

BROCHURE ON FORM ADV-II

January 10, 2012

H.S. Dreher Capital Management, LLC

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www.interestoninterest.com

Thank you for reading our brochure, which provides information about the qualifications and business practices of H.S. Dreher Capital Management, LLC. Should you have questions or want to know more about the contents of this document, we encourage you to visit our website, write or call us at the above number. Additional information about H.S. Dreher Capital Management, LLC also is available on the SEC's website at

www.adviserinfo.sec.gov.

Sincerely, Thomas E Velevis, CFP, Managing Principal; Henry S Dreher, Chief Compliance Officer.

Neither the U.S. Securities and Exchange Commission or state securities authorities have approved or verified the following information.

Summary of Material Changes:

The firm is no longer required to register with the U.S. Securities and Exchange Commission because it has less than \$100,000,000 under management. Accordingly, the firm is registered, registering or filing the appropriate notices, with the State of North Carolina, its domicile, and other regulatory authorities.

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Business of the Firm:

H.S. Dreher Capital Management, LLC designs, builds and manages investment portfolios for retirees and individuals planning for retirement. The firm was established in September 1994; it is currently owned by Thomas E Velevis, CFP, Managing Principal. (See **Supplement.**)

- Written Investment Strategies are developed for each client. These strategies attempt to identify the client's needs and develop an investment allocation system that corresponds to these needs.
- Execution of Client Investment Strategies involves the purchase and sale of stocks, bonds and No-Load mutual funds. These transactions are performed mainly on a discretionary basis by the firm. (The firm does not vote proxies.)
- Reviews of Client Accounts, including performance, are offered on an annual basis. These reviews include consolidated statements prepared by the firm; clients receive monthly statements directly from independent, third-party custodians who hold their assets and effect securities transactions.

Written Investment Strategies:

Designing an Investment Strategy involves developing a financial profile based on information obtained from clients, such as spending, income, and taxes on income. Income items might include pension, part-time work, annuities and Social Security. Often there is a negative difference between spending and income after taxes. This gap may represent the amount of funds that clients need to withdraw from their investments each year. This process helps to identify this figure, and the firm utilizes its knowledge of financial markets to determine if clients have enough capital to generate this amount of investment return without taking risks that are not appropriate. This financial profile assists clients in making spending decisions and plans for their retirement.

The Investment Strategy also may address special investment considerations and client preferences: these might include but are not limited to low-price stocks, the requirement to notify clients before transactions are made in certain positions or income tax related matters. (See **Investment Discretion.**)

The next step in developing an Investment Strategy is to transfer this financial profile into a risk profile, which is an attempt to balance client needs with the investment risk necessary to supply the needs.

Execution of Client Investment Strategies:

The firm uses the asset allocation plan established in client Investment Strategies as its road map to buy and sell stocks, bonds and No-load mutual funds for clients. This service is performed on a discretionary basis, meaning the firm communicates directly with the

client's broker-custodian to execute its buy and sell decisions. (See **Investment Discretion.**) Because of the firm's remuneration structure, it is advantageous for both the client and the firm to have its buy and sell decisions executed on a cost effective basis. As a result, the firm may help clients select a brokerage-custodian to hold the client's financial assets and effect securities transactions using discounted commissions. (See **Fees and Compensation.**)

(Recommending and selecting brokerage-custodians involves conflicts of interest. Only a limited number of brokerages offer discount commissions in conjunction with the trading and accounting platforms that enable the firm to convey its services in a cost effective manner. These platforms, and other services provided by the brokers that the firm may use and recommend to clients, are provided with the intention of influencing the firm's choice of brokerage-custodians for its clients. These conflicts of interest are described more fully in this filing. (See **Brokerage Practices.**)

Reviews of Client Accounts:

Our account reviews are designed to examine the efficacy of our clients' investment activity. We provide consolidated statements that allow clients to see if their Investment Strategy is being followed. We also compare client returns with the returns on a benchmark of similarly constructed investment portfolios for comparable periods. Clients can thereby see not only if their Investment Strategy is being followed; they can judge if the Investment Strategy is working.

