NOESIS CAPITAL MANAGEMENT

A REGISTERED INVESTMENT ADVISOR

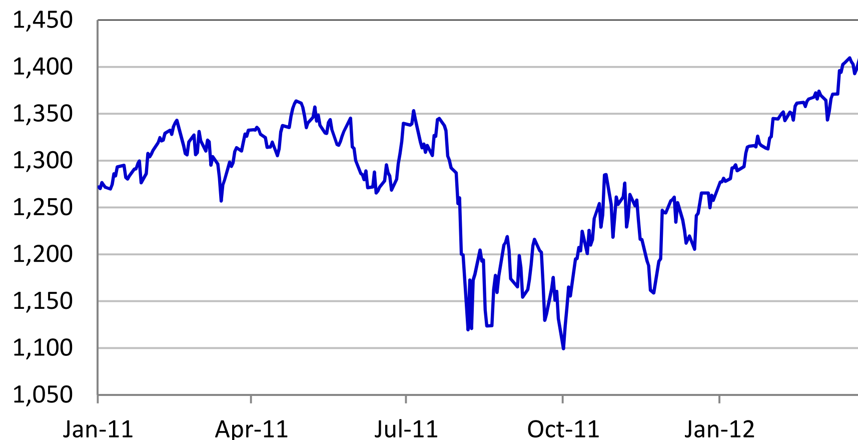
April 15, 2012

Dear Client:

What a pleasant surprise equity markets worldwide provided in the first quarter!

Many of the concerns we heard during the second half of 2011 were focused on the heavily-leveraged Euro Zone, specifically the "PIIGS" (Portugal, Italy, Ireland, Greece and Spain), and a potential breakup of the European Monetary Union. Investors were worried about a double-dip recession and rushed out of the financial markets, driving prices dramatically lower (see Chart 1). Even at the beginning of 2012, many respectable investors and Wall Street experts continued to provide pessimistic outlooks. These predictions were all proven incorrect, at least for the first quarter. Once again, recent market movements teach us that attempting to time the market can be dangerous and remind us to be cautious in our investments.

Chart 1: Standard And Poor's 500 Index



The catalyst for this market turn was a €1 trillion injection by the European Central Bank last December. This liquidity immediately saved the system from a potential "Lehman-like" crisis. As investors' fears subsided, a huge amount of cash was rushed into the markets and rapidly pushed prices higher.

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Although the default risk for European banks was temporarily minimized, the over-leveraged balance sheets remain a time bomb. Liquidity is only buying us time. In fact, European finance ministers warned before the quarter end that the underlying causes of the banking crisis had yet to be resolved. Whether these issues can be resolved—and how quickly—remains to be seen. Investors need to keep their antennas high.

As equity markets worldwide continue to rise rapidly, we don't want to blindly chase them. We will continue to adhere to our strict discipline and, when they become available at attractive prices, purchase only securities of excellent quality. With that in mind, last quarter we only purchased one position, took some profits, and kept some cash on the side. From a risk/reward perspective, we believe that our portfolios are well-positioned in the current environment.

Our Investment Process

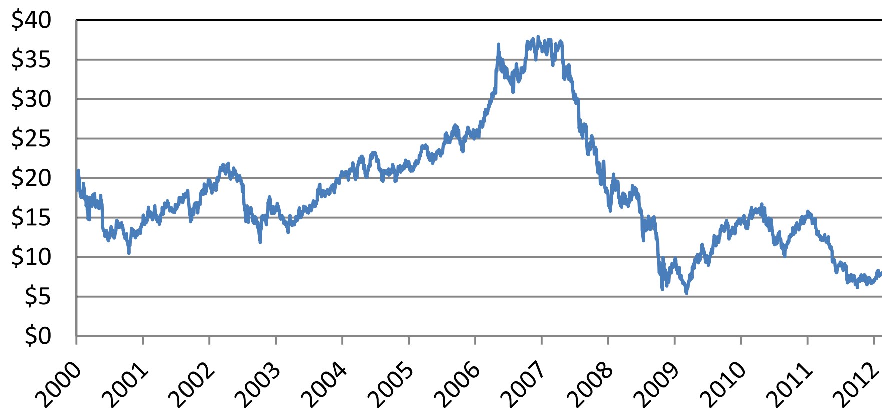
In terms of equity investment, we must never forget that stocks represent ownership interests in real businesses. Before we commit to owning a share, we rigorously evaluate a stock the same way any successful business owner evaluates his/her business opportunities. We exercise due diligence in order to make sure that the business we are purchasing offers an attractive long-term growth opportunity and that the price we pay offers a sufficient margin of safety. In addition, buying a share is like casting a vote. We use this voting power to encourage good business and discourage bad business. This is very important, and many investors do not pay enough attention to this responsibility of ownership. After the initial purchase decision is made, we remain owners for as long as the long-term outlook remains positive and valuation remains within a reasonable range.

