What We Do Not Know

An important tenet of the Aristotle investment methodology, it is best to illustrate the lesson from our analyst with an example. One of the biggest variables for the U.S. economy is when the housing market will recover. Here is a graph that gives us some hope that the timing could be near.

Household Total Financial Obligations Ratio



Sources: J.P. Morgan; Bloomberg

This graph depicts the U.S. consumer household financial obligations ratio. It is the total of all debt payments (mortgage, credit card, auto loan/lease, property taxes and rental payments for apartment dwellings) divided by total disposable personal income. It represents how “stretched” the U.S. consumer is with financial obligations. Note that the consumer was extremely overburdened in the latter part of the last decade. Something had to crack, and it did – big time. But now (as of June of this past year), through

a combination of lower interest rates and less outstanding debt, the consumer is near the lowest point of financial burden that we have experienced for the past thirty years. A good sign indeed; one of many we monitor that implies the potential end to the housing bust.

But while we believe that consumers have the **propensity** to re-engage the housing market, it does not mean they will. Numerous other factors such as lending standards, foreclosures, negative home equity and others point to a still-moribund housing market. So our **gap** of knowledge must incorporate this variability in our investment selections. How so?

➤ **Toto** is a bathroom products company headquartered in Fukuoka, Japan. It focuses on the high end of sanitary ware, selling throughout Japan, the U.S. and, most recently, China. While new housing starts around the world are depressed, Toto is thriving as it is a leader in “low flow” toilets. As water consumption is increasingly an issue in both developed and developing markets, Toto’s ability to create products that work extremely well while minimizing water consumption makes it uniquely likely to thrive regardless of the future housing environment.

➤ **Lennar**, a recent addition to Aristotle’s Global and Value Equity portfolios, is a U.S. homebuilder with a high share of market in California, Texas, Florida and 16 other states (including the recently entered markets of Washington and Oregon). While its homebuilding fortunes are linked to the demand for newly built single-family homes, it also benefits from the ongoing dislocations of the housing market through its Rialto “work-out” subsidiary. We see this company as a “balanced” investment as it could do well if housing remains anemic and it could do even better when the environment turns positive.

➤ **J.C. Penney** has suffered more than most department stores these past few years as it has a disproportionately high share of the household furnishings market. Sales of draperies, wall coverings, pots & pans and the like have declined precipitously along with declining home sales. So, adjusted for its mix of product sales, in our view, JCP has actually done quite well. With new and exclusive label merchandise and a successful partnership selling cosmetics with Sephora, the company’s results have shown great promise. Incoming CEO Ron Johnson was credited with **Apple’s** retail success and will no doubt, in our opinion, propel the shopping experience at his stores far above his competitors.

Home Depot as well as our recent purchase of **Martin Marietta Materials** is also exposed to the U.S. housing market, so it appears as though we are making a “bet” on its recovery. Yes, in all of these cases we believe that the

fortunes of the companies have been hindered by the historically low level of housing activity. While our analysis has led us to conclude that housing will improve within our investment time horizon of three-to-five years, we must **Mind the Gap** as we do not know when (or even with certainty “if”) the recovery will occur. We will, therefore, seek out and invest in businesses **not** because of a cyclical rebound in housing, but because these businesses could do well even if housing remains anemic. A recovery would be icing on the cake.

Housing is but one example of our own understanding of the limits of our knowledge. Of course, we are never content with our limitations and strive to broaden our understanding of many issues each and every day. Indeed, our “mantra” to all our investment team members is to go out and **learn**. Learn about great business models, learn about improving companies and industries, and learn at least something new each day about every single one of our investment holdings. This is a cornerstone of our philosophy, one from which we will not stray.

