

PORTFOLIO MANAGER LETTER

ARIEL FOCUS FUND

December 31, 2009



Dear Fellow Shareholder: Ariel Focus Fund beat its primary benchmark in the fourth quarter, extending its outperformance streak to eight of the last nine quarters. For the quarter ended December 31, 2009, the Fund rose +7.34% versus +4.21% for the Russell 1000 Value Index, +6.07% for the Russell 1000 Index and +6.04% for the S&P 500 Index. For the full year, the Fund gained +33.46% versus +19.69% for the Russell 1000 Value Index, +28.43% for the Russell 1000 Index and +26.46% for the S&P 500 Index. Over the last nine quarters the Fund has outperformed its primary benchmark in every quarter except the fourth quarter of 2008. Over the last three years it has outperformed the Russell 1000 Value Index by nearly 3.5% per year.

Before taking a look at the stocks that helped and hurt performance in the quarter, we thought we would try to summarize our outlook for 2010. You do not often see President Harding quoted in an investment letter (or anywhere else for that matter). But we will invoke the 29th President by predicting "A Return to Normalcy." It is our view that after two years in which the market witnessed extraordinary volatility, both down and up, we could be entering a period of normal performance. In such an environment, outperformance will come from superior stock picking rather than portfolio positioning against major market moves. In this type of market, we would expect broad equity returns in the high single- or low double-digits rather than the 30% or greater swings we have seen over the last two years.

The best evidence for this "Return to Normalcy" is the collapse of risk premiums in the market. Risk premiums are the return an investor can reasonably expect from taking on financial risk. Last March, fear of a broad financial collapse was so prevalent that an investor could be highly compensated for taking even minimal risk. Stocks in our own portfolio such as AFLAC Inc. (AFL) and American Express Co. (AXP) were priced as if bankruptcy was a significant possibility, with both stocks trading around \$11 per share on March 9, 2009. An investor willing to take that risk could reasonably expect large returns if the financial system simply survived. In fact, the system did survive and Aflac quadrupled from its \$11.49 March low to \$46.25 at year-end and American Express tripled from \$10.64 in March to \$32.85 when we exited the position at the end of August.¹

Today, however, the situation is quite different. In our opinion, lower-quality securities with financial leverage and cyclical exposure to any disappointment in the economy have rallied so dramatically that they no longer represent a good risk/reward trade off. Last March, we thought we were being amply rewarded for holding positions in companies with modest risk. Today the market is not offering the same risk premium, and we have adjusted the portfolio accordingly. Our largest positions are among our highest-quality names with very little financial leverage. For example, Johnson & Johnson (JNJ) is our biggest holding. The company has a AAA balance sheet and has posted 46 consecutive years of dividend increases. Besides Johnson &

Disclaimer: Performance data quoted is past performance and does not guarantee future results. The performance stated in this document assumes the reinvestment of dividends and capital gains. We caution shareholders that we can never predict or assure future returns on investments. The investment return and principal value of an investment with our Funds will fluctuate over time so that your shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. [Click here](#) for the annual expense ratios and standardized performance current to the most recent quarter and month end periods for Ariel Focus Fund.

Johnson, the portfolio is dominated by some of the highest-quality names in business including Accenture plc (ACN), Berkshire Hathaway Inc. (BRK.B), International Business Machines Corp. (IBM), Omnicom Group Inc. (OMC), JPMorgan Chase & Co. (JPM), Walt Disney Co. (DIS) and Toyota Motor Corp. (TM). Even our more controversial holdings like Dell Inc. (DELL) and Apollo Group, Inc. (APOL) have cash holdings that exceed total debt outstanding. With the decline in risk premiums, we sold some of our more volatile positions. Although we earned an excellent return on American Express in 2009, we exited our position when the stock rallied so dramatically. We were delighted to own it when the market was assuming the worst. We are not willing to own it when the market is assuming the best.

Today we believe high-quality large-cap companies present a great investment opportunity. While price/earnings (PE) multiples have their limitations, it is instructive when a whole group of comparable companies trades at a discount to the market on a PE basis. At year-end the S&P 500 Index was trading at a multiple of 15.6x forward earnings. Historically, market-leading, high-quality companies with strong balance sheets have traded at a premium to the market. One might have thought the last two years of volatility would have produced a "flight to corporate quality." But it has not. At year end, J&J was trading at a 13.1x consensus forward earnings, IBM at 12.0x, JP Morgan at 12.9x, Accenture at 14.9x, Omnicom at 14.4x, Carnival Corp. & plc (CCL) at 13.8x and Merck & Co., Inc. (MRK) at 10.6x. As we mentioned in our last quarterly letter, our portfolio currently has the rare triple convergence of higher-than-market expected five-year earnings growth (11.6% versus 9.6% for the market), stronger-than-market balance sheets (16.5x interest coverage versus 8.1x for the market) and lower valuation multiples (13.8x versus 15.6x for the S&P 500). We cannot promise this convergence will last, but we plan to invest heavily while it does.