Annual reviews also provide a format for evaluating the client's financial profile. Income and spending projections can be adjusted and refined, so the firm's client records are kept up to date. For the convenience of the firm and clients, annual reviews can be conducted either in person or by phone, and reviews can take place more frequently than annually depending on circumstances and concerns. Reviews are conducted by Thomas E Velevis, CFP, Managing Principal and Henry S Dreher, Chief Compliance Officer and Research Consultant. (See **Account Reviews.**)

As of December 31, 2011, the firm managed \$44,912,601.

Fees and Compensation:

The firm is compensated on a fee-only basis, meaning that it is paid only by its clients: the firm does not receive commissions or other remuneration from third parties representing the investment selections it makes for its clients. Fees are invoiced and paid quarterly and deducted from client accounts or remitted directly by the client, depending on client preference. On an annual basis, our fee schedule is 1.0% of assets under management up to \$250,000; 0.8% of assets under management between \$250,000 and \$750,000; and 0.5% of assets under management over \$750,000. The firm does not have a capital threshold to open an account, but its minimum annual fees are \$2,500. Select client accounts may pay the firm on a performance basis.

Through negotiation, the firm may deviate from this schedule based on special circumstances including but not limited to the following:

- Clients may plan to increase their assets under management, in which case the firm may charge a lower minimum on a temporary basis.
- Depending on client circumstances, we may develop an Investment Strategy that does not utilize the firm's full range of investment expertise. As an example, given today's low interest rate environment, a client hiring the firm to construct an intermediate ladder of government bonds could pay more in management fees than the interest received on some short-term bonds. In this example, it would be advisable to negotiate a lower fee, as the firm does not believe that management fees should become a structural impediment to investment returns.
- Some client investments are located in high-fee structures, such as company-sponsored retirement plans that may charge fees for custody, mortality, investment management and administration. As well, investment selections in these programs may be limited. In such instances our advice may still be valuable, but we negotiate a lower fee so as not to unnecessarily increase fees that are already being paid.

Based on our fee structure, clients pay their own commissions. And to the extent we purchase mutual funds for clients, they pay investment management fees on top of the fees we charge. As a result, we encourage clients to use discount brokerage companies for their custodians, and we are careful to select mutual funds whose investment results justify the investment management fees they charge (although we cannot guarantee that our selections will meet our expectations). (See **Brokerage Practices**.)

Performance-Based Fees and Side-by-Side Management:

Because select client accounts compensate the firm based on investment performance, a conflict of interest exists between performance-based accounts and fee-based accounts. For example, a portfolio manager with a limited investment opportunity (a small offering of municipal bonds, perhaps, that he believes is undervalued) has an incentive to place the investment in the performance-based account. Firm policy would direct the account manager to place the investment in the account with the best fit (most relative cash, for instance), but this policy would not eliminate the conflict. In other words, although the firm has a policy to address this conflict of interest, it is not possible to guarantee that all transactions take place on a fair and equitable basis when viewed from the perspective of a performance-based account versus a fee-based account. (See **Brokerage Practices.**)

Types of Clients:

The firm manages investment accounts in many forms:

- Individual and Joint Accounts
- Trust Accounts
- IRAs
- Other Retirement Accounts
- Corporations and Business Entities

As stated previously, the firm does not require a minimum account size to establish and maintain our services. However, the firm's minimum investment management fee of \$2,500 may impair the firm's effectiveness in delivering adequate investment results for small accounts. (See **Fees and Compensation.**)

Methods of Analysis, Investment Strategies and Risk of Loss:

Primarily, the firm uses fundamental analysis to estimate the risks in financial assets. Fundamental analysis is supplemented by diversification, and the firm recognizes four basic investment categories that it believes require some exposure for its clients to achieve a complete investment experience. Diversification among these investment categories is determined to some degree by macro-economic analysis, which is an attempt to describe economic conditions, such as monetary and fiscal policies, that might influence interest rates, inflation and other important determinants of investment values. The percentage of client assets allocated to each category represents the final component of the client Investment Strategy.

Despite our use of fundamental analysis, diversification and macro-economic analysis, all clients will have losses on individual investments from time to time, because investing in securities involves risk of loss. The goal of our work is to offset these losses with investments that deliver overall portfolio income and gains that meet reasonable expectations during retirement. We cannot guarantee that our efforts will attain this goal in the future, and to the extent it has been achieved in the past, it is important to remember that past performance does not guarantee future results.

