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Client Letter - June 30, 2011

Over the past quarter, the S&P 500 was essentially flat with a 0.1% gain, whereas YCG returns averaged 2.12% across composites. We are also pleased to report that this quarter marks 3 years since the inception of our concentrated composite with option enhancement. Over that time frame, the composite returned 12.82% annually versus 3.33% for the S&P 500, putting our performance in the top 1 percentile amongst domestic equity managers according to Morningstar data.

Greek debt chatter dominated the headlines while they stand on the brink of default; and Portugal, Spain, Italy, and Ireland seem not too far behind. If the U.S. did not have the luxury of having the dollar as the world's reserve currency, thus giving us the ability to print money, sadly our country would probably be added to that list. Housing is still in the dumps, in fact, prices appear to have actually double-dipped in most parts of the country. Unemployment remains stubbornly high and consumer income continues to stagnate. One of the market's largest stimulants, the Fed's Treasury bond-buying program (QE2), has come to a close and left many to wonder if the market can continue forward on its own. None of these disturbing issues are a secret, and yet the market seems to remain in denial.

All-Time Highs

During the quarter, the S&P 500 reached an intraday high of $1370.58 on May 2, 2011. Despite the fact that this price remains 13% below its previous intraday high of $1576.09 reached on October 11, 2007, we would argue that the general market is back to pushing new all-time highs. This becomes particularly apparent when you look at another index such as the Russell 2000 (primarily a small-cap index) where last quarter the price level surpassed prior highs from 2007 by 1.4%. But this phenomenon is not only reserved for small cap stocks – the same holds true amongst several individual sectors within the S&P 500 itself. For example, ETFs that track the separate sectors also reached new all-time highs or were very near to them when adjusted for dividends, including Consumer Discretionary (XLY), Consumer Staples (XLP), Health Care (XLV), Technology (XLK), Industrials (XLI), Materials (XLB) and Energy (XLE).

The one sector that is the main culprit holding everything back is Financials (XLF), which has lost more than half its value from prior peaks, even when adjusting for dividends. This stems from the permanent losses that took place during the credit crisis amongst firms such as Fannie Mae, Freddie Mac, Bear Sterns, Lehman Brothers, AIG, Wachovia, Washington Mutual, Citigroup, Bank of America, etc. – losses that are never to be recouped again. In other words, the losses in the financial sector have created a false illusion that the stock market still has plenty of upside to return to prior peaks, when in reality we have actually attained new highs amongst the majority of individual stocks.

This would not be so troubling if there were earnings to back these prices up. However, mean-reverting operating margins are also back to elevated levels as a result of vicious cost cutting. When you normalize these earnings, and when you take into account the recurring "non-recurring charges," the market does not appear cheap by historical standards. In fact, we are trading at valuations that have preceded prior market collapses.

The point of this discussion is not to scare our investors, rather, we hope you can take comfort in knowing we recognize the forces at play and have taken them into consideration. Some investors may be inclined to attempt to time the market and move completely into cash. Not only has this proven to be a losing strategy, it is important to highlight that this can be more detrimental in the event of serious inflation. We could potentially have a situation where the nominal prices of equities continue to rise creating the false impression of positive returns; but in real terms, when you account for inflation, investors have actually experienced a loss. In this situation, sitting purely in cash would create an even steeper loss because your dollars would not stretch as far as they used to – your purchasing power would be declining as your dollars are rapidly losing value.

Additionally, individual stocks *can* appreciate in a falling market. This is why we have been able to generate positive returns over time periods when the general market has struggled. And even if the market were to experience a sweeping collapse where prices of all asset classes are unable to escape, it is important to remember that you own shares of businesses that continue to compound their earnings. What other people tell you your shares are worth (ticker quotations) is irrelevant until the moment you choose to sell. Benjamin Graham advised "man would be better off if his stocks had no market quotation at all, for he would then be spared the mental anguish caused him by *other persons*' mistakes of judgment" (The Intelligent Investor, 1973, p. 107). Speculators are "instructed" by the market as to what the value of a stock should be, whereas investors are "served" by the market which conveniently offers them attractive buying and selling opportunities.

So, as long as we successfully purchase businesses at prices below their worth, then in the long run you will not experience permanent losses of capital. In other words, losses in the short run would be what we call "temporary paper losses," or a deferral of future performance because the earnings per share in the underlying business would continue to grow and the value would eventually be recognized again.

Recognizing the importance of exercising caution in this giddy market, we now discuss our most recent significant purchase.

Switching to Cisco

Cisco certainly does not represent a Wall Street darling. In fact, investors of Cisco since July of 1998 have had a loss in the stock, though not entirely Cisco's fault. Cisco was at one time one of the tech stock kings, trading higher than 100 times earnings only to find its price falling back to earth with the rest of the tech bubble (gravity does that to objects high in the sky with no apparent force keeping them up…) Now, at a single digit P/E, nobody wants anything to do with Cisco.

They cite a rapidly changing industry, restructuring within the company, and poor decisions by management as reasons to avoid the stock like a plague. While these concerns are real, Cisco is still the 800-pound gorilla in the router and switch market, commanding a 70% market share in the Ethernet switch market, providing huge scale advantages. At its current price, Cisco does not have to do anything amazing, it simply has to show it has a pulse!

The challenge in analyzing Cisco is putting a proper value on the massive lump sum of cash on Cisco's balance sheet. Nearly 90% of that cash is held overseas and would be subject to repatriation tax. Furthermore, what if they burn that cash by carelessly throwing it at high priced acquisitions as they frantically search for growth? Or will they repeat history by making more poor investments with that cash such as the one for the flip video camera, which drew Cisco away from its core business? When it comes down to it, we believe the answers to these questions do not matter much because they do not help you determine if Cisco is cheap, but simply to what degree. If you value the cash at $5/sh., and estimate normalized earnings power of $1.40/sh., then Cisco is only trading at 7.5x earnings after stripping out the cash.

The current restructuring of the company is a positive sign that Cisco should not be off track for too long. They recognize consumer-related products were a drag on earnings and are re-sharpening their focus back into their core businesses, a move which should benefit as more and more business migrates to "the cloud." Although Mr. Chambers sure has his work cut out for him in many aspects, we believe that at prevailing market prices Cisco is definitely an attractive long-term investment.

Concluding Remarks

Through all the noise, we continue to stay focused on our strategy of identifying solid businesses trading at prices below their worth. We believe your portfolios currently represent such opportunities and are positioned to deliver strong risk-adjusted returns over the long haul.

Thank you for your continued trust and loyalty.

Sincerely,

Brian A. Yacktman

Manager

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Manager

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