

FOCUSED INVESTORS LLC  
— INVESTMENT MANAGEMENT —

PORTFOLIO AND PERFORMANCE REVIEW  
FOURTH QUARTER 2011

<u>Performance*</u>	<u>Fourth Quarter</u>	<u>2011</u>	<u>Since Inception**</u>
<b>FI Concentrated Value Composite (gross of mgmt fees)</b>	<b>9.4%</b>	<b>6.1%</b>	<b>6.5%</b>
<b>FI Concentrated Value Composite (net of mgmt fees)</b>	<b>9.3%</b>	<b>5.6%</b>	<b>5.6%</b>
Russell 1000 <sup>®</sup> Value Index	13.1%	0.4%	(0.4%)

\* Important performance disclosures are included at the end of this letter.

\*\* Annualized. Inception Date: 8/1/06.

The U.S. equity markets rallied during the fourth quarter, bringing an end to a rollercoaster year. Despite the late rally, our benchmark still ended the year almost exactly where it started. Our portfolio of high-quality companies continued its rather predictable pattern of past behavior – not quite keeping pace when equity markets rise strongly but declining less when they fall sharply. Consequently, our portfolio underperformed our benchmark for the quarter, but outperformed it nicely for the year. As in our previous letters, we urge investors to attach little weight to quarterly or even annual results given our concentrated portfolio.

Last year provides a good illustration as to why we believe so strongly in our investment philosophy of focusing on the quality of the companies in which we invest and the price at which we do so, rather than trying to position our portfolio based on macroeconomic or other non-company specific considerations. The equity markets seesawed in 2011 as investors began the year by shunning high-quality companies in search of businesses that would benefit from the then prevailing presumption of a strengthening economy. However, as the year progressed and economic data proved weaker than expected, investors' faith in the economy faltered, and they once again sought the safety of the high-quality companies we own.

High-quality companies continued to benefit as investors' confidence eroded further, due in part to political posturing by Congress over raising the U.S. debt ceiling and to Standard & Poor's subsequent downgrade of the long-term sovereign credit rating on the United States from 'AAA' to 'AA+'. The European sovereign debt crisis further added to investor discomfort. However, as 2011 came to a close, investors' confidence returned, driven in part by better than expected domestic economic results and actions taken by the European Central Bank which temporarily eased concerns over the European sovereign debt problems.

Had we attempted to continually "re-position" our portfolio in response to the various developments last year, our performance most definitely would have suffered and our portfolio turnover would have skyrocketed, bringing joy only to the brokers with whom we trade. Instead, we stayed the course with our portfolio of high-quality companies, changing positions solely in response to company-specific price/value relationships. Our unrelenting focus on individual company valuations virtually guarantees that we will be out of step with the market in the short-term, but we believe it will prove to be the source of our value-added in the long-term.

From an attribution standpoint, our relative performance in the fourth quarter was hampered by our lack of exposure to *Energy*, the benchmark's best performing sector. Despite returning just over 10%, *Consumer Staples* was the benchmark's third-worst performing sector

for the quarter. Our significant overweighting in *Consumer Staples* detracted from our relative results as did the performance of our *Information Technology* holdings. We benefited slightly from our lack of exposure to *Utilities* and *Telecommunication Services*, the benchmark's two worst performing sectors.

For the third quarter in a row, McDonald's was the largest positive contributor to our performance based on its sizeable portfolio weighting and share price gain. McDonald's management has done an excellent job of growing global comparable sales by introducing new menu items and implementing selective price increases without negatively impacting customer traffic. These actions have helped offset significantly higher commodity costs that have been responsible for recent pressure on operating margins. Financial results have continued to outpace investors' expectations, and management is taking advantage of the company's current operating strength to accelerate new restaurant openings and renovations of existing restaurants in 2012.

McDonald's share price has risen faster than our estimate of the company's underlying business value, pushing up the company's price/value ratio to a level that, while still cheap, no longer warrants a nearly 10% position size. Accordingly, we reduced our position during the quarter and are evaluating whether a further reduction is appropriate. We still believe that McDonald's is a great company, but it is not as cheap as it was earlier in the year.