Level I: Conservative Income:

The firm recognizes three principal risks when buying fixed-income securities.

- One is fundamental risk, often referred to as “ability to pay.” The firm uses major rating services (such as Moody’s and Standard & Poor’s) to measure this risk. It also uses a proprietary screening process with data gathered from investment publications and U.S. Securities and Exchange Commission filings. By using this information to select investments in this category, the firm attempts to eliminate losses that stem from business failures and defaults. These efforts notwithstanding, losses can occur; and when they do, the account’s diversification will determine the damage to the client’s overall investment portfolio.
- The second risk in fixed-income securities is “market risk,” or “interest rate risk.” This is the risk of lower security prices during the investor’s holding period. Since bond prices decline during periods of rising interest rates, investors who sell before maturity may experience investment losses. The firm addresses interest rate risk with maturity selection and tax-loss selling, allowing clients to access a portion of their capital (bond maturities) and capitalize on higher interest rates.
- Reinvestment risk is number three. Reinvestment opportunities represent an important component of a fixed-income portfolio’s total return. While yield-to-maturity (a stated rate of return assuming reinvestment of interest at the same rate) is used for price discovery to establish a bond position, higher interest rates that result in lower bond prices between purchase and maturity dates will result in an overall

return that is greater than yield-to-maturity. The opposite is also true: if interest rates decline and bond prices rise during the investor's holding period, her rate of return will be lower than the yield-to-maturity.

Since these principles may seem counterintuitive, an easy way to think of reinvestment risk (or opportunity) is to assume interest payments are reinvested in a money market fund. The higher the rate paid during the holding period, the more money the investor will have at the end of the holding period, when the bond matures. And vice versa. Although reinvestment rate risk is to a large extent an exogenous factor the firm cannot control, nevertheless we look for reinvestment opportunities for the income generated by all of the firm's investment categories.

Level II: Aggressive Income:

The firm uses equities with high dividends as a portion of its income category. Because the return of principal is not provided by contract, as it is with fixed-income investments, Aggressive Income investments contain more volatility and fundamental risk than Level I, or Conservative Income investments. The fundamental methods used to analyze growth investments, described below, also are the most important factors in selecting investments for this category. Diversification between categories and within the Level II category supplements this analysis, but despite these safeguards, investment losses can occur. This category also includes high-yield debt obligations, whose ability to pay is weaker by definition.

Levels III and IV: Conservative and Aggressive Growth:

Growth investments, as defined by the firm, rely more on capital appreciation than income for investment return. Selection of investments for growth involves fundamental analysis wherein the firm estimates the value of a stock at present and in the future. If a stock price is below these estimates, it may represent a growth opportunity. Once purchased, any appreciation in price is compared to the stock's estimated future value. Given no change in estimated future value, a certain amount of appreciation will reduce expected future return and the position will be sold. In an ideal world, rising sales, cash flow, earnings and other metrics will increase the estimated future value, the stock price will appreciate accordingly and the position will not be sold.

In the real world, in our opinion, investing in the stock market for growth has only one guarantee: losses will occur. Our forecasts are either too optimistic or not optimistic enough, and stock prices rise or fall by amounts that we believe are out of proportion with the company's prospects. Thus, while we would prefer to be long-term holders of our growth investments, we recognize that mistakes as well as opportunities happen that behoove us to make transactions. Therefore, the objective of our fundamental analysis and sell disciplines is to deliver a positive investment experience that corresponds to client objectives over time. Whether or not we can achieve this goal cannot be guaranteed, nor can any success we may have experienced in the past.

General Comments on Fundamental Analysis and Risk of Loss:

In the firm's experience, fundamental analysis has certain shortcomings that require recognition by those who practice it.

- Given the same information, assuming it is correct, all market participants will not necessarily come to the same conclusion. Thus, even though one has the correct data, he cannot be certain that his investment choices will deliver gain or loss.
- All information is not correct. When primary and derived data is not accurate, for whatever reason, false conclusions can result in investment losses.
- Given correct information, and accurate forecasts based on the information, investors are not guaranteed any specific investment result. The amount investors will pay for certain results in the future, and when they will pay it, cannot be known ahead of time.

