SIRE LINE
Capital Management

2012 Annual Report

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Performance Report from
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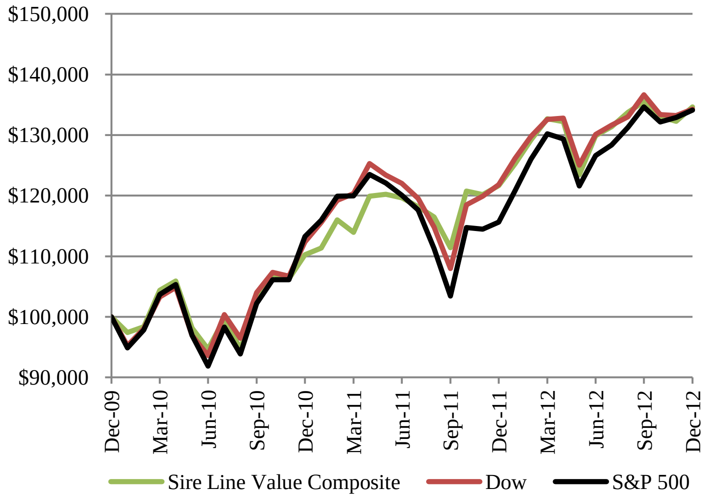
THE VALUE OF A $100,000 INVESTMENT IN THE SIRE LINE VALUE COMPOSITE FROM INCEPTION (1/4/2010) TO PRESENT (12/31/2012) AS COMPARED TO THE S&P 500 INDEX AND THE DOW JONES INDUSTRIAL AVERAGE (UNAUDITED)



NOTE: *Accounts included in this product composite are fully discretionary taxable and tax-exempt portfolios. They are managed under our value style, which invests primarily in high-quality businesses that 1) are simple to understand, 2) have a consistent operating history and favorable long-term prospects, 3) are managed by honest and able managers whose interests are aligned with ours and 4) can be purchased at a significant discount to intrinsic value. The performance of the Sire Line Value Composite is net of all fees and expenses. All performance figures in the chart above begin as of the close on January 4, 2010. Your personal results may differ depending on the timing of your investment and the effects of additions to and withdrawals from your capital account.*

Performance Measurement

The objective for all of our portfolios is to outperform all relevant benchmarks over the long term. The chart above shows a comparison of a $100,000 investment in the S&P 500 Index (S&P 500), the Dow Jones Industrial Average (Dow) and the Sire Line Value Composite since inception.

The S&P 500 is an unmanaged, market capitalization weighted index that measures the equity performance of 500 leading companies in the U.S. today. Firms included in the S&P 500 account for approximately 75% of the value of all U.S. stocks. Therefore, it acts as a fairly good proxy for the total market. Clients could easily replicate the performance of the S&P 500 by investing in an index fund at little cost. For discussion purposes below, I will focus on this benchmark to address our relative performance.

Our Performance in 2012

The Sire Line Value Composite (SLVC) declined 0.6% in the final quarter, resulting in a gain of 10.7% for all of 2012. The S&P 500 declined 0.4% in the final quarter, resulting in a gain of 16% for the year (the Dow declined 1.7% in the last quarter and gained 10.2% in 2012). Most of our gains in 2012 were generated in the first three months of the year. That may end up being true for 2013 as we are already up 5% in the first few weeks of January.

Since inception (1/4/2010) the SLVC has increased 34.7%, while the S&P 500 Index has gained 34.1% (34.3% for the Dow). While our overall performance is only slightly better than the S&P 500 and the Dow, we have achieved our results with less volatility. In addition, all of the figures above include reinvested dividends and are net of all fees and expenses. It should be noted that our private investment fund for high-net-worth individuals (the Nearco Value Fund), which carries fund-specific operating expenses, accounts for over half of the SLVC. Excluding the impact of relatively high operating expenses during the Fund's startup phase, the SLVC is comfortably outperforming both the S&P 500 and the Dow since inception.

Notable winners for us in 2012 include eBay (+59%), Comcast (+58%), Heineken NV (+47%), Anheuser-Busch InBev (+43%), Time Warner (+32%), Diageo (+31%) and JPMorgan Chase (+30%). Our largest detractors include Best Buy (-49%), Dell (-31%) and Western Union (-25%).

