January 8, 2013

Dear Client and Friends,

We are pleased to provide our year-end commentary and, for our clients, your December 31, 2012 portfolio appraisal, performance history and realized gains and losses reports. We also enclose a summary, written by our partner, Lea Highet, of the most pertinent tax and planning issues relating to the fiscal agreement signed into law early this month. As we do each year at this time, we enclose our privacy statement. Our Form ADV – Part 2 is available upon request.

Before commenting on the year just ended, we would like to note several developments at Douglass Winthrop Advisors. As indicated in the nearby table, we now have a ten year investment record. It has been our privilege to serve our clients in the past decade, and we are truly grateful to you for giving us the opportunity to create this firm, grounded in the principles of investment excellence and dedicated client service. With your help, we have grown from a start up to a leading independent registered investment advisory firm with approximately $1.0 billion under management. As we mark this milestone for the firm, we are thrilled to announce that Joshua C. Huffard has joined Douglass Winthrop as a Managing Director in San Francisco. We have known Josh for years and are confident he embodies the values we prize most. In the months ahead Josh will be developing our business on the west coast, working with our clients in the San Francisco area and participating in our investment committee.

The table below illustrates the results of our Composite since inception.[1]

Period Ending December 31, 2012	DWA Equities	S&P500 Total Return	DWA Composite (Gross)	DWA Composite (Net)
1 year	14.6%	16.0%	12.9%	12.3%
3 years	45.0%	36.3%	39.0%	36.0%
5 years	19.9%	8.6%	20.3%	15.7%
10 years	121.9%	98.6%	105.6%	91.5%
10 years, annualized	8.3%	7.1%	7.5%	6.7%

We are pleased to note that our long term results are strong in absolute and relative terms, and that our clients have experienced a degree of transparency, tax efficiency, capital preservation and liquidity less readily available in other strategies.

Rising stock prices in spite of Washington

The S&P 500 returned 16.0% including dividends in 2012, a remarkable result considering the train wreck negotiations in Washington to avert the combination of spending cuts and tax increases referred to as the fiscal cliff. Last year's result extends an upward trend for the market that has returned 100% for investors since March 2009. Wall Street is a factory of trite expressions, but the term "climbing a wall of worry" surely seems apt to describe the performance of stocks since the 2008 recession.

The tangle of negotiations and resulting provisions of the tax bill signed into law in January have been exhaustively chronicled, and our perspective won't shed new light on the outcome. The law will affect you

[1] As of January 1, 2009, the Douglass Winthrop Advisors Composite (DWA Composite) includes all fee-paying accounts open for at least one quarter that provide data to Douglass Winthrop's Advent system. Prior to January 1, 2009 DWA Composite included all fee-paying, discretionary accounts that provided data to Douglass Winthrop's Advent system with an equity weighting of 65% or greater and a total value of $100,000 or greater on the last day of the prior quarter. Equity Composite and Fixed Income Composite represent the equity portion and fixed income portion, respectively, of all accounts in the DWA Composite. Results are calculated using a "Time Weighted Rate of Return" methodology, are gross of fees except where indicated, and include the reinvestment of dividends. Prior to January 1, 2009, DWA Composite excluded accounts that maintained legacy positions not initiated by Douglass Winthrop where these positions comprised more than 25% of account's value, and accounts open for less than one quarter. Past performance is no guarantee of future performance, and any investment could lose value. Results are unaudited.

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as investors however. To summarize its key provisions, marginal tax rates on income for families earning over $450,000/year will rise, and tax rates on capital gains and dividends will increase from 15.0% to a maximum of 23.8%. Families earning over $300,000/year will experience a cap on the amount of deductions available to them. The law makes permanent low Bush era tax rates for most Americans, restructures the Alternative Minimum Tax and preserves a $5 million exemption for estate tax purposes.

Sadly, the agreement does nothing to reduce federal spending, either on Medicare and entitlement programs or with respect to defense and discretionary spending. Far from the grand bargain once contemplated, the deal merely averts a series of automatic spending cuts and postpones the hard work of tax reform, entitlement restructuring and lower discretionary spending that are integral to long term deficit reduction. We can expect debate on these issues in the months ahead. In the meantime, we grapple with an unsettling question: whether our political system is up to the task of managing fiscal policy in a bipartisan manner, or whether the brew of special interests, ideological rigidity, and money in politics has become so toxic that our economic competitiveness and standard of living are imperiled.

