



Forester Value Fund

QUARTERLY UPDATE

Happy 2012

2011 is in the books and year 3 of the presidential cycle did not see the best equity returns of the cycle. There are probably a couple of reasons for this. 8% fiscal deficits mean that there is little left for fiscal stimulus. 0% Fed Funds rates mean that there is little left for monetary policy except for the printing press. So there was not much in the way of US stimulus. There was also plenty of Euro drag. So we shall see what year 4 of the presidential cycle brings. Hopefully it is better than last time (2008).

US continues growth

So far, GDP growth has accelerated in H2 2011. The US has been the only port in the storm and has benefitted from a flight to quality (below chart, line rising is quality outperforming). Investors have been willing to buy 10 yr US Treasuries that yield less than 2% as they are more concerned about a return of capital than a return on capital.



Financials were hit hard in 2011 as investors worried about contagion from Europe and capital quality in the large banks. This crimps lending and is usually a drag on GDP growth.

Oil prices were a bright spot in H2 as average gas prices dropped from the high \$3s to the low \$3s. This spurred spending just in time for Christmas. Prices would have to drop even more for the positive effect to continue.

Savings were drawn down in H2 as the savings rate went from 5% to 3.5%. This is near the lows, when people were taking equity out of their homes, so it is probably not sustainable longer term.

High quality stocks have outperformed low quality stocks this year. We would expect this to continue unless there is coordinated massive money printing campaign by the global central banks. Such an event would cause large long term problems, but the benefits would be front loaded. At these interest rate levels, bonds would get hurt, but stocks would benefit.

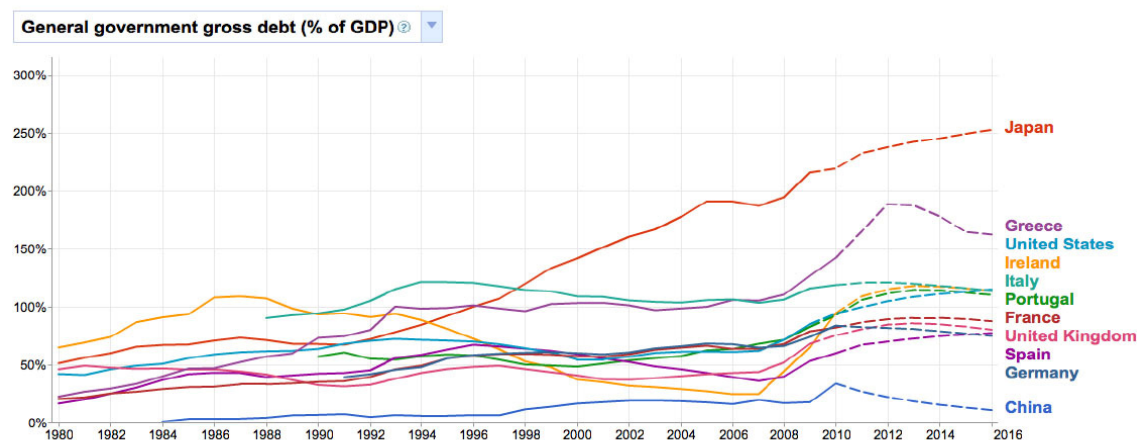
ECRI, which produces leading indices, has said that its indicators suggest a US recession in the next 6 months. They have a very good forecasting record and accurately forecast that we would not go into recession in 2010 when things looked bleak. We're already running an 8% fiscal deficit, so stimulus will be difficult. Imagine what GDP would look like if we had to balance our budget?

We think that 2012 will be mixed as there is a tug of war between slow growth and recession driven by contagion from Europe.

Euro redux

Probably the most important thing to get right in 2012 will be the Euro crisis and its impact on the global economy. To understand the crisis, one must understand how we got to these levels of debt on both a sovereign and global bank level. Below is a graph that shows the current levels of country debt as a percentage of GDP.

Figure 1:



Source: International Monetary Fund, September 2011 World Economic Outlook

As can be seen above, most of the developed world is near the 100% Debt/GDP level, which has marked trouble in the past. Demand for government debt has been strong regardless of high fiscal deficits and accumulated debt. We believe that the root cause is the Risk Weighted Asset (RWA)

concept which determines minimum bank capital. In general, RWA is a logical concept which says that a bank's required capital should vary with how risky its assets are. The problem is not the concept, but the application.

