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Our partner William "Ledge" Mitchell worked at David L. Babson & Co. before co-founding Johnston, Reid and Mitchell in 1986. Following are his observations on the investment background as we start the New Year:

The Year in Review

A recent financial headline asked "All this for nothing?" For many investors, 2011 will long be remembered as the year of the big Goose Egg. Despite record levels of turmoil in the financial markets, at year end the Standard & Poor's 500 Index was little changed from the year before.

These "nothing for something" results also were prevalent in the U.S. Treasury markets. As 2011 began, investors looking for income were receiving *only a fraction of one percent* -- 5 basis points (0.05%) -- from one-month Treasury bills. By year end, this yield had slipped into negative territory at -0.01% -- a negative 1 basis point. Essentially, one-month Treasury bills produced a zero rate of return for all of 2011.

On the other hand, the dividend-paying, blue-chip companies in the Dow Jones Industrial Average did very well. McDonald's and IBM were at the top of the pack, advancing some 25% to 30% in price. As a whole, the Dow increased almost 6% in price. In comparison, the non-dividend-paying companies in the S&P 500 fell roughly 10% in price last year.

While dividends were foremost in the minds of many investors, quality also stepped to the fore as the year progressed. The Dow surpassed the Russell 2000, a common benchmark for small- and mid-cap companies, by its biggest margin in 13 years. Smaller companies typically do not have the quality markings of larger, more seasoned companies.

Behind this rush to quality and dividends was unprecedented volatility. In August there was an unforgettable four day stretch when the Dow either soared or plunged over 400 points. For the entire year, there were 35 days in which the S&P 500 moved either up or down by at least 2%, and 69 days when 90% of the issues moved in the same direction. For investors using market-timing strategies, if they were out of the market during the five best days last year, they finished the year down almost 16%!

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Hedge funds employing high-frequency trading strategies normally thrive during periods of high volatility. Published data is scant but indications are that many such funds were undone by the markets last year. Also, some believe that such hedge funds may actually be the cause of much of the volatility seen in the markets, so it will be telling to see what happens this year as regulatory scrutiny increases.

Looking ahead, our economy slowly continues to mend. Payroll gains are pointing to a gradual rebuilding of the workforce while sales in the housing market are improving, aided by record low mortgage rates. And as we noted in our fourth-quarter letter to clients, the manufacturing and service sectors have been in expansion territory for over two years.

Wall Street analysts are notorious for being wide of the mark, but earnings estimates for S&P 500 companies are projected to pass the $100 level for the first time ever this year. Corporate balance sheets remain flush with cash as many companies cope with the new rules and regulations coming out of Washington.

So where do we go from here?

Long-term investors should remain focused on their common stock selections. In these uncertain times, financially strong, high-quality companies with dominant or leading market positions are more likely to continue to expand their operations and grow their earnings and dividends than lower quality, less stable companies.

Many years ago, Dave Babson noted that the basic reason for owning common stocks is to share in the growth of the earning power and the dividend-paying ability of the underlying companies. This statement is as true today as it was fifty years ago when the Dow was but a fraction of its current level.

The key issue is not what stock prices will do in the next hour or tomorrow, next week, next month or next year. Instead, the most important issue is whether or not the company can increase its revenues with new products, services and markets and continue increasing its earnings and dividends.

Navigating the many tricky cross-currents of today is a daunting challenge for investors. Our course remains set by the still valid investment compass established years ago. We remain convinced that seeking out and investing in "best-in-class" companies at reasonable valuations will amply reward shareholders over time.

William H.L. Mitchell