General Comments on Diversification and Risk of Loss:

Also in our opinion, diversification has shortcomings.

- Investors who rely on diversification need to remember that, a priori, diversification means one doesn't know where to put the money. We believe this precept is inconsistent with relying completely on diversification, which is an attempt to prepare for the unknown (and in some cases the unknowable).
- History has taught that during market crisis, high correlation among many investment categories can greatly reduce the efficacy of diversification.
- Following the logic expressed above, it is possible that investors would benefit from the analysis of what they already know, such as their living expenses in current dollars and the mathematical relationships between bond prices, maturity dates and reinvestment rates. (Not to be confused with the complicated—unknowable, as it turned out—equations associated with derivative investments.)
- Counter-intuitively, therefore, it is possible that concentration into what is known may at times yield superior investment results than strategies with more diversification in preparation for what is not known.

General Comments on Macro Analysis and Risk of Loss:

The firm believes it is important to understand the conditions of markets we use for investments. We allocate considerable resources toward this goal, including but not limited to subscriptions to publications, review of expert opinions and attendance of economic forums. Although we claim no proprietary knowledge in this area, we believe it is important for investors to be on the look out for extreme economic conditions. Such conditions can represent danger as well as opportunity.

Disciplinary Information:

The firm has no disciplinary information to report.

Other Financial Industry Activities and Affiliations:

The firm recommends outside professionals to clients for expert advice in estate planning, income taxes, insurance and other areas. However, the firm is not affiliated with any of these professionals or their firms, and we make such recommendations based on what we believe is the ability of the professional to give our clients the best advice.

Code of Ethics, Participation or Interest in Client Transactions and Personal Trading:

Code of Ethics:

H.S. Dreher Capital Management, LLC has a written Code of Ethics that describes the behavior the firm deems appropriate for its principals and employees. It specifically calls for client interests to be placed ahead of all other interests. In regard to the purchasing and selling of securities by the firm's personnel, the Code establishes procedures designed to assure that the objective of placing client interests first is achieved. Clients and prospective clients may obtain a copy of our Code of Ethics by contacting the firm by phone at 910-692-4330, or writing to H.S. Dreher Capital Management, LLC, 275 SE Broad St, Southern Pines, NC 28387.

Participation or Interest in Client Transactions:

An employee of the firm owns an interest in an investment club whose portfolio is managed by the firm. A conflict of interest is present, therefore, when the firm makes a transaction for the investment club in securities being purchased, sold or owned by its other clients, or when the firm makes a transaction for other clients in securities being purchased, sold or owned by the investment club. The firm is careful to keep the investment club's transactions on an equal basis with other clients, and to date the firm is not aware of any evidence that this structural conflict has comprised the firm's clients.

Personal Trading:

In managing our own investments, firm employees may buy or sell securities that are also bought and sold for our clients. Due to different time horizons, investment objectives and other circumstances, we may buy a security previously sold for a client, or sell a security that continues to be held for a client. Because this activity can result in a conflict of interest between client accounts and employee interests, it is policy to execute orders for clients first, and for employees to conduct themselves so as to ensure that clients' interests are always ahead of their own. The firm's Code of Ethics is designed to monitor trades made on behalf of the firm and its employees to enforce this policy.

Brokerage Practices:

Research and Other Soft Dollar Practices:

During its conduct of business, the firm receives valuable resources from the brokers it recommends to clients. These include but are not limited to investment research, special statements used by the firm to cross reference investments, direct computer access to client accounts, stock quotes, bond quotes, newsletters on various aspects of managing an investment advisory business, general market information, electronic trading and record keeping. Brokers provide these incentives to encourage the firm to recommend clients to the brokers.

These services do not benefit all clients equally, and the firm does not have a method of compensating clients who (in effect) pay for the services but do not utilize them. Thus, a conflict of interest is present. As an example, a broker may supply the firm with research on mutual funds; but some clients may not buy mutual funds, so they could be considered to be paying for research the firm uses for the clients who do use mutual funds.