Under RWA, AAA securities have a zero risk weighting. So in theory, a bank with 100% French government debt would require no capital. With no capital required, a bank could buy unlimited French government debt and its balance sheet would only be limited by the size of its deposit base, Central Bank repos and debt.

The RWA regime assumes that the rating agencies are both competent and timely at assessing risk. Given the past AAA subprime problems, that assumption is suspect.

RWA is also a way of expanding lending with less capital. Said another way, it levers up banks. As long as AAA really means no risk, then perhaps it works. But when AAA gets risky, it takes on systemic proportions.

Since rating agencies are slow to change ratings, especially for sovereigns, RWA allows AAA entities to borrow too much. It is easier for a country to deficit spend when it knows there is a ready buyer of its debt. Banks have traditionally not done a lot of credit analysis when a security has a AAA rating so they purchase too much AAA paper and find themselves in trouble when the underlying credit deteriorates.

This is the problem in Europe. They are stuffed full with so called AAA and other highly rated paper that has little capital against it to buffer any losses. So when the credit deteriorates, like now, they find themselves in trouble. Usually the host country will recapitalize them but now the host countries have too much debt and have more limited capacity to help their banks.

So we think that the RWA regime has led to over-valuing AAA securities and has allowed AAA entities to over-borrow leading to over-leveraged countries and banks. We have included an appendix for those that are interested in a more in depth look at the Euro crisis.

There are four ways forward. 1. Cut spending (austerity). 2. Raise revenues (taxes). 3. Add more debt (fiscal stimulus). 4. Print money (monetary stimulus).

Option 1 has short-term pain but long-term gain. Option 2 has short-term pain and less long-term gain than 1. Option 3 limits short-term pain but adds to long-term pain. Option 4 limits short term pain but adds huge uncertainty to long-term pain. Politicians always opt for limiting short-term pain. So they will choose Options 3 and 4 until the markets revolt. Then they'll have to consider Options 1 and 2.

In the US, we have been adding more debt and printing money. 2009-2012 saw the federal government make up for weak consumer and corporate demand by adding stimulus and running a large deficit financed by selling debt. The Federal Reserve printed billions of dollars to buy that debt and other GSE debt. The federal government is running a 40% deficit to total spending (8% compared to GDP). We have built up a pile of debt. Our debt/GDP is approaching 100%. At some point investors start demand high higher interest rates.

The US has benefited from a flight to quality, out of Europe, and demand has remained high for US debt. If that reverses, we could look more like Europe and see our medium and long term interest rates rise, even if the Fed keeps short term rates low.

2013 may be quite difficult for the US as we may not have the luxury of running 8% deficits. That would leave us with only options 1, 2 and 4. 1 and 2 are not fun. If 4 gets out of hand, like the hyperinflation in Germany in the 1920s, we have huge problems.

In Europe, the markets have refused to finance the PIIGS at low interest rates. The European Central Bank (ECB) is not allowed to buy new issue government debt.

So Europe is left with Options 1 and 2. While we think that will lead to a stronger Europe longer term, in the short run, it probably leads to recession and lower equity prices.

For the US, the \$64,000 question is, does a European recession tip us into a recession as well?

Emerging markets have slowed in H2. China PMI has been around 50 which is stagnant GDP. China enacted a massive stimulus plan in 2009 (30% of GDP) through its banks. Now China is seeing an increase in bad debts and a slowdown in capital spending. China has the ability to stimulate if needed, but things are currently slowing.

India is contracting and Brazil is flat. We have been hearing that credit is tightening in both countries. This could be a result of Euro banks shrinking their balance sheets. Foreign credits should be more affected as Euro banks protect their home markets, especially if the Euro bank needs to recapitalize with help from its home country.

All of these factors lead us to be cautious in H1 of 2012.

Our stock selection was very strong in 2012. Equity only returns were high single digits. Our high quality names had a strong year.

VF Corp (VFC) was the portfolio's top performing stock this year, returning 52.2%. Demand remains strong for the company's North Face and Vans brands, the European turnaround is well underway, and cotton prices fell during the second half of the year, easing cost pressures. Another catalyst for the name was the company's acquisition of The Timberland Company, which is an excellent strategic fit and expected to be very accretive to earnings.