Defining a circle of competence

For investors the temptation is great to ponder macroeconomic questions such as this, to forecast the direction of interest rates, the price of oil or the outcome of elections. And to be sure, the answers to these questions will affect financial markets, at least in the short run. The hard part, as we have discussed in past letters, is to get the macroeconomic context right and to have the agility to express one's view profitably in a portfolio of securities. While there are ETFs, mutual funds and macro hedge funds that aspire to this form of investing, such strategies are often risky, expensive and complex – and frequently don't work. In our view many investors devote too much time attempting to forecast unknowable and uncontrollable events, generally of the macroeconomic sort, which distracts them from evaluating the intrinsic value of specific investments. We are most comfortable researching and owning the common stocks of shareholder-oriented companies with predictable free cash flow, reinvestment opportunities, pristine balance sheets and wide competitive barriers. Experience instructs us that sticking to this discipline is the best way to serve our clients. Indeed, our best work has been done precisely when others are distracted by news of the moment, whether fears of recession, an election outcome, a currency crisis or a political impasse.

As we round the ten-year mark as a firm, we thought it might be useful to highlight a handful of observations, in addition to the importance of fundamental value investing alluded to above, that have served us well. As portfolio managers, a working knowledge of financial accounting is a good place to start, in particular an understanding of free cash flow, earnings quality and balance sheet accounting. How a company deploys its free cash flow is an important measure of how management views stockholders, and we seek to invest in companies where shareholder interests are paramount. We seek businesses that have durable competitive advantages, or "moats," that discourage rivals and offer ample opportunities for reinvestment. A margin of safety or low purchase price is an underappreciated element in successful investing, and we are happiest adding to positions when our estimate of intrinsic value is materially higher than the market price. Beyond evaluating the competitive and financial aspects of a business, we remind ourselves of the importance of common sense. The best investors we know balance humility and an open mind with the tenacity to stick to a lonely position when the consensus holds an opposite view. A contrarian impulse can be valuable in investing as it helps one respond calmly to market rattling events and take advantage of irrationality that periodically grips markets.

Perhaps the most enduring observation is the importance of investing in our firm. While achieving excellence in portfolio management and wealth advisory is our core business, our most important success factor is not performance or assets under management, but rather the quality of our people. In the years ahead, if we continue to be successful in attracting accomplished colleagues with sound judgment, personal integrity and investing acumen, then our mission of serving our clients will be achieved.

Finding opportunities today

Our focus on firm, as opposed to short term performance or asset gathering, encourages us to be long term stewards of our clients' capital, to care equally about capital preservation as we do about potential return. A long term focus may be helpful in the months ahead as we see fewer bargains in most asset classes, including stocks, than we have since the recession ended in 2009. Long duration, high quality bonds seem hopelessly overvalued, with interest rates poised to edge higher after years of easing by the Federal Reserve. And stocks, now trading at roughly 15x earnings, could struggle if corporate profit margins contract or the economy slows following a weak but sustained recovery. Longer term, resurgent inflation, shocks in the supply of natural resources (especially water) and the potential for armed conflict in certain regions pose threats to investors that are not adequately discounted in current prices.

Despite looming clouds, we are confident we will find opportunities for our clients as we have in the past. A nascent housing recovery in the U.S., increasing demand for natural resources including natural gas, and the rise of an economic middle class in formerly emerging market countries – all will present opportunities for careful investors. In the meantime, we feel our clients' portfolios are adequately protected against the risk of permanent capital loss and are well positioned for the risks and opportunities we sense ahead. We own companies leveraged to housing, resource scarcity and emerging markets, including Berkshire Hathaway, Loews, Praxair, Canadian National Railway, Deere, MasterCard and Nestle. Nearly all our portfolio companies enjoy pricing power, abundant reinvestment opportunities and market leadership. It is worth noting that in the last century, despite two world wars, a great depression, an energy crisis and the threat of nuclear conflict, the Dow Jones Industrial Average returned 5% annually before dividends, climbing from 70 to 11,500. An equivalent annual return in the years ahead would propel the Dow Jones Industrials to 1,000,000 sometime before the century ends.

As we begin a new year, we are grateful for the support of our clients and for the opportunity to do work we find meaningful and challenging. Please give us a call or stop by our new office to let us know how we can be helpful. We look forward to seeing you and wish you a happy and prosperous new year.

Sincerely,

Douglass Winthrop Advisors LLC