Although this conflict exists, the firm is not aware of paying extra trading commissions, or other payments, for special services that benefit a limited number of clients.

Brokerage for Client Referrals:

The firm does not use client brokerage to compensate or otherwise reward brokers for client referrals.

Directed Brokerage:

As stated above, the firm recommends that clients use discount brokers to custody assets and effect transactions. (See **Business of the Firm**, *Execution of Client Investment Strategies*.)

To the extent clients direct the firm to use full-service or other brokers, it is possible that clients will pay higher fees and commissions for similar services. Although the firm cannot guarantee that the brokers it recommends charge the lowest fees and commissions, we believe their rates are contemporary and do not impact the firm's investment advice.

Trade Aggregation:

In placing orders for clients, the firm may aggregate trades. This practice results in an average price, but it does not entitle clients, or the firm, to a transaction discount. Trade aggregation is mainly for the convenience of the firm.

Other Considerations-Allocation of Trades:

Because the firm deals mainly in securities exhibiting high liquidity, conflicts of interests and discrepancies are rare. An example is referenced under **Performance-Based Fees and Side-by-Side Management**, wherein a limited-opportunity investment (such as a small quantity of municipal bonds) may be appropriate for more than one client account. The portfolio manager is instructed to use his judgment to select the account with the best fit; while this could be determined by the least invested account, or similar parameters, sooner or later the allocation process could be considered subjective. An analogous situation would be Initial Public Offerings, especially one considered “hot” with expected price appreciation. However, the firm generally does not participate in Initial Public Offerings.

In rare circumstances, the firm may enter an aggregated order on a limit basis (most of our orders are market orders). This creates the possibility of a partial fill. Because this is an infrequent occurrence, the firm does not have a structured process to allocate the trades under these conditions, and allocation in such circumstances may be inconsistent. For example, an order may be entered to sell 3,000 shares of Microsoft at \$26 per share for 10 client accounts. If 500 shares filled one day, under ordinary circumstances it would be impractical for the firm to allocate 50 shares to each account, or to allocate shares to each account in proportion to the account’s size. In such a case, the shares might be allocated in alphabetical or reverse alphabetical order.

If, however, the circumstances were not normal—trading in the stock was halted, for example, and it opened down \$2 following the trading halt—we would micro manage the allocation process to be as fair as possible. These efforts notwithstanding, it would not be possible to complete the process without subjectivity.

Review of Accounts:

The firm offers clients account reviews on an annual basis. These are conducted either by Thomas E Velevis, CFP, Managing Principal, Henry S Dreher, Chief Compliance Officer and Portfolio Manager, or both managers acting together. The firm prepares a consolidated statement and performance report for the client's holdings; additionally, the firm may make financial projections based on new information of client circumstances or client concerns. This review provides the opportunity for the client to evaluate the effectiveness of her Investment Strategy, and it helps the firm learn about changes that might have occurred in the client's life during the year. Adjustments to client Investment Strategies may or may not be necessary depending on the outcome of these processes. For the convenience of clients and the firm, account reviews may be conducted via phone. (See **Business of The Firm, Reviews of Client Accounts.**)

More informally, the firm may be said to review client accounts on a continuous basis, since our principal work activity is to examine investments that could improve the investment returns our clients are receiving. In addition, clients may notify us at any time if changing circumstances require an account or Investment Strategy review or change.

Throughout the year, the firm communicates with its clients electronically and in writing. Reports include quarterly performance reports, consolidated statements, descriptions of investment changes and an annual report that discusses market conditions. The firm also publishes special reports on investment themes and conditions from time to time.

Client Referrals and Other Compensation:

As stated previously, the firm operates on a fee-only basis; it does not receive commissions or other remuneration based on the investments it buys and sells for its clients. Only clients pay the firm. (See **Business of The Firm**, *Execution of Client Strategies.*)

The firm does not pay for client referrals.

Custody:

Third-party custodians, or brokerage companies, hold our clients' assets. Generally, through a limited power of attorney, clients give us authority to initiate withdrawals from their accounts that go to them at their address of record or to depository accounts with the same name. This withdrawal authority is for the convenience of our clients. For example, a client may tell us to transfer x amount of dollars to her local bank so she can purchase a car.