IBM (IBM) was another top performer in 2011, posting a 27.6% return. The company continues to benefit from several secular growth tailwinds (Smarter Planet, the cloud, business analytics, and emerging markets) that help to soften cyclical headwinds, such as economic weakness in Europe. In addition, the company is committed to returning a large amount of cash flow to shareholders via share repurchase, which helps to boost EPS growth.

UnitedHealth Group (UNH) was up 42.4% for the year. The company had strong revenue growth in its health insurance business as well as its higher margin services business. UNH's leading market share and solid balance sheet helped it outperform its peers.

LOOKING FORWARD

We try to produce the best risk-adjusted returns available. As risks have increased, we have increased our protection. If risks subside or are priced in, we will gladly reduce our protection. But until the market more fully reflects these risks, we will remain cautious.

Best regards,



Thomas H. Forester
CIO and Portfolio Manager

For more complete information on the Forester Funds, including charges and expenses, obtain a prospectus by calling 1-800-388-0365 or visiting www.ForesterValue.com. The prospectus should be read carefully before investing.

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Euro Crisis Appendix

Banks are traditionally an arm of monetary policy as fractional reserve banking creates the credit available to an economy. As such, sovereign countries generally bailout their banks to keep the credit and payment systems in place (the equity and debt losses incurred are variable).

Sovereign countries used to limit how much debt they took on so they would have the flexibility to bailout the banking system if needed. That is why banks have historically carried higher credit ratings than their high leverage might imply. Bank credit ratings are generally close to the sovereign ratings. Modern Portfolio Theory also got caught up in the act, as they assume that the sovereign rate is “risk-free.”

The last 20 years or so have seen a large shift away from the low leverage/high credit rating sovereign. In fact, sovereigns have used this concept of them being “risk-free” to run fiscal deficits and balloon their Debt/GDP ratios.

The Bank for International Settlements (BIS), in Basel, Switzerland, is known as the Central Bank's, Central Bank. They have developed guidelines to regulate large global banks. You may have heard of Basel III, the latest proposed regulations which increase the amount of capital that banks must have by June 2012.

As we mentioned last quarter, the BIS came up with the Risk Weighted Assets (RWA) idea for banks. In general, the concept was that banks with less risky assets should need less capital and vice versa.

Below is a chart of large banks ranked by their Tangible Common Equity (TCE). The next column to the right is their Tier 1 ratio which is TCE/RWA. If you look at Credit Agricole, for example, according to Bloomberg, its TCE is 1.50% of assets and its Tier 1 ratio is 5.95%. Both are very low by international standards.

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Bank TCE

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Ticker	Short Name	TCE Ratio LF	TCE/RWA	Market Cap	Tot Assets LF	P/E	Oper ROE LF	
1) ACA	FP	CREDIT AGRICOLE	1.50%	5.95	13.14B	2.31T	5.53	6.62%
2) 8308	JP	RESONA HOLDINGS	1.52%	N.A.	10.94B	553.70B	4.02	45.72%
3) DBK	GR	DEUTSCHE BANK-RG	1.61%	9.60	32.68B	3.07T	5.35	10.15%
4) 8411	JP	MIZUHO FINANCIAL	2.27%	6.65	32.04B	2.09T	7.13	8.03%
5) CSGN	VX	CREDIT SUISS-REG	2.36%	12.13	27.27B	1.17T	8.04	15.10%
6) CBK	GR	COMMERZBANK	2.50%	2.84	8.48B	992.86B	2.36	3.88%
7) BNP	FP	BNP PARIBAS	2.85%	8.78	44.68B	2.79T	4.23	12.60%
8) BARC	LN	BARCLAYS PLC	2.90%	10.59	31.41B	2.40T	7.51	8.53%
9) UBSN	VX	UBS AG-REG	2.95%	18.60	44.19B	1.60T	7.40	11.10%
10) GLE	FP	SOC GENERALE	2.96%	9.22	16.61B	1.68T	3.42	9.97%
11) DANSKE	DC	DANSKE BANK A/S	3.07%	9.69	11.75B	611.03B	21.85	3.22%
12) 8421	JP	SHINKIN CENTRAL	3.18%	N.A.	9.66B	412.95B	32.29	1.81%
13) NA	CN	NATL BK CANADA	3.21%	N.A.	10.98B	157.06B	9.79	18.62%
14) 8316	JP	SMFG	3.24%	8.31	39.18B	1.73T	8.16	7.44%
15) NDA	SS	NORDEA BANK AB	3.25%	11.47	29.19B	902.44B	8.52	10.76%
16) SHBA	SS	SVENSKA HAN-A	3.43%	15.31	15.89B	363.04B	9.11	13.63%
17) CM	CN	CAN IMPL BK COMM	3.43%	9.48	27.98B	355.43B	9.96	21.32%
18) UCG	IM	UNICREDIT SPA	3.52%	8.49	17.49B	1.33T	7.10	3.00%
19) BNS	CN	BANK OF NOVA SCO	3.65%	8.85	51.59B	578.07B	10.63	19.06%
20) RY	CN	ROYAL BANK OF CA	3.65%	10.11	67.68B	755.38B	11.16	17.69%
21) SAN	SM	BANCO SANTANDER	3.81%	7.76	62.44B	1.68T	6.18	11.65%

