



December 31, 2011

Dear Appleseed Shareholder:

"The first panacea for a mismanaged nation is inflation of the currency; the second is war. Both bring a temporary prosperity; both bring a permanent ruin. But both are the refuge of political and economic opportunists."

-Ernest Hemingway-

The stock market last year can best be characterized in one of two ways. First, "lots of ups and downs, but not much to show for it." This refers to the fact that stocks were more volatile last year than in all but a handful of years since 1950; yet, for all of the market's gyrations, the S&P 500 Index ended the year unchanged (up 2.1% after dividends). Volatile stock markets, like 2011, are a reminder that when it comes to forecasting, the stock market can make fools of even the most astute observer.

Another characterization--"more than enough drama"--refers to the fact that risks to investors in 2011 were seemingly everywhere. Between upheavals in the Middle East and North Africa, natural disasters in Asia, sovereign debt crises in Europe, disappointingly tepid economic growth, and various credit rating downgrades, there was no shortage of forces vying for investor attention and contributing to the volatility of stocks.

The year began with the stock market showing good strength, buoyed by investor optimism about the prospects for a strong economy. By the end of April, the S&P 500 Index had increased 8%. But then, investor concern surrounding the solvency of European banks and governments grew. Around the same time, Congressional deadlock over raising the debt ceiling caused investors to fear that the U.S. Government could end up in technical default of its debt. The result was that the market dropped 18% from its peak in the spring to its bottom on October 3rd. At that point, the stock market was down 10% for the year. While little of substance changed over the final months of 2011, the market rallied and, as mentioned, ended the year basically where it began.

In effect, a large part of what we experienced last year were bouts of panic interspersed with periods of relief, much of which was driven by fragments of news and sometimes mere rumor. While often unsettling in the short-term, as a general rule, we view volatile markets as opportunities to put capital to work at attractive prices.

The swings were as great as they were in 2011, in large part, due to the impact of excessive financial leverage in the industrialized nations of Europe, but also due to the impact of excessive financial leverage in Japan and the U.S. as well. With leverage, small changes, one way or another, have an amplified result, and, the greater the leverage, the more exaggerated the result.

The Math of Private Debt Leverage

We believe this issue of debt leverage is the linchpin for much of what ails the world we live in today; if you would, please bear with us—

Hypothetically—if you are a bank with \$2 of assets, \$1 of debt, and \$1 of net worth, a decline in asset value of 10%, while clearly a hit to your net worth, likely is manageable. Using this assumption of a 1:1 debt-to-equity



ratio, the use of debt or leverage is not overly burdensome. After the loss, you have \$1.80 in assets, \$1 of debt and 80 cents of net worth.

But, if you have \$10 of assets along with \$9 of debt and your net worth is still \$1 and you suffer an asset decline of 10%, it could be your financial ruin. With a 9:1 debt-to-equity ratio, the loss reduces your assets to \$9 and eliminates all of your net worth. The use of an excessive amount of leverage, in this instance, has put you firmly on the path to financial insolvency.

This math applies to the balance sheets of corporations and of individuals, where debt-to-equity and debt-to-net worth are the appropriate measures of leverage, respectively. The amplified nature of leverage explains the housing bust, the U.S. credit crisis of 2008, and the current European banking crisis. Another more recent casualty of leverage, MF Global, a commodities broker and investment bank with a debt/equity ratio of 40:1, invested heavily in European government debt obligations. When the prices of those bonds declined and erased its thin layer of capital, MF Global quickly went bankrupt.

To say the obvious, the crisis in Europe is as much a banking crisis as it is a sovereign debt crisis. Many of the largest banks in Europe are employing debt/equity ratios of 30:1 or more, and an unhealthy portion of their assets are invested in the sovereign debt issues of Greece, Italy, Portugal and Ireland, which just a few years ago were considered risk-free credits. The math we described above would suggest that the equity capital of many of these banks has been wiped out or nearly wiped out.

At Appleseed, we spend as much time looking at balance sheets as we do looking at anything else these days. We have said to investors over the past two years that our portfolio is defensively positioned. One of the major ways that we maintain a defensive position is by investing in companies that have healthy balance sheets. If the debt/equity ratio is low, or if there is no debt, a bad decision on the part of management is not likely to cause the death or near-death of a company that we own.

One example of such a company is **PDI Inc. (PDII)**, a healthcare services provider which offers sales and marketing services to pharmaceutical companies. At the end of Q3, the company held \$4.53 per share in cash on its balance sheet. In comparison, PDI's stock price on 12/31/11 was just \$6.45 per share. PDI has no debt, so the debt/equity ratio is effectively 0:1. We added to our position in PDI during Q4 because we see significant potential for the business; we expect revenues to continue growing at a double-digit rate. Equally important is the fact that, if we are wrong in our assessment of management's ability to create value, our downside appears limited due to the health of the company's balance sheet and the value of PDI's cash in relation to our purchase price.