Our recent purchase of Staples illustrates how these principles drive our decision-making process.

Compared to Office Depot's annual revenue of $11.5 billion and OfficeMax's $7 billion, Staples Inc.'s $25 billion in yearly sales makes it the world's leading office products company. The company has three business units: the North American Delivery Division accounts for 40% of total revenues and North American Retail comprises another 39%, while International Operations accounts for the remaining 21%.

The office supply industry is certainly facing some difficult secular trends, such as declining paper consumption, declining profit margins on technology products, and rising competition from online retailers such as Amazon. In addition, industry sales are highly correlated to employment and the weak U.S. labor market of recent years negatively impacted it, which has been reflected in the group's stock prices (see Chart 2). Furthermore, Staples' international operations are primarily located in Europe, with the remainder in Australia, Latin America, and Asia. While we regard Staples' international expansion as positive in the long-term, in the near term it provides another headwind to the company.

Chart 2: Office Supply Industry



Note: The index is the average of Staples, OfficeMax and Office Depot's stock prices

We made our initial purchase of Staples in mid-2003. Share prices rose relatively quickly, causing us to trim our holdings a couple of times during 2006. While we were concerned about rising competitive pressure in the industry, we still kept a minimal position in our portfolios, as we remained impressed by Staples' management team and its ability to execute. The company continued to gain market share without sacrificing much of its margins and return on equity.

Contrasting common practice, Staples invested for the future during the recent recession. Unfortunately, even the best-in-class company was not immune in a very difficult environment, and growth rates for both same store sales and earnings per share declined for several consecutive quarters. Share prices were cut almost in half. We struggled to decide whether we should increase our existing position or liquidate our shares entirely and seek an alternative investment. So we went back to dig through our research files and crunch numbers again.

When these three companies reported their most recent quarterly results in late February, we analyzed them once again. We saw the industry showing initial signs of recovery, even though Staples did not meet our expectations. As we continued analyzing the details, we were torn between selling and buying.

Within two days, the big picture became clearer. While we understand the secular trends, we think a strengthening labor market should support the industry in coming years. In addition, Staples commands a respectable online presence. It generates over 40% of its sales through e-commerce, making the company the second largest Internet reseller in the world behind Amazon. The decline in office paper consumption is a well-known issue, ongoing for years, and Staples' management reacted early with innovative service offerings in technology as well as copy and print. Staples has consistently delivered returns on equity in the mid-teens with little debt, and paid back shareholders by repurchasing shares as well as raising dividends. As Staples continues to gain market share in each business segment, we believe it is well positioned to benefit from the upcoming positive business cycle.

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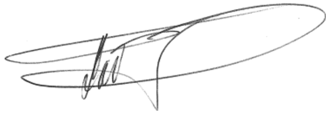
We expect that earnings per share could grow close to double digits at a minimum. In terms of price/earnings ratio, Staples' 9.4 times represents a discount of around 20% to the S&P 500 Index of 12 times. Staples' enterprise value is only six times its earnings before interest, taxes, depreciation and amortization. With these solid fundamentals in mind, we think the current stock price already discounts most investors' concerns. Consequently, we decided to increase our existing position.

As we consider learning part of our Noesis DNA, this case serves as an excellent example of the applied methodology we use to make investment decisions. Even though we have followed this company and its peers for over eight years, we went through another intense round of analysis and discussion before reaching a final conclusion. Who knows what the market will do to the stock price, as factors like the mood of "Mr. Market" remain beyond our control. However, with such an extensive analysis, we are confident that our understanding of the company and industry increases the probability of achieving a favorable outcome for our clients.

Thank you for the referrals you gave us. Please do not hesitate to contact us if you wish to discuss your portfolio or have questions.

Sincerely,



Joseph Lai, CFA
Chief Investment Officer

Our most recent Form ADV, Part II is available upon request

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