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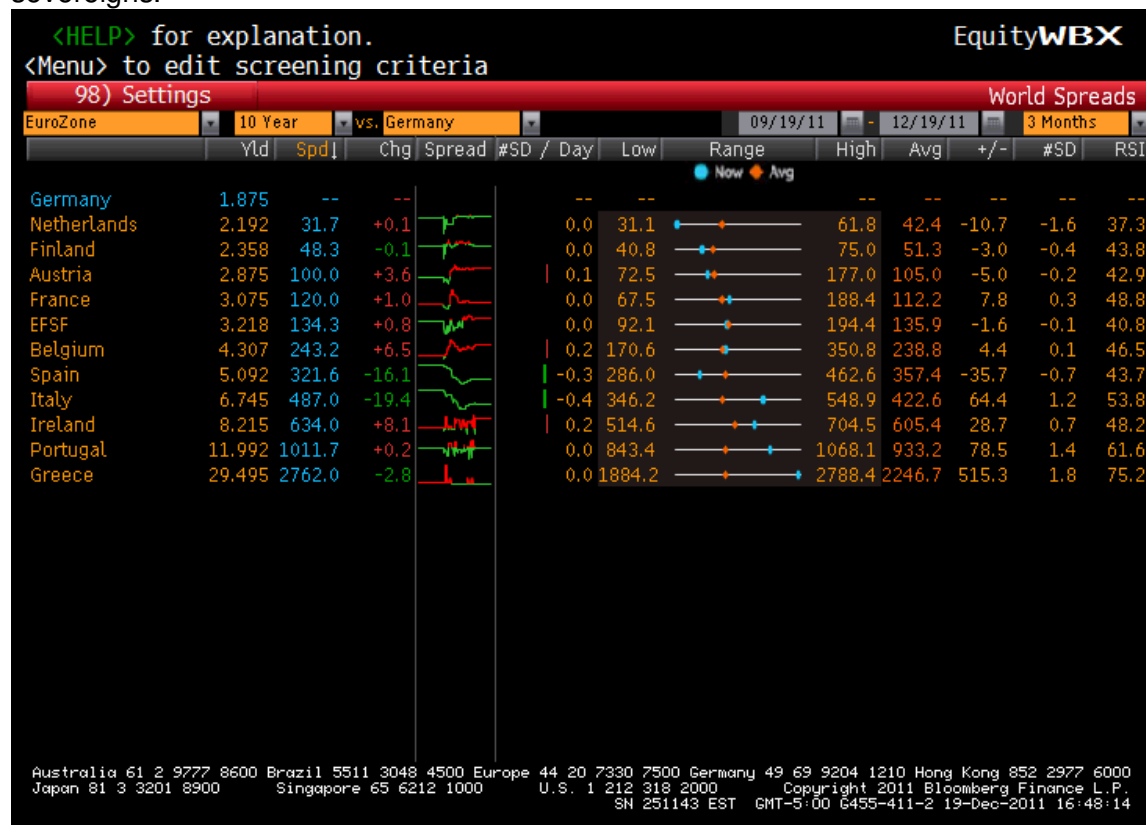
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Credit Agricole will argue that they do not need as much capital as most of their assets are AAA (which have a zero weight) so they are safe. However, there are at least two major problems with that statement.

One is that it assumes that the assets are correctly marked to their true market value. If Credit Agricole had a lot of Italian or Spanish debt and it was marked at par (100) instead of the discount that they are trading in the market (89), the assets would be overstated and thus the TCE would be overstated. Since there is not enough information on the exact assets that Credit Agricole is holding to assess what the correct market values for all assets would be, one must take the numbers on faith. This makes Credit Agricole more opaque and subject to wide stock price swings based on rumors.