The Math of Government Debt Leverage

For governments, one of the most important metrics of leverage is the amount of a country's public debt in relation to its annual output—Gross Domestic Product (GDP). Generally speaking, debt-to-GDP ratios that approach 1:1 become concerning, while ratios greater than 1:1 create significant default risk. As debt-to-GDP ratios rise, periods of low or no economic growth result as more and more income is diverted to making interest payments. In the current situation, emerging market countries are not the ones with the high debt levels; rather, it is many of the developed countries of the world which have poor and deteriorating balance sheets.

The other thing that is different about leverage between governments and individuals/companies is the way that default occurs. An individual or a company defaults by not making an interest payment or a principal repayment. However, as noted by Ernest Hemingway, countries typically default by debasing their currency to more easily pay back their debts. In 2005, when talking about the sustainability of the U.S. Social Security system, Alan Greenspan famously said-- "We can guarantee cash benefits as far out and for



whatever size you like, but we cannot guarantee their purchasing power.” In this telling statement, he was alluding to the particular way in which countries tend to default on their financial obligations.

A country with a high debt/GDP level has two ways to reduce that ratio and improve its financial situation. The first is to reduce the numerator of the equation, which is the level of debt. This usually involves painful and politically unpopular cuts in government spending or increases in taxes, otherwise known as “austerity measures.” The second is to increase the denominator of the equation, GDP, through a combination of real economic growth and inflation.

Japan: With Europe’s debt woes so much in the news, there has been little focus on Japan, but Japan is perhaps the most leveraged industrialized country with a high debt-to-GDP ratio (of 2.33:1) that will likely be a drag on the country’s prosperity, perhaps for decades. In addition to having to contend with its high debt, Japan’s aging, no-growth population will weigh heavily on the country’s ability to grow GDP. Giving recognition to its excessive leverage, Moody’s recently downgraded Japan’s credit rating to Aa3. In addition, the International Monetary Fund warned that Japan’s debt level was unsustainable and a threat to the financial stability of the world. That Japan is able to finance its public debt has been due to the unwavering (to date) appetite for government debt by domestic investors. At some point, Japan will have to take steps to reduce its debt/GDP ratio and the yen will likely decline in value; nobody knows when that will be, however.

Appleseed Fund’s Japanese holdings include Mabuchi Motors (Tokyo: 6592), Shimano (Osaka: 7309), Rohm (Osaka: 6963), and Dr. Ci: Labo (Tokyo: 4924). Mabuchi, Shimano and Rohm would benefit greatly from a weaker yen, due to the fact that their exports would be more competitively priced. Dr. Ci: Labo produces personal care products for the domestic market in Japan, and Appleseed’s yen exposure in Dr. Ci: Labo and all of its other Japanese holdings have been hedged through currency futures.

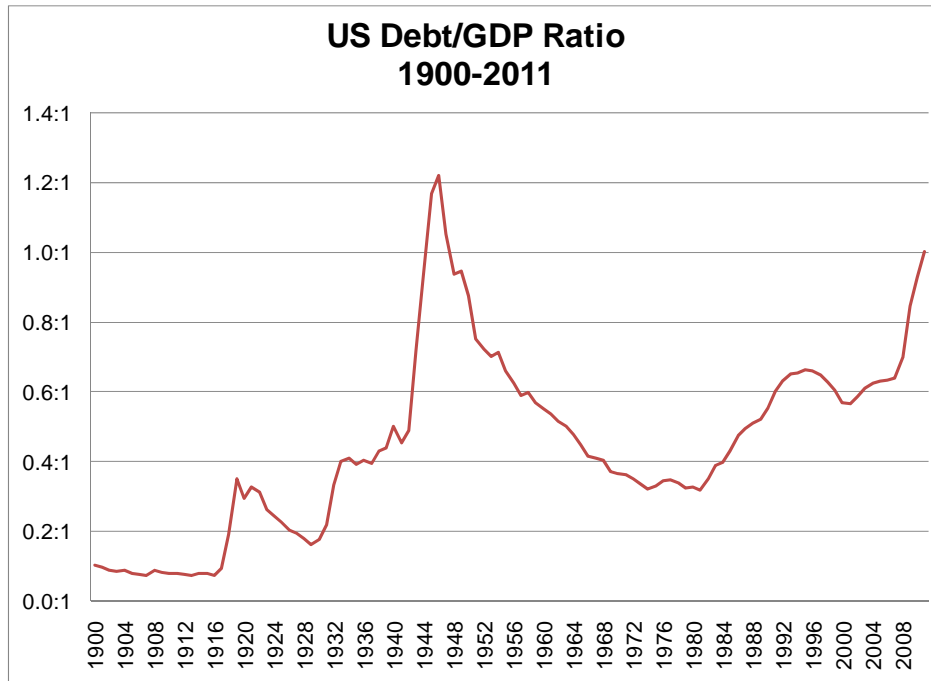
Europe: The Euro-Zone, as a whole, may not be as leveraged as Japan, but recent downgrades by Standard & Poor’s of several European nations’ debt ratings are yet another reminder that Europe’s fiscal problems are bad and getting worse. Portugal, Italy, Ireland and Greece all have debt-to-GDP ratios greater than 1:1 and clearly have an immediate need to de-lever. (Debt-to-GDP for the European Union as a whole is about 0.8:1.) In 2012 alone, Euro-Zone countries have \$1.3 trillion of debt coming due; whether some of these countries will be able to refinance their debt and at what cost remains to be seen.