I spoke a bit about Best Buy in the most recent quarterly report. We continue to hold the name, although it remains a small position. The market continues to focus its attention on Dell's declining, low-value hardware business (PC manufacturing) rather than its improving, high-value enterprise solutions and services business. Investors are also overlooking the significant amount of cash and investments on the company's balance sheet, which amount to over $8 per share—roughly 80% of Dell's stock price at the end of 2012. We continue to have a sizable position in Dell. Western Union lowered its guidance last quarter as the slowdown in global economic growth continues to have a negative impact on the company's money transfer business. The company is experiencing some competitive issues in certain transfer corridors. However, we believe that most of recent slowdown in Western Union's business is more cyclical than secular. Investors were disappointed by the news, sending the stock down nearly 30% in one day. We were also disappointed by the new guidance, but believe the stock decline was much worse than the decline in the company's underlying business value. We remain holders of the stock and believe that as global economic growth improves, guidance will reverse to surprise on the upside.

The following table summarizes the historical performance of the S&P 500, the Dow and the Sire Line Value Composite:

	TOTAL RETURN (1)		
Annual	S&P 500 (2)	Dow (3)	**SLVC (4)**
2010	13.2%	12.4%	**10.3%**
2011	2.1%	8.4%	**10.3%**
2012	16.0%	10.2%	**10.7%**
Cumulative:			
2010	13.2%	12.4%	**10.3%**
2010-2011	15.6%	21.8%	**21.5%**
2010-2012	34.1%	34.3%	**34.7%**
Annual Compounded Rate:	10.3%	10.3%	**10.4%**

(Footnotes to table above)
(1) All performance figures begin as of the close on January 4, 2010.
(2) Based on changes in the value of the S&P 500 plus dividends (reinvested) that would have been received through ownership of the Index during the period.
(3) Based on changes in the value of the Dow Jones Industrial Average plus dividends (reinvested) that would have been received through ownership of the Index during the period.
(4) Based on changes in the value of the Sire Line Value Composite including dividends and after all fees and expenses.

Changes to Our Portfolios

In the second half of 2012, I added four new names to the portfolio and eliminated six. New to the portfolio are American International Group (insurance), Staples Inc. (retail office supply), Coach Inc. (retail luxury) and DIRECTV (satellite broadcasting).

Staples invented the office superstore concept back in 1986 and today has nearly 2,000 retail locations, a strong online presence and operations in 26 countries. The company's stock has declined nearly 60% from its all-time high of $28 back in 2007. The office products sector is highly correlated with employment trends, with a key driver being small business spending. Despite the recent economic weakness, the company still generates a significant amount of free cash flow and pays a generous 3.9% dividend. As the U.S. economy improves and employment gains some momentum, Staples should see strength in its underlying fundamentals.

Coach is a luxury retailer of high-quality modern American classic accessories. Momentum investors have recently lost confidence in Coach's stock as the company's growth has decelerated from an hyper rate to something more sustainable. Coach generates among the highest returns on invested capital of any company we follow, which is why we were excited for the chance to become part owners in such a high-quality business at a price we believe does not adequately reflect the future growth in its earnings power.

DIRECTV offers satellite-based pay-TV service in the U.S. and Latin America. Although the company competes with another one of our portfolio holdings—Comcast—in the U.S., we don't think DIRECTV's fast-growing Latin American operations is getting the investor attention it deserves. While domestic subscriber growth has clearly decelerated, the U.S. segment throws off significant free cash, which is being used to fund continued expansion in Latin America and repurchase a sizable amount of the company's outstanding shares each year.

In the second half of the year, I eliminated Nestle, Diageo, eBay, Time Warner, Liberty Interactive and Becton Dickinson from our portfolios. I consider Becton Dickinson to be a failed investment, although we did not lose any money on the name. All of the other eliminations were successful investments which had advanced close to my estimate of intrinsic value. Over the three years that these high-quality names held a place in our portfolios, we realized total gains of between 40% and 105% on each one. For those of you wondering why we would ever sell such great businesses out of our portfolios, remember that great businesses do not always translate into great stocks. There must be an adequate "margin of safety" between a company's underlying intrinsic value and its market value (stock price) to protect against a permanent loss of capital. These three stocks no longer meet this requirement. For the sports fans among us, a track and field analogy might better explain the point. Think of a track relay team where each runner, once he or she completes the required distance, hands the baton off to the next runner with fresh legs. Nestle, Diageo and eBay, Time Warner and Liberty Interactive have run the required distance (the initial margin of safety has narrowed) and now it is time to hand the baton off to a new portfolio holding with fresh legs (an investment with a large margin of safety). One of these new holdings is American International Group...

American International Group

During the second half of 2012, I made a sizable investment in American International Group (AIG), making it the largest position in our portfolios. Because AIG was at the epicenter of the U.S. financial crisis and needed a government bailout just a few short years ago, a more detailed explanation of our investment is called for.

