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Let Them Eat Tortillas...

Last February, Mexicans took to the streets to protest rapidly rising corn prices. It turns out that a major contributor to this phenomenon is wider U.S. production of corn-based ethanol for use with gasoline. However well intentioned, the competition between combustion engines and stomachs has inflated food prices while, some argue, doing little or nothing to improve the environment. In this newsletter, the forces behind the ethanol craze will be examined and one of Hamilton Point's fundamental stock selection criterion will be demonstrated: to avoid business models that rely heavily on government legislation and regulation to survive.

SEEKING ALTERNATIVE ENERGY SOLUTIONS

Projections estimate that the world will consume one third more energy by 2030, even after factoring in conservation measures. A myriad of non-petroleum energy sources are being advocated as a way to meet this growing demand, including wind, nuclear, solar, geothermal, methane, ocean wave, fuel cell and the processing of ethanol fuel from bio-mass materials. When burned, ethanol produces very clean emissions whether it's made from sugar cane, switch grass, wood chips, soybeans, pond algae or corn.

Some countries are achieving success in pursuing alternate energy sources. Notably, Brazil has achieved complete energy independence by using its own clean burning resources, including natural gas and the processing of sugar cane into ethanol for use by cars engineered to burn 100% of the stuff. Since sugar cane is naturally suited to efficient energy processing, and as long as rain forests aren't being destroyed to grow it, Brazil is doing its part to meet energy needs on a truly clean and sustainable basis.

As for the United States, the story is different. First of all, global warming has yet to make our climate suitable for growing sugar cane. U.S. farmers are, however, growing massive amounts of corn for processing into ethanol — at great cost, we might add. These costs include fossil fuels burned to produce fertilizer and to operate farm machinery (which, together, consume nearly as much fossil fuel as is ultimately replaced by the ethanol). In addition, fertilizer run-off may be contributing to a worrisome growing "dead spot" in the Gulf of Mexico. Moreover, each gallon of ethanol consumes 1,400 gallons of water during processing.

UNDERWRITING ENVIRONMENTAL INEFFICIENCY

You certainly can't blame American farmers for rushing to plant and sell corn given lofty prices of \$3 to \$4 a bushel, nearly twice historic rates. Unfortunately, it appears that what is driving this increase in corn production is not necessarily responsible environmental economics. It is more likely a U.S Government production mandate and related subsidy of around \$.50 per gallon granted to ethanol producers plus an equal tariff on imports made

out of sugar cane. Together, these incentives essentially force an environmentally inefficient process to continue.

Now why would our government subsidize the use of nearly a gallon of fossil fuel to replace a gallon of fossil fuel — all while driving food prices higher and polluting water? Well, the answer appears to be the combination of good intentions and old-fashioned politics.

Despite evidence that corn-based ethanol's environmental record is questionable, Washington voted on December 17th to mandate a 5-fold increase in the use of ethanol through 2020. Interestingly, a major benefactor of this largess is the Archer Daniels Midland Company — no stranger to aggressive business practices, including recent jail terms for management found guilty of price fixing. This company is also known for giving millions to both political parties, especially to politicians in agricultural states. One result of this practice was recently in the news: an energy bill passed by Congress. Although this bill addresses some wonderful improvements in environmental practices, like raising the mileage target on cars to 35 miles per gallon and encouraging the use of more energy-efficient light bulbs, it may also lead to even higher food prices due to provisions likely to encourage the production of more corn-based ethanol.

TAKING A CLOSER LOOK

The point here is that the business dynamics of the U.S. ethanol industry are difficult to predict, unless you know for sure what Washington D.C. will do next. While a quick buck might be made investing in this area, there is no escaping the fact that heavy-handed government influence and spurious environmental claims underpin this industry.

As for how this relates to Hamilton Point's portfolio decisions, recall that the lion's share of our equity portfolios consists of 40 carefully selected companies that in our opinion operate in industries that are less subject to undue legislative influence. This is a deliberate choice on our part. It is this time-tested discipline that led to fortuitous sales of pharmaceutical and telecommunications holdings years ago and encourages us to steer clear of tobacco and hospital/nursing home management companies today. Put simply, if we can build portfolios without relying on Washington lobbyists, why not do so?

Make no mistake, the race for solutions to energy needs is on and it's real. In fact, it is amazing how well the global economy has absorbed increases in energy prices and how much true innovation is being fostered by many respected companies on our Global Core Equity buy list.

We just prefer to choose our related investments very, very carefully. At Hamilton Point, we will continue to seek investments in companies whose business plans are girded by strong economic fundamentals, respected management teams and solid balance sheets — all while assiduously avoiding companies wrapped up by excessive government influence.

Andrew C. Burns

President/Chief Investment Officer

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