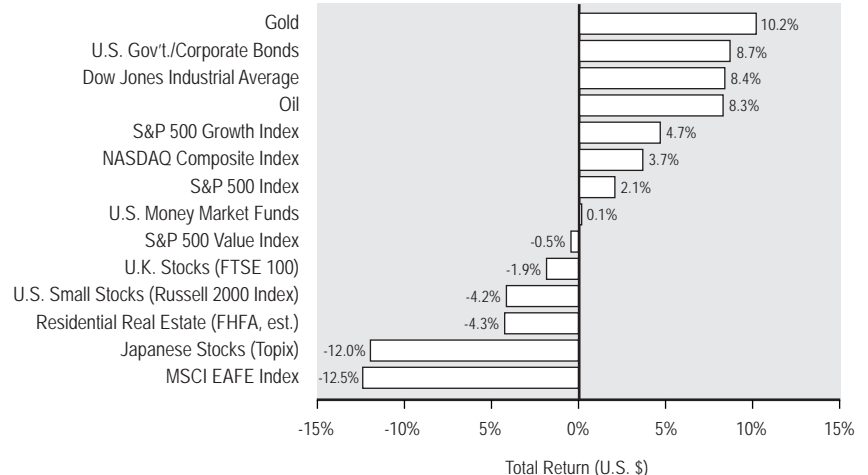
EQUITIES STRATEGY

Our *der Mut zur Lücke*, or the courage to **Mind the Gap** of knowledge, extends beyond the housing cycle. We have for years pointed out that ours is not a philosophy that dwells on macro or political analysis. We also do not invest based upon what we believe *should* happen, but what is most likely *to* occur. For example, while we do not believe that the European economic crisis will cause a global depression, we do not, at this moment, know the ultimate solutions. We also admit the shortcomings of capitalism in its current form, but think it likely to remain the best economic system out there, capable of adapting and benefiting from some “tweaking” at the margins.

As the chart at the top of the next column shows, for the year 2011, the U.S. was, as we have heard said by others, “the cleanest dirty shirt in the closet.”

The U.S. stock market, as measured by the broad S&P 500 Stock Index, gained +2.1%, (all figures include income). Value indices (with their heavy weighting of financial companies) underperformed the broad market for the year while growth (led by technology) outperformed somewhat. Foreign stock markets did far worse as the MSCI EAFE International Index gave up -12.5% as measured in U.S. dollars. This tracks developed markets (Japan -12.0%, Germany -16.8% and Spain -10.9%) while many emerging country markets (the “darling” of prior years) declined even

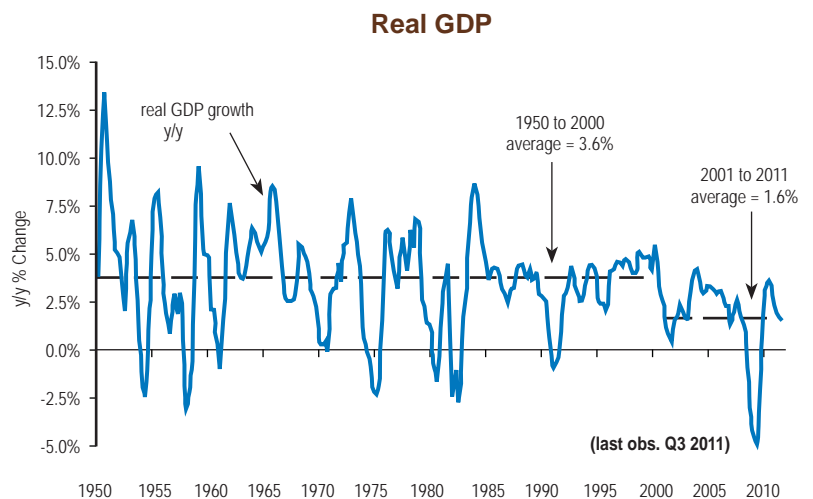
2011 Asset Performance



Sources: Bloomberg; Various

more precipitously. China, Taiwan and Hong Kong stocks, for instance, declined by approximately 20% during 2011.

As discussed in more detail in the inaugural edition of *The Essence* entitled “Everyone Loves a Wonton” [available on our website at www.AristotleCap.com], we are sanguine, yet not wildly so, about the future. We therefore continue to seek out unique individual companies whose fortunes are not reliant upon robust economic growth. The following chart is consistent with this message.



Sources: Bureau of Economic Analysis; Encima Global

Here we see real (inflation-adjusted) growth in Gross Domestic Product for the U.S. from 1950 through the present. Two items are worthy of mention: First, note that the 50-year average to 2000 was 3.6% annual real growth. This growth dropped to 1.6% in the past decade. Second, note the much more volatile pattern of economic growth until 1991 (the last time the U.S. experienced a consumer

recession before the most recent “big” one). It is possible that recessions need to occur on a regular basis to rid our system of excesses. Policies of the past twenty years – both fiscal and monetary – were partially designed to avoid these temporary downturns. This may have contributed to the “doozy” of a downturn we have just gone through and from which we are still recovering.