Wal-Mart's share price also rose nicely during the quarter. After reporting declines in comparable store sales for nine consecutive quarters, Walmart U.S. finally achieved positive comparable store sales growth last quarter. Aggressive pricing helped drive this positive growth which reflected an increase in average ticket size partially offset by a decline in traffic compared to last year. While the decline in traffic is disappointing, the overall growth in comparable store sales is encouraging and suggests that some of the company's sales growth initiatives are bearing fruit. We believe management is taking the appropriate actions to position the company for future sales and earnings growth while continuing to return significant cash to shareholders through dividends and share repurchases. We remain very comfortable with our position.

CVS Caremark's stock performed well last quarter as management announced continued progress in both attracting major new clients to the company's pharmacy benefits management (PBM) business and improving the PBM's previously disappointing financial performance. Based on new client activity and the increased profitability arising from a number of branded drugs moving to generic versions in 2012 as their patents expire, management expects a significant improvement in Caremark's 2012 operating profit.

On the retail side, CVS drugstores continue to perform well. CVS stands to gain a meaningful number of pharmacy customers from Walgreens, its major competitor, due to a contract dispute between Walgreens and Express Scripts. Even before taking these former Walgreens pharmacy customers into account, CVS expects to generate mid-teens earnings growth in 2012 and significant free cash flow. In December, management announced a 30% dividend increase which follows a 43% dividend increase announced at the beginning of 2011. We expect management to continue to devote a substantial portion of the company's free cash flow to future dividend increases and share repurchases. Because of our increased confidence in management's progress in turning around the Caremark PBM business, we have adjusted upward the cash flows in our CVS valuation. Accordingly, our assessment of the underlying business value of CVS grew in line with the recent strength in the company's share price, and we believe CVS remains significantly undervalued.

Diageo's share price reacted positively to stronger than expected quarterly sales growth as well as to the company's recent investor conference in New York. During the conference, management provided details on the company's plan to drive sales growth while expanding operating margins and increasing return on invested capital. Given the company's leading brands

in the distilled spirits category and management's proven track record in improving long-term operating margins and return on invested capital, the company's financial targets seem reasonable. Excess cash flow will be used primarily to fund dividends and acquisitions rather than repurchase stock. While we would prefer more of a bias towards share repurchases, we are comfortable with the company's current capital allocation strategy.

NIKE's share price rose during the quarter as the company reported better than expected quarterly earnings per share, driven by strong revenue growth, operating expense leverage and a lower average share count, all of which were offset by significantly lower gross margins primarily due to higher product costs. There is a 6-9 month lag between changes in input costs and when they get reflected in cost of goods sold. Therefore, the peak product costs experienced in the second half of 2011 will continue to pressure gross margins through the beginning of 2012, while the recent decline in product costs will not benefit gross margins until the second half of 2012.

Product innovation and design supplemented with highly effective marketing continue to drive impressive demand for NIKE products. At the end of the company's November quarter, worldwide futures orders for NIKE Brand athletic footwear and apparel scheduled for delivery from December through April 2012 grew 15% over the prior year, reflecting a 7% increase in unit orders and a 6% increase in average price per unit. These higher prices should also help improve gross margins in the latter part of 2012. Although NIKE continues to be a very high-quality company, we believe its current share price warrants a slightly lower position size, so we sold some shares during the quarter.

Pfizer was the best performing stock in our portfolio last quarter; unfortunately, it was a small position. The company reported strong quarterly results driven by higher than expected revenues and raised its 2011 earnings guidance range. The company also accelerated its share repurchases and raised its 2011 share repurchase target by \$2 billion to \$7-\$9 billion. In mid-December, Pfizer raised its dividend by 10% and announced a new share repurchase program for up to \$10 billion in addition to the amount remaining under its current repurchase program. Management expects to repurchase \$5 billion of stock in 2012 with the remaining authorized amount available in 2013 and beyond.

Not only has the company recently made its capital allocation far more shareholder friendly, but it has also brought a new level of discipline to spending on research and development, and it seems to have some promising new drugs in the pipeline. The long awaited patent expiration for Lipitor in the U.S. finally occurred at the end of November. However, Pfizer is managing the loss of exclusivity through the use of aggressive couponing and discounting and appears on track to maintain a higher level of Lipitor sales than previously anticipated albeit at a reduced level of profitability. Pfizer remains modestly undervalued at current prices.