AIG traces its insurance roots all the way back to Shanghai, China in 1919. After building an enviable global franchise between 1919 and the 1980s, AIG eventually strayed from its roots by expanding into other areas of financial services. In 1987, AIG created AIG Financial Products Corp. (AIGFP), which, among other things, specialized in interest rate and currency swaps. Eventually it would come to be a large player in credit default swaps. A credit default swap is basically a financial insurance product or "agreement" whereby the buyer of the swap makes periodic payments to the seller, and in return receives a payoff from the seller if the underlying financial instrument defaults.

In the years leading up to the financial crisis, AIGFP was a large seller of mortgage-related credit default swaps. This means that AIG would be required to make sizable payouts to other financial institutions in the event of a real estate market collapse. Not only did AIGFP sell swaps that were tied to real estate loans, it also made large direct investments in residential mortgage-backed securities which began to experience dramatic losses in value in 2007 and 2008. By the second half of 2008, more than a few large financial institutions had failed, real estate values had plunged and global credit markets were barely functioning. Although AIG had substantial assets on its balance sheet, it did not have the necessary short-term liquidity to meet its immediate cash requirements. If AIG had failed, many of the institutions that it made promises to would also fail. The U.S. Government couldn't let that happen as the potential outcome of such a domino-like scenario throughout global capital markets was unthinkable. So the Federal Reserve Bank of New York and the U.S. Treasury began to inject massive amounts of liquidity into AIG, which over time would amount to roughly $182 billion.

In 2009, there was a complete overhaul in corporate leadership at AIG, with the most important change being the hiring of an outsider, Robert Benmosche, for the roles of President and Chief Executive Officer. While most people believed that AIG would immediately sell off all of the individual pieces of the company at fire sale prices leaving nothing behind but ashes, Benmosche came up with a much better plan. In 2010, he reorganized and simplified the government's ownership structure, which allowed the U.S. Treasury to slowly sell its AIG equity stake over time as asset values returned to more normal levels. In 2010 and 2011, Benmosche sold off certain non-core assets, raising tens of billions to help re-fortify AIG's balance sheet, regain investor confidence and help pay off the debt owed to the U.S. Government. In addition, he completed the wind-down of virtually all of the AIGFP derivatives portfolio, which was responsible for putting the company in jeopardy in the first place.

Finally in 2012, the U.S. Government sold its remaining ownership in AIG, which at one point amounted to as much as 92% of the entire company. Late in 2012, AIG announced the sale of virtually all of its remaining non-core assets at very attractive valuations. Once these sales have been completed, it will further strengthen AIG's balance sheet and lower the capital intensity of the company. It should be noted that not only did AIG eventually repay the U.S. Government in full, the U.S. Government actually ended up recognizing a $23 billion profit from the AIG bailout.

So, after shedding all of its non-core assets over the last few years, AIG has finally returned to its operational roots. Today, AIG is strictly a leading global provider of property & casualty insurance and a domestic provider of life insurance and retirement services. AIG is actually a very large and important player in the global insurance industry, from acting as the lead insurer for the new World Trade Center in New York to helping Joplin, Missouri, recover from devastating tornadoes to guaranteeing financial relief to those on the East Coast hurt by Hurricane Sandy.

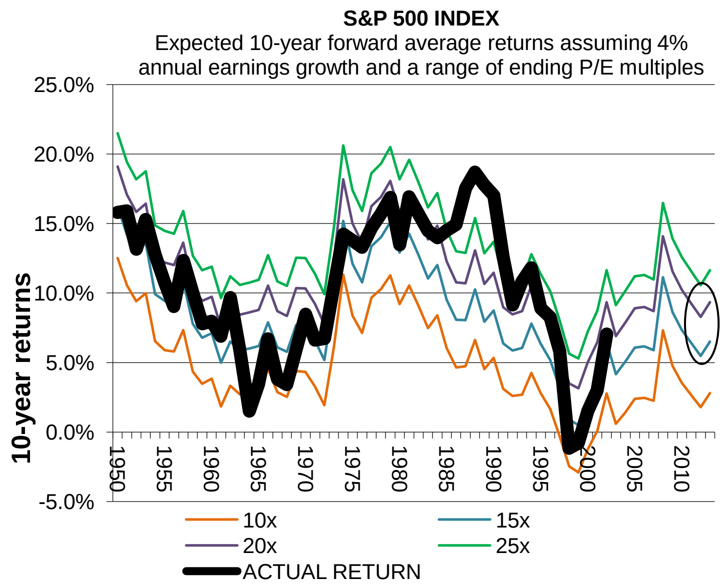
Those are the qualitative highlights. On the quantitative side, AIG likely ended 2012 with shareholders' equity (net asset value) of close to $70 per share and underlying cash earnings power of $5-$6 per share. With a current stock price of around $35 (which is higher than our average purchase price), AIG can be purchased for roughly half of shareholders' equity and 6x-7x earnings power. In addition, after AIG finalizes the sale of its remaining non-core assets, it will be overcapitalized and should be able to return significant value to shareholders via dividends and share repurchases.