This limited power of attorney also allows the firm to debit client accounts to pay our quarterly investment management fees, for which we provide an invoice to our clients describing the amount of the fees and how they are calculated.

Importantly, the monthly or quarterly statements sent to our clients from these third-party custodians represent an arm's-length method for our clients to review their holdings and dealings they have with the firm. Clients should review these statements carefully. By comparing these custodial statements with the statements sent by the firm, clients can participate in a system to detect fraud, as well as to identify mistakes or questions that may occur. The statements we send to clients referencing holdings and account values advise clients to make these comparisons.

Investment Discretion:

We perform our services on a discretionary basis, meaning we deal directly with client brokers, without consulting clients to obtain permission, to make securities transactions that implement client Investment Strategies. Generally, clients give us this authority via limited powers of attorney that are a component of brokerage account documents completed and signed by clients (usually with our assistance).

As stated previously, special considerations in client Investment Strategies may limit discretionary authority in certain cases, such as a large position or low-cost, inherited investment, etc. Firm employees attempt to spend as much time as required to develop Investment Strategies that represent client needs and circumstances before using the Strategy as the road map to make discretionary investment decisions. (See **Business of The Firm, Execution of Client Investment Strategies.**)

Voting Client Securities:

The firm does not vote client securities. Clients receive proxy statements from their custodians, and although they are welcome to contact us with questions regarding issues, the firm does not represent that it remains abreast of all election choices and other matters that may arise for voting. From time to time, the firm may send out special reports that call attention to proxy choices it believes are in the best interests of its clients.

Financial Information:

The firm bills all client accounts quarterly in arrears, meaning after services are performed. We are not aware of any condition likely to impair our ability to meet contractual commitments to our clients.

Principal Executive Officers and Management Persons:

Thomas Edward Velevis, CFP

Year of Birth: 1969

Formal Education after High School:

Bachelor of Arts-University of North Carolina, Chapel Hill-1993

Business Background:

October 1999 to August 2010:

Associate/Principal: H.S. Dreher Capital Management, LLC
(Formerly Longleaf Capital Management)
Southern Pines, NC

September 2010 to Present:

Managing Principal: H.S. Dreher Capital Management, LLC
(Formerly Longleaf Capital Management)
Southern Pines, NC

Henry Samuel Dreher:

Year of Birth: 1944

Formal Education after High School:

Bachelor of Arts-University of Kansas, Lawrence-1966

Masters in Business Administration-University of Kansas, Lawrence-1968

Business Background:

September 1994-August 2010:

President and Founder: H.S. Dreher Capital Management, LLC
(Formerly Longleaf Capital Management)
Southern Pines, NC

September 2010-Present:

Chief Compliance Officer, Portfolio Manager, Research Consultant
H.S. Dreher Capital Management, LLC
(Formerly Longleaf Capital Management)
Southern Pines, NC

Other Business:

Neither the firm nor its principal employees are engaged in any business other than investment counsel as described herein. (See **Business of The Firm.**)

Performance-Based Fees:

As stated, select clients pay the firm based on performance of their assets under management. Specifically, these clients pay fees up to two percent of assets under management given certain absolute and relative return thresholds, up to one percent given other parameters and one half of one percent in any event. These contracts are negotiated in accordance with client objectives. However, all of these arrangements require at least a one-year look-back period and the calculation of a High Water Mark. Clients must be accredited investors to negotiate performance-based fees. Generally, the firm does not believe performance-based management benefits other than select accounts, and the firm is not promoting this form of management.

Clients paying the firm on a performance basis need to recognize that a structural incentive exists for the firm to select risky investments, because higher investment returns will translate into higher fee revenue. For the record, the firm believes this conflict is contained by its High Water Mark policy, wherein the firm cannot be paid more than one half of one percent of client assets under management unless and until client assets, plus withdrawals minus contributions, equal or exceed their previously recorded high levels. Based on this policy, the firm and its principal employees would rather attempt to earn higher fees by being conservative (losing less in down markets) than aggressive (outperforming in up markets). (See also **Performance-Based Fees and Side-by-Side Management.**)