A number of the companies we own have significant international business operations. The recent strength in the U.S. dollar relative to other currencies, especially the Euro, will negatively impact revenues and earnings for these companies in the near term. We believe this currency-induced volatility is more than compensated for by the higher growth prospects of the foreign markets in which our portfolio companies operate. Nonetheless, we may see some short-term weakness in the share prices for these companies as investors react to the negative foreign currency impact.

As usual, there was only modest activity in our portfolio last quarter. We trimmed our positions in McDonald's, NIKE and IBM as their stock prices rose and their discounts to our estimates of their intrinsic values declined, and we added a new position in Wells Fargo. The rationale for our purchase of Wells Fargo is outlined in the following paragraphs.

Wells Fargo is a diversified financial services company engaged in residential mortgage origination and servicing, commercial lending, investment banking, insurance brokerage, wealth management, retail brokerage and card services. As with other banks, Wells Fargo's non-performing assets and credit-related losses increased substantially during the past few years, and its foreclosure-related expenses and mortgage-related litigation expenses spiked upward as well. The company's net interest margin compressed significantly due to the ongoing low interest rate environment combined with minimal opportunities to grow its loan portfolio. Consumer and financial reform legislation passed in 2009 and 2010 has reduced various revenue sources including credit and debit card related fees, and the banking industry's capital requirements are set to increase with the implementation of the Basel III capital proposals.

Despite this litany of challenges, we believe Wells Fargo has a number of attractive characteristics that qualify it as a high-quality company. Management is widely respected in the industry, and the company is well-capitalized and efficiently managed. The company's portfolio and revenue stream are both broadly diversified with noninterest income providing a meaningful portion of total revenue. Wells Fargo has a very solid retail deposit base that provides a stable, low cost funding source that will prove quite valuable once interest rates rise. Until 2008, the company had a 20 year track record of consistently generating returns on equity in the 18%-20% range while earning even far higher returns on tangible equity. The company navigated the financial crisis far better than many of its competitors while avoiding significant damage to its balance sheet and business franchise.

As Wells Fargo works through its portfolio of non-performing assets and defends itself against various mortgage-related lawsuits, we expect the company's operating and litigation expenses to remain elevated. However, once these issues are resolved, the related expenses will decline significantly. A return to a more normal interest rate environment combined with modest portfolio growth should reverse the compression in the company's net interest margin and result in substantial growth in net interest income. Rising revenues combined with lower operating expenses should drive Wells Fargo's long-term return on equity closer to historical levels. However, the higher capital requirements and restrictions imposed by recent legislation most likely will prevent the returns from fully reaching pre-2008 levels. To the extent allowed by regulators, we believe management will continue its past shareholder-friendly policy of allocating a substantial portion of "excess capital" to dividends and share repurchases. We purchased Wells Fargo at an attractive valuation – roughly 8 times depressed earnings and a modest premium to reported and tangible book value.

As always, our commitment to our clients is unchanged: we will remain rational, disciplined investors as we search for opportunities to preserve and compound the capital that has been entrusted to us. We also will maintain a significant portion of our own net worth invested alongside our clients thereby "eating our own cooking".

Thank you for your continued interest in Focused Investors.

Bruce G. Veaco  
Partner and  
Portfolio Manager

Nugroho (Dédé) Soeharto  
Partner and  
Portfolio Manager

**Performance Disclosures**

Focused Investors (“FI”) Concentrated Value Composite was created on August 1, 2006, and contains all fully discretionary, fee-paying accounts that are managed according to FI’s concentrated value strategy. FI’s concentrated value strategy seeks to invest client assets primarily in common stocks of companies that are trading at prices significantly below FI’s estimate of their intrinsic values at the time of initial purchase. Accounts that participate in the composite can be separately managed institutional accounts or pooled investment vehicles.

The FI Concentrated Value Composite is the firm’s only composite at this time. A complete description of the composite and additional information regarding policies for valuing portfolios, calculating performance, and preparing the compliant presentation is available upon request.