There is a clear need for these European nations, along with Spain, Belgium, and others, to reduce their debt/GDP levels. Yet, austerity measures are resisted, sometimes violently, by those affected by such measures, and austerity measures have done nothing to improve debt/GDP ratios. Also, much of the debt of these countries is held by highly leveraged, essentially insolvent European banks, and policy makers seem unwilling to do anything which might force these banks to recognize their losses. Further complicating resolution of the issue is the fact that member countries of the European Union do not have the option today to depreciate their currency as they are unable to print money. The fragmented political structure of the European Union is a complication that may not have been fully thought through when the common currency was created.

Appleseed Fund’s European holdings include Willis Group (WSH), Novartis (NVS), and Noble Corporation (NE). Willis Group is based in the U.K., while Novartis and Noble are Swiss companies. Although these companies are headquartered in Europe, all three operate global businesses with sales and profits that are generated all over the world. All three have sound balance sheets and generate healthy levels of cash flow.



United States: The U.S., itself no model of financial restraint, presently has a debt-to-GDP ratio of slightly more than 1:1. The graph below shows the public debt/GDP ratio of the U.S. from 1900-2011.



As you can see in the graph, this is not the first time the US had a public debt-to-GDP ratio of 1:1 or more. The enormous cost of waging World War II caused our debt/GDP ratio to reach 1.2:1 by the time the war ended. At that time, the private sector was substantially under-leveraged following first the Depression, when debt was generally viewed as somewhat foolhardy, and then subsequently the war effort, which limited private consumption, resulting in forced savings. Therefore, private consumption was in a good position to increase GDP growth in the 25 years following the war. To support the rising levels of consumption, consumers initially turned to their accumulated savings and then subsequently increased their credit usage. This private sector consumption was an important driver of GDP, as was the rate of inflation, which also was markedly higher than it has been in recent years. At the same time, government spending declined with the end of the war, while the highest marginal tax rate was above 80%. As a result, by the mid-1970's public debt-to-GDP had declined to 0.3:1.

Over the next three-plus decades, however, as a result of increased government spending and lower tax rates, the debt/GDP ratio increased to 0.7:1 by 2008. The impact of the financial crisis of 2008 and the accompanying recession, coupled with the government's policy response to both issues over the past three years, pushed the debt-to-GDP ratio to the present 1:1. Just briefly, both the private sector and the public sector of the U.S. were in a long-term leveraging cycle from the mid-1970s to the present, and that leveraging cycle was a major driver of GDP growth. At the current level of private and public sector debt, this cycle has ended and is now set to reverse.



The United States is in better shape than either Europe or Japan, but policy makers in the United States can no longer ignore the need to de-lever. They face the task of having to choose one or more of three options. None are especially attractive.

1. The U.S. Treasury can default on its debt obligations by not making interest or principal repayments. Given that the U.S. alone holds the world's reserve currency and can print its own money to buy its own debt, we view this as a highly unlikely outcome.
2. Congress can opt for austerity measures by cutting spending and/or raising taxes. This option was discussed at length by policy makers just before the government debt ceiling was raised last summer, but after watching the political charades, it is clear that significant austerity is currently viewed as an unpalatable option.
3. The Federal Reserve can flood the system with printed money in an attempt to ignite the economy and depreciate the dollar. If inflation can cause GDP to grow faster than our debt grows, then the debt/GDP ratio will decline.