Here follows an interesting quote from Nike’s September 22, 2011 quarterly earnings release: “*Uncertainty is the new normal!*” Commenting on this, Juergen Kolb, an equity analyst at Cheuvreux, in his analysis of Nike competitor **Adidas** said, “*In such an environment, companies that have the ability to invent products that appeal to its clients and enjoy a healthy balance sheet will fare better than others. Adidas fits that bill and will see growth.*” While this comment may always be true, the “times of uncertainty” part is something we now hear the world over. Thus, instead of the phrase popularized by Pimco, “the new normal,” we think it may be more accurate to think of the future economic environment as “**back to normal.**” This incorporates more frequent economic fluctuations combined with greater uncertainty. Companies should be mindful of (and not have a **Gap** in their understanding of) their need to adapt.

Another “back to normal” trend could be a return to manufacturing for the U.S. Tobias M. Levkovich, Equity Strategist for Citi Investment Research, has said:

“An American manufacturing renaissance appears to be taking place. Reports of companies bringing back manufacturing to the U.S. have emerged due to higher land costs and wages in China, and there appears to be a much more competitive dynamic in America currently. While many have perceived the U.S. manufacturing base as being in permanent decline, there are indications of a turn taking place. Tragic natural disasters in Japan and Thailand also have made companies want to have more domestic sourcing options. We have even heard that building a new plant in Tennessee is cheaper than doing so in China given property price increases in Asia. Our sense is that investors would look at American markets from a very different vantage point as the likely trends converge. Factors such as energy self sufficiency and a manufacturing revival would dramatically change the perspective on the U.S. where such concepts were not even being contemplated by the majority of the investment community. While we do not expect the markets to react to these drivers in the near term, their coalescence could generate a much more impressive rally over the next few years, and we suspect that such views are far from the current consensus.”

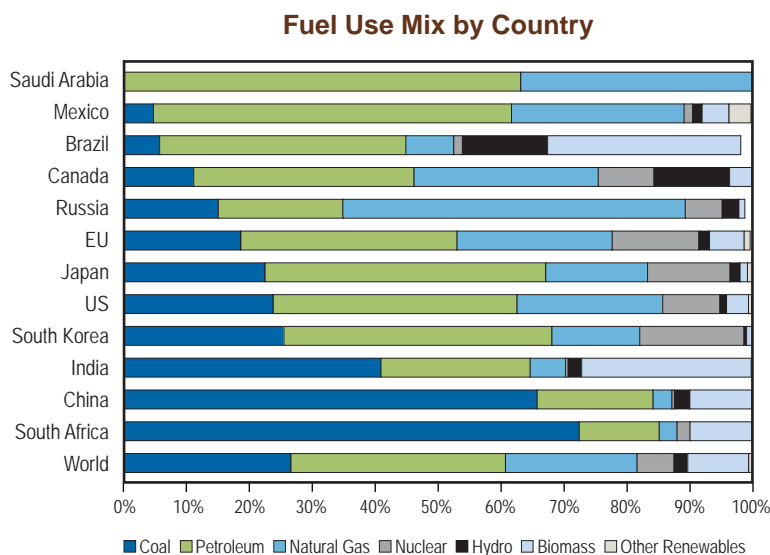
While we will “**Mind the Gap**” with respect to the timing and degree to which U.S. companies regain a foothold in global manufacturing, we do see this as an early trend to monitor.

INVESTMENT ACTIVITY

One of the reasons given for the renewed competitiveness of U.S. manufacturing companies is the increasing abundance of, and lower price for, a critical raw material in many products – natural gas. In the past we discussed **Dow Chemical** and how this company benefits from its access to this critical commodity. This quarter, we’d like to highlight a recent addition to any or all of Aristotle’s equity strategies:

- **Pioneer Natural Resources** (PXD) is a large independent exploration and production (E&P) company with operations mostly in the United States. It has benefitted, and we believe will continue to benefit, from new technologies available to extract oil and gas from shale. Somewhat unique in its industry, PXD lives within its means. That is, it invests in new wells only that cash which is generated from what it recovers from its existing portfolio. Opportunities beyond that are either passed up or financed in a conservative manner. It is via a recent equity offering that we recognized a material new *catalyst* developing for the company in a newly discovered shale field in Texas.