Given how recent the bailout was, investor skepticism is still extremely high. But it is precisely that general skepticism that creates opportunity for us. If investors really did their homework they would see that AIG today is a completely different company than the AIG that needed to be bailed out by the government back in 2008.

U.S. Equity Markets: Cheap or Expensive?

While we are stock pickers first and foremost, we recognize that it is also important to keep an eye on the overall value of equity markets. One measurement that we believe is a good indicator of whether U.S. equity markets are cheap or expensive is the expected 10-year forward rate of return on the equity market. Forward rates of return for the stock market can be implied by using its current valuation as a starting point, a conservative assumption for earnings growth going forward and a range of price-to-earnings (P/E) multiples in the final year. A 10-year time period is used to make sure that the model captures an entire economic cycle.

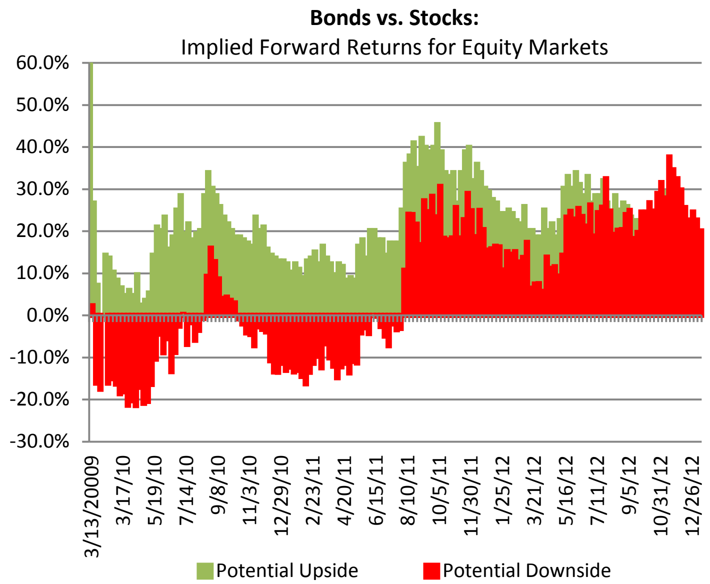
In the chart below, the thin colored lines represent <u>expected</u> 10-year forward rates of return for the S&P 500 Index assuming an average annual earnings growth rate of 4% and a range of ending P/E multiples (10x, 15x, 20x and 25x). The heavy black line shows the <u>actual</u> 10-year forward rate of return experienced for the S&P 500. Based on this analysis, the current 10-year forward rate of return for the S&P 500 Index is expected to be in the range of roughly 6.5%–9.5% assuming an ending P/E multiple of between 15x and 20x (circled on far right of the graph).



Even if one were to assume a worst case scenario over the next 10 years (an ending P/E multiple of only 10x), the expected rate of return for the market would still be higher than the current yield on the 10-year risk-free Treasury bond (2.8% for the S&P 500 vs. only 1.8% for the 10-year Treasury bond).

Another measurement that we track closely is the relationship between the yield on U.S. investment grade corporate bonds and the earnings yield for the equity markets. The reason that this relationship is important is because bonds and stocks are always in competition for investor dollars. Investors will always gravitate toward the asset class that offers a higher risk-adjusted return.

Based on the historical relationship between these two yields, the current relationship implies that the risks in the equity market continue to favor the upside (potential upside of 17%). You can see this better in the chart below. (Simplistically, positive green/red means stocks are relatively more attractive than bonds, while negative red/green means stocks are less attractive than bonds.)



Administrative Items

Our custodian, FOLIOfn, is hard at work preparing our end-of-year tax documents. As soon as they have been completed, final 1099s will be available on the FOLIOfn website and ready for downloading. I expect this process to be completed by the end of February. Please feel free to call or email me with any questions.

As always, thank you for your continued loyalty and support. I am proud to be your partner.

With appreciation,

Daren Taylor, CFA