The composite’s benchmark is the Russell 1000<sup>®</sup> Value Index and is provided to represent the investment environment existing during the time periods shown. The Russell 1000<sup>®</sup> Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower than expected growth values. The Russell 1000<sup>®</sup> Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The Index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics. For comparison purposes, the Russell 1000<sup>®</sup> Value Index returns do not reflect transaction costs, management fees, or other expenses that would be incurred in managing an account. While FI’s objective is to outperform its benchmark, this does not imply that FI’s portfolio strategy will share or track the same or similar characteristics as the benchmark. In addition, there can be no guarantee that FI will achieve its objective. The index returns are not covered by the report of independent verifiers.

Performance for the composite and the benchmark is calculated on a total return basis, which includes reinvestment of all income, plus realized and unrealized gains and/or losses. Individual account performance will vary depending upon, among other things, timing of transactions and market conditions at the time of investment. Returns are stated in U.S. dollars.

Because FI’s portfolios are relatively concentrated, the performance of each holding will have a greater impact on an account’s total return and may make the return more volatile than a more diversified portfolio. In addition, while FI believes that the portfolio holdings are value stocks, there can be no assurance that others will consider them as such. *Past performance does not guarantee future results. As with any investment vehicle, there is always the potential for gain as well as the possibility of loss.*

Gross-of-fees performance returns are presented before management and custodial fees but after all trading expenses. Prior to January 1, 2010, net-of-fees performance returns were calculated by deducting one-twelfth of the highest management fee borne by any account in the composite (1%) from the monthly gross composite return. Subsequent net-of-fees performance returns are calculated by applying the standard management fee schedule for separately managed accounts, including tiers, to all accounts in the composite. Actual fees vary. FI’s standard management fee schedule for institutional separately managed accounts is as follows: 90 bps on the first \$10 million of assets under management, 70 bps on the next \$10 million of assets under management, 50 bps on the next \$80 million of assets under management, 45 bps on the next \$100 million of assets under management and 40 bps on all assets under management in excess of \$200 million. Based on this fee schedule, accounts of the following varying sizes would pay an effective annual fee of:

Account Size (millions)	\$50	\$100	\$200	\$300	\$400	\$500
Effective Annual Fee (bps)	62	56	51	47	45	44

FI’s management fees are more fully described in Form ADV Part II, which is available upon request.

By using model rather than actual fees, all portfolios in the composite are treated equally. In actuality, the composite includes a pooled investment vehicle in which certain participants do not pay a management fee. As of December 31, 2006, December 31, 2007, December 31, 2008, December 31, 2009, December 31, 2010, and December 31, 2011, respectively, 77.5%, 53.2%, 35.0%, 8.8%, 3.9%, and 2.4%, respectively, of the composite's assets represented non-fee paying accounts.

No measure of dispersion is presented for periods where there are less than five accounts in the composite for the full year as it is not considered meaningful. Internal dispersion is calculated using the asset-weighted standard deviation of annual gross-of-fees returns of those portfolios that were included in the composite for the entire year.

The three-year annualized ex-post standard deviation measures the variability of the composite (using gross returns) and the benchmark for the 36-month period ended on the following dates:

December 31	Standard Deviation (%)	
	Composite	Benchmark
2011	15.5	21.0
2010	18.2	23.5
2009	17.3	21.4

### **Forward-Looking Statements**

As investment managers, one of our responsibilities is to communicate with our investors in an open and direct manner. Insofar as some of our opinions and comments in our letters are based on current management expectations, they are considered "forward-looking statements" which may or may not be accurate over the long-term. While we believe we have a reasonable basis for our comments and we have confidence in our opinions, actual results may differ materially from those we anticipate. You can identify forward-looking statements by words such as "believe," "expect," "may," "anticipate," and other similar expressions when discussing prospects for particular portfolio holdings and/or the markets, generally. We cannot, however, assure future results and disclaim any obligation to update or alter any forward-looking statements, whether as a result of new information, future events, or otherwise. Further, information provided in this letter should not be considered a recommendation to purchase or sell any particular security.

### **Form ADV**

Our most recent Form ADV (Parts I and II) is available at <http://www.adviserinfo.sec.gov>. If you would like to receive a printed copy of either, please contact us.