Here follows a chart of the mix of fuels consumed in different regions around the world. The data is taken from 2008 and has not varied much since.



Note that the U.S.’ mix of fuel consumption is nearly identical to that of the world average. This could change. Partly due to the success of PXD and its peers, natural gas production is growing strongly in this country, while oil continues its decline (though flattening out, also due to shale discoveries), nuclear is difficult to expand and coal is seen as environmentally unfriendly. Thus, the proportion of the U.S.’ energy

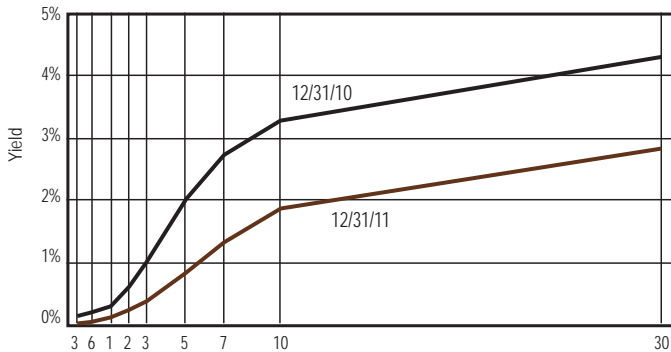
consumption coming from domestically produced natural gas could increase meaningfully. This could improve our balance of trade (much of our oil is imported) and provide greater energy independence while giving meaningful competitive advantages to our industrial companies. **Pioneer Natural Resources** is helping to make this possible. [Note that a significant move towards natural gas or electric vehicles could significantly propel our thesis, but this would be a long-term trend, likely not available to alter our investment thesis with regards to PXD within our investment time horizon.]

FIXED INCOME STRATEGY

Clearly we must *Mind the Gap* of our knowledge with respect to the direction of interest rates. For several years now we have been warning of the danger of a turnaround in rates. If rates rise, then, inversely, bond prices fall. We have therefore remained very conservatively postured, keeping maturities short within our fixed income and balanced portfolios.

But, while short rates have been “pegged” near zero since 2008, longer-term U.S. treasury yields continue to decline.

**U.S. Treasury Yield Curve
12/31/10 versus 12/31/11**



Source: Bloomberg

The U.S. 10-year Treasury note ended this past year at a yield of 1.88%, its lowest on record. For most years since hitting its peak yield (15.84% on September 30, 1981), 10-year yields have fallen. Also, for most of those years, common “wisdom” was that we had hit bottom. Clearly the collective

“Gap” of knowledge continues to widen. But even though we do not know if and/or when interest rates will begin their ascent, we do know with certainty that the risk-reward tradeoff in the high-grade fixed income markets is not favorable for risk-averse investors.

We shall therefore retain this conservative posture, generally investing only up to a five-year maturity for Treasuries, corporates and, where appropriate, municipal bonds. We shall also employ government guaranteed GNMA mortgage-backed securities to gain some additional yield, with little additional risk.

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CONCLUSION

We again, this quarter, take a little life experience to illustrate one of the elements of Aristotle’s investment methodology. Ours is not a quantitative approach, nor one that fits neatly in a little box. It takes nearly as many examples as investments we have made over the years to fully paint the picture of our style.

This quarter we’ve highlighted, via a phrase familiar in Europe, one of the elements of our process. We must constantly *Mind the Gap* of our knowledge and know what we do not know. With this humility, we can focus on risk avoidance and downside protection wherever possible. Understanding the many risks of investing helps us to better navigate the uncertainty of what we see as a “return to normal,” whereby greater volatility may be common once again. But 100% safety (via U.S. Treasury bills, for instance) may not produce acceptable long-term results. So we will continue to focus on those businesses that may do very well in the environment we envision, yet also do well as the future takes its unpredictable turns.

“It is just that we should be grateful, not only to those with whose views we may agree, but also to those who have expressed more superficial views; for these also contributed something, by developing before us the powers of thought [and reason].”

- Aristotle -

As Reed, Conner & Birdwell is now officially Aristotle Capital Management, we will remember to MIND the GAP going through 2012 and into the future.

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