ALLEY COMPANY
Separate Account Investment Management

Alley Company Quarterly Letter
Maintaining the Discipline

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We have written frequently about "The Great Paradox," which is the tug and pull between the negative macro-economic concerns on one hand and positive company-level fundamentals on the other. The macro problems have been daunting while at the same time great U.S. companies have achieved record results. This paradox has understandably flummoxed many investors.

We have suggested that the macro problems must be worked out over years, undoubtedly with fits and starts, as they are complex and have taken years if not decades to develop. We have also recognized that high-quality U.S. companies have executed well in this environment, producing all-time high earnings while building solid balance sheets and in many cases paying out attractive cash dividends.

Viewing the paradox through the lens of valuation, one might conclude that the macro concerns are trumping the positive company-level fundamentals because the S&P 500 (stock market) is trading at an historically "cheap" earnings multiple of 12x while the safe-haven ten-year Treasury (bond market) is trading at an historically "expensive" yield of 1.5%.

For investors, buying growth assets at "cheap" prices seems preferable to chasing "expensive" assets with no inflation-fighting growth potential. That said, whatever unfolds from current valuation levels, The Great Paradox continues and is causing some investors to be confused about what to do and others to simply disengage.

This provides us the opportunity to review the merits of our investment discipline, emphasizing not only the clarity it provides in paradoxical times but also its importance in achieving long-term investment success. We believe that every investor should maintain a Disciplined Investment Management Program that they can live with through thick and thin and we view the development of such a program as a hallmark of our firm.

Among other elements, the following basic tenets should provide the foundation of a structured program: 1) getting the strategic, or long-term, asset allocation decision right, 2) generating the appropriate level of current income, 3) having appropriate liquidity, or ready access to funds, and 4) understanding what you own. Said in reverse order, if you understand what you own, can

Alley Company LLC
585 Bank Lane, Suite 2400
Lake Forest, IL 60045
Phone 847-482-0938
Fax 847-482-1237
www.alleycompanyllc.com

access a meaningful portion of your funds relatively quickly, are generating an acceptable level of current income as a "bird in the hand," and have a strategic asset allocation decision that allows you to sleep well at night, then you have gone a long way toward "maintaining the discipline."

Asset allocation is an all-important decision and should be developed in accordance with each investor's objectives and risk tolerance. We start with the critical decision of allocation between the "big two" asset classes of stocks and bonds. From there, real estate and other asset classes are taken into account. With stocks being weighed upon by macro concerns and fixed income offering record low levels of interest income, this discussion seems more challenging than ever. We get this decision right by working with each client to set an overall strategic asset allocation plan within their risk tolerance and overlay tactical shifts as appropriate.

Regarding current income, we believe it should be highly considered in the total return analysis. As mentioned, current income from traditional sources is very low and poses a potential problem for investors. We believe there are solutions to this problem in certain areas of the bond market, including investment grade corporates, high yield corporates, and municipals. And in the stock market, we can generate an attractive level of current income with high-quality dividend paying companies.

Taking liquidity and understandability together, they generally are not taken seriously enough. Having a portion of one's assets tied up in illiquid investments like real estate or private equity is fine, but just not too much relative to total net worth. Many investors found out about the ills of illiquidity during the financial crisis and not understanding what you own magnifies the problem. We often see investment programs that are too complex with hundreds of securities managed by numerous money managers. In other instances we hear the recommendation of "alternative investments" that the investor doesn't really understand except to have been told that they have low correlation to the stock or bond market. Knowing what you own is a basic tenet of our discipline.

We advocate an investment program that addresses asset allocation, current income generation, liquidity, and understandability. With the current paradox layering on uncertainty, maintaining the discipline of a structured investment management program is perhaps as important as ever.

Please contact us if you have questions about the content of this letter or want to discuss the details of our investment management program.