Another problem with AAA statement is that we have seen AAA securities trade at extreme spreads to one another, thus implying that some AAA securities (think subprime mortgages) were never AAA to begin with. The rating agencies have lost a lot of credibility in their ratings. The same is true with sovereign ratings and bank ratings.

One way to see this in Credit Default Swap (CDS) spreads. Now CDS markets are not perfect but one would not expect a AAA-rated sovereign to trade at the same CDS rate as an A rated sovereign. The below chart looks at the CDS rates and spreads to Germany of some of the Euro sovereigns.



France and the EFSF (Euro bailout fund) are both currently rated AAA. But you can see that the cost of protecting a French 10 year bond is 120 basis points more than protecting a AAA-rated German 10 year bond. If these two countries are really both AAA, then the CDS spread should be much tighter. Based on the CDS rate, France is trading more like an A rated sovereign.

In the above Credit Agricole example, the RWA part of the equation would go up if French bonds were treated as A-rated instead of AAA-rated. This would cause the Tier 1 ratio to go down. If you applied CDS implied ratings to Credit Agricole assets instead of S&P or Moody's ratings, the Tier 1 ratios would go down dramatically. Importantly, CDS rates are market driven and very timely, while S&P and Moody's ratings can lag dramatically.

So when Italian bonds go down in price (up in yield), stock prices for banks that own such bonds go down. In addition, the CDS for the bank's sovereign (in the example, Credit Agricole's sovereign is France) will also go up as there is a larger chance that the sovereign will have to take on more debt to bail out the bank or guarantee its assets.

If you look back at the TCE chart again, you will see that some of the largest banks in Europe (and the world) have less than 3% TCE. These banks include Deutsche Bank, BNP (Paris), Barclays and Societe Generale. Now all of these banks will point to their higher Tier 1 capital ratios for proof that they are safe. But if the accuracy of the risk of the assets is in question, so is the Tier 1 ratio.

Basel III requires more Tier 1 capital from the banks. The banks can either raise equity, sell assets, get capital injections from their sovereign or a combination of all three. With most banks selling at a significant discount to book value, it is very dilutive to raise equity. So European Banks are trying to sell assets over the next 6 months to strengthen their balance sheets. By June 2012, the host country may have to add equity to their banks if raised equity and asset sales are not enough for the banks to be fairly capitalized.

So hopefully after this more in-depth review of the European crisis, you can see that the sovereign and bank issues are intertwined.

Also, one can see that European banks need to raise capital or shed assets. Brokerage firms estimate that Euro banks need between €500 billion to €3 trillion in additional capital. As mentioned above, a deadline has been set for June 2012 for this to occur. While this deadline may be extended, there will probably be a tighter global credit market and a drag to global growth as European banks shed assets.

Already this is probably being felt in Brazil and India as both of these countries are seeing industrial production growth flatten. It may be felt in the US as Euro banks lose USD funding and have to shed assets.

DIFFERENCE BETWEEN LONG TERM BALANCE SHEET (DEBT) ISSUES AND SHORTER TERM INCOME STATEMENT (GDP GROWTH) ISSUES.

In 2008 investors were looking at US bank balance sheets, which required quarterly mark-to-market accounting, and correctly concluded that many banks were at least undercapitalized if not technically insolvent. This was a balance sheet issue and as long as no debt came due that could not be paid, and as long as the FDIC did not shut them down, the bank could continue. It is analogous to an underwater homeowner where, if his house is his only asset, he is technically insolvent, but, as long as he pays his mortgage, the bank will not foreclose and the insolvency is not recognized.

In 2009, the FASB changed the accounting rules so that banks did not have to mark-to-market. This stopped the banks from having to recognize mark-to-market losses in the income statement and instantly made the banks "profitable" again. With profitability, the banks could pay their debts and like the underwater homeowner, the insolvency was not recognized. The assumption being that the banks could use their profits to recapitalize and address the losses at a later date. This took the focus off of the balance sheet, which was suspect, and put it back on the income statement. which looked better without the mark-to-market quarterly charges.

The Euro zone has a similar problem. As long as investors are looking at the sovereign balance sheet, which is done by focusing on Debt/GDP levels above or near 100%, Europe looks extended and higher yields are demanded to roll over debt.