Thus far the Federal Reserve has pursued option 3 by capping interest rates, which it accomplishes by buying treasury and agency mortgage backed securities and holding them on its balance sheet. What does this policy accomplish? In the United States, if the Treasury's borrowing costs were more historically normal, say 4% on the 10-Year Treasury bond instead of slightly less than 2%, our budget deficit would be a whopping \$300+ billion (20% plus) higher than it otherwise would be. Adjusted for the rate of inflation, the "real" yield for investors who own the 10-Year Treasury is decidedly negative, thanks to capped interest rates. Unsurprisingly, the Federal Reserve has announced that it intends to keep a lid on short-term interest rates at historically low levels through at least mid-2013.

These measures have given the markets a certain surface stability. To use Hemingway's words, money printing has worked as a temporary panacea for the United States, although general prosperity is clearly declining. The current temporary stability markets are experiencing may only be the result of bigger problems in Europe and liquidity injections which have delayed the day of reckoning for the United States. The more important long-term problem is that government debt continues to grow at a far faster rate than GDP, which means that the debt/GDP ratio should continue to worsen in the short-term. The dollar's status as the world's reserve currency should buy the United States more time to address its debt issues, but the risks to the dollar are increasing. Eventually, we expect to see accelerating inflation and/or far more austerity, neither of which will be particularly pleasant for either investors or citizens.

None of this is news—but what is new is the magnitude of government debt in the industrialized nations of Europe, the United States and Japan, the ever-increasing role of central banks as a backstop for the banking sector, and the reality that policy options are narrowing because of political dysfunction. And this dynamic is what causes us to expect continued stagflation in the global economy. We are continuing to look for and find undervalued equities, but we have adjusted our valuation models somewhat in anticipation of tepid real growth and accelerating inflation over the intermediate period ahead.

Fund Update

Compared to the tumultuous market, Appleseed Fund's volatility was relatively muted in 2011. The Fund declined by less than the market during corrections, and the Fund surged by less than the market during bouts of optimism such as the one experienced during Q4 2011. Overall, the Fund fell short of the return of the S&P 500 Index during 2011, due largely to a dearth of big winners in our portfolio. Our best performing stocks during 2011 were **Dr. Ci: Labo (Tokyo: 4924)**, **Weyerhaeuser (WY)**, **Pfizer (PFE)**, and **K-Sea Transportation (KSP)**. These stocks did not make up for the poor performance of our worst performers, which included **Sealed Air (SEE)**, **Nabors (NBR)**, and **John B. Sanfilippo (JBSS)**. In our opinion, these



companies, although already inexpensive, became even more attractively priced during the course of the year. We continue to hold onto our position in all three of these companies, and we added substantially to our position in Sealed Air.

Despite the market strength of the fourth quarter, we have recently been finding opportunities to buy undervalued equities. During Q4, we added **Avon Products (AVP)**, **Western Union (WU)**, and **Shimano (Osaka: 7309)** to Appleseed Fund's portfolio. Furthermore, at the end of Q4, Avon Products and Shimano became top ten holdings of Appleseed Fund. We also added considerably to our position in Weyerhaeuser in September, and Weyerhaeuser, too, is now a top ten holding at the end of Q4. The only holding that we sold during Q4 was Appleseed's position in **Asahi Glass (Tokyo: 5201)**.

As always, as Appleseed's portfolio managers, we remain vigilant in our search for opportunities where we perceive the risk to be modest and the return potential to be well above average---all the while seeking to protect the real (inflation-adjusted) value of your capital. How the year ahead will unfold is anyone's guess. Much will depend on how the central banks of Europe, Japan, the United States and perhaps China (as the world's largest creditor nation) react to the slow (or no) growth economy and how they deal with the pervasive debt in the system. While constantly tweaking our investment strategy, we feel good about the positioning of Appleseed Fund as we enter 2012. We continue to play defense with the expectation that the business environment will remain relatively stagnant, but we also are relatively well prepared should inflation accelerate.

In closing, we thank you for your confidence and support of our efforts and will endeavor to earn it in the years ahead.

Sincerely,

Rick Singer, CFA

Ron Strauss, CFA

William Pekin, CFA

Josh Strauss, CFA

Adam Strauss, CFA



You should carefully consider the investment objectives, potential risks, management fees, and charges and expenses of the Fund before investing. The Fund's prospectus contains this and other information about the Fund, and should be read carefully before investing. You may obtain a current copy of the Fund's prospectus by calling 1-800-470-1029.

On December 31, 2011, Appleseed Fund's position in PDI was 2.0%, in Weyerhaeuser was 4.2%, in Avon Products was 7.2%, in Western Union was 2.6%, in Mabuchi Motors was 4.3%, in Rohm was 2.6%, in Dr. Ci: Labo was 2.6%, in Willis Group was 3.9%, in Noble Corporation was 3.5%, in Novartis was 4.2%, and in Shimano was 4.0%. Pfizer and K-Sea Transportation were no longer holdings as of December 31, 2011.

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