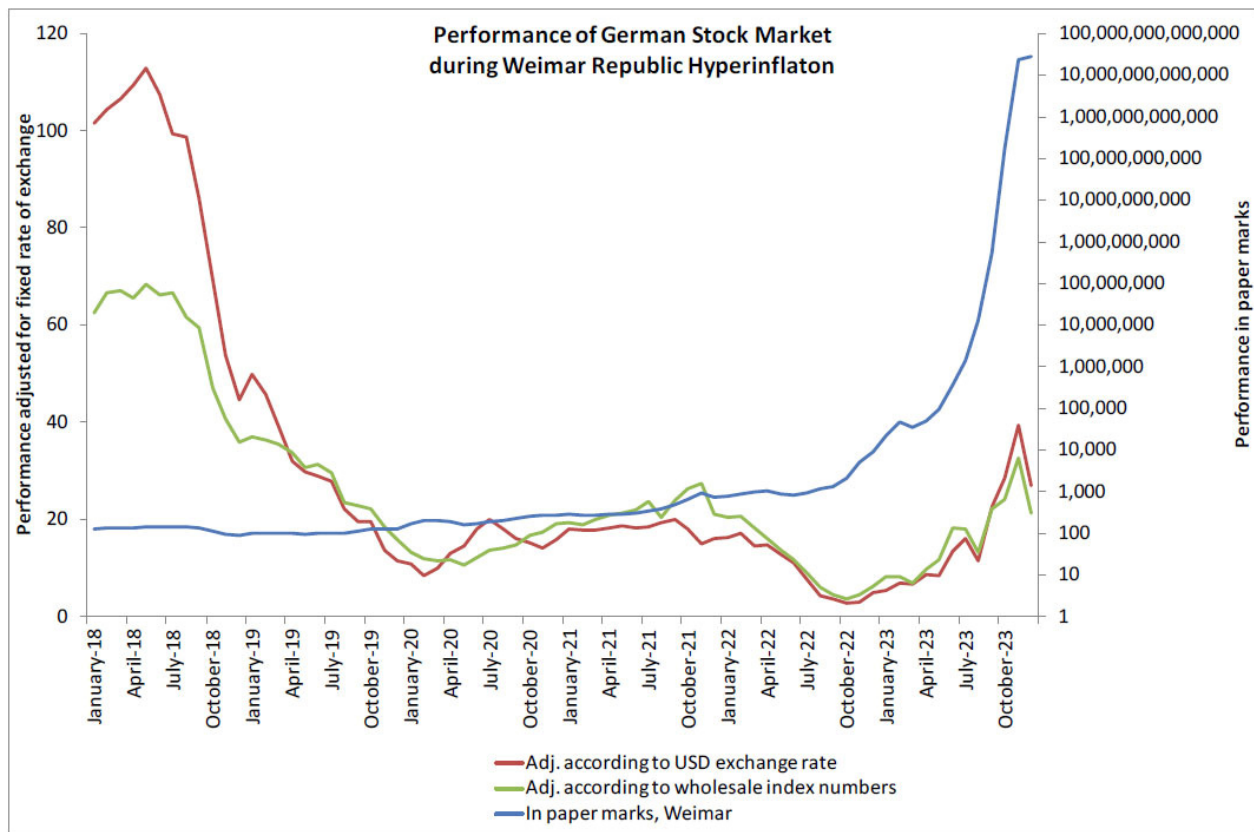
The corollary to the bank analogy would be to look at the country's income statement, that is, their fiscal balance. If there is a surplus, then the country can pay down their debt over time.

Unfortunately, most of the Euro zone is running deficits. Also, since the economies are slowing, cutting government spending compounds the problem. The Euro zone is already highly taxed, so raising taxes may not add much in added revenues. So unfortunately, focusing on the Euro zone income statement does not help the situation.

However, countries have one additional tool that private companies do not have, the printing press. Many analysts have been calling for the European Central Bank (ECB) to print money to bailout the countries and the banks.

Germany tried the printing solution in the 1920s and the results were a disaster: hyperinflation. Wheel barrows full of cash to buy food. It only took three years from the time printing started until hyperinflation was in full gear. Perhaps it will be different this time, but it remains uncharted territory.

Currency devaluation can create the *illusion of economic growth*



Source: Artemis