Now for a look back at last quarter. In the fourth quarter and for the year as a whole, Ariel Focus Fund posted strong performance despite generally unfavorable market trends. Overall in 2009, more-leveraged companies outperformed less-levered ones, lower-quality outperformed higher-quality, and smaller companies did better than big ones. Companies in the Fund have less debt, higher-quality ratings and a larger average market cap than the benchmark. As such, one might have guessed 2009 would be a tough year. Instead, we outperformed as a direct result of strong stock selection and the solid performance of some previously over-penalized companies. For example, IMS Health, Inc. (RX), which gained +36.2% by the time we exited the position in November, boosted our returns the most during the quarter.¹ In November, IMS announced it had agreed to be sold in a leveraged buyout led by private equity investors at a price of \$22.00 per share. IMS had traded as low as \$11.20 in March. IMS's stock had been beaten down to unreasonably low levels due to investor frustration with a string of quarterly earnings misses. We believed the market's punishment of the stock was excessive given the company's virtual monopoly in providing market data to the world's leading pharmaceutical companies, as well as its excellent cash flow. Two private equity firms, TPG Capital and the CPP Investment Board, a Canadian entity, agreed to buy the company at almost twice its March low.

With IMS fresh in our thoughts, we should mention one more trend for 2010, namely a return of mergers and acquisitions activity. Our sources in the investment banking community tell us potential acquirers are motivated by a need to find new sources of growth combined with extremely low interest rates. These companies are now finding many acquisition targets should grow earnings as early as year one, particularly when funded with existing cash balances earning almost no interest income. We expect private equity firms to take advantage of the enormous rally we have seen in the high yield market and the remaining multi-billion dollar commitments they have from their limited partners to announce new buyouts like the IMS deal. While Ariel Focus Fund, with its larger market cap, will not benefit from this trend as much as Ariel's smaller market cap portfolios, we do have a number of holdings we could see being acquired in 2010.

Accenture, which gained +13.5%, followed IMS as the second largest positive contributor to performance during the fourth quarter. In this difficult economic period, Accenture has continued to produce solid

¹ Contribution to return measures the contribution of the portfolio securities to overall portfolio return. Return contribution is of absolute nature, neglecting the portfolio benchmark. The contribution of a security is calculated as the product of its weight and its return and is geometrically linked over time.

operating results by keeping margins high despite sluggish revenue growth. While some clients did defer large consulting projects, technology outsourcing remained strong. Turnover among Accenture's employee base has declined markedly, an important metric given the cost of hiring and training. Weakness in the labor market has actually helped Accenture lower its compensation expense, the single-largest cost item on its income statement. Despite it being our second-best performing stock last quarter, we still think Accenture represents a good value, trading at only 14.7x our estimate of forward earnings and an 18% discount to our calculation of intrinsic value. Furthermore, we believe large system integration projects have been deferred, not permanently canceled, particularly in the financial services industry.

The two stocks detracting most from performance in the fourth quarter were Dell and a new position in the for-profit education company Apollo. Dell's -5.9% fall came from three factors. First, before the end of the third quarter, Dell's stock had essentially doubled from its February low of \$7.99 to \$16.92 in September with some investors believing the stock had gotten ahead of itself. Second, the company's acquisition of Perot Systems at what seemed to be a very full price was not well-received. Finally, Dell's quarterly results seemed to show a loss of market share in pursuit of better margins. We support this strategy, but a number of analysts reduced their estimates for 2010. We continue to think of Dell as a good company at a very cheap price with no net debt. Dell has an excellent double-digit free cash flow yield and the company should benefit from a corporate computer "refresh cycle" in 2010.

A new position, Apollo was down -8.0% from our initial purchase in September through year end. While Apollo's operating results have been nothing short of spectacular (new students up 14%, and revenues up 30% year-over-year in the most recent quarter), a letter from the SEC announcing an "informal investigation" of the company's revenue recognition policies put pressure on the stock. Through our long investing experience within this industry we have learned to expect the inevitable negative headlines that seem to come with the business. Pressures on state budgets and funding of state schools plus a still tight labor market should continue to provide tailwinds for Apollo and their flagship University of Phoenix for the foreseeable future. Apollo is one of the cheapest stocks in our portfolio currently trading at 11.5x our estimate of forward earnings and a 32% discount to our calculation of private market value.

We will close by noting that while we are pleased with the consistent relative performance of Ariel Focus Fund over the last two tumultuous years, we look forward to a less rocky period where we can apply our disciplined stock selection process predicated on taking a long-term approach to investing and a willingness to think independently in a less dramatic environment. The last two years have not been slow and steady for anyone we know, so a Return to Normalcy would suit us just fine.

We appreciate your consideration and the opportunity to serve you and welcome any questions or comments you might have. You can also contact us directly at email@arielinvestments.com.

Sincerely,



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Co-Portfolio Manager



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Ariel Focus Fund is a non-diversified fund and therefore may be subject to greater volatility than a more diversified investment. Investing in mid-cap stocks is more risky and more volatile than investing in large cap stocks.

This commentary candidly discusses a number of individual companies. These opinions are current as of the date of this commentary, but are subject to change. The information provided in this letter is not reasonably sufficient upon which to base an investment decision and should not be considered a recommendation to purchase or sell a particular security. The performance of any single portfolio holding is no indication of the performance of other portfolio holdings of Ariel Focus Fund or of the performance of the Fund itself. [Click here](#) for the schedule of holdings and other holdings data for Ariel Focus Fund.

The Russell 1000® Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. As of December 31, 2009, this index had an average market capitalization of \$30.1 billion based on a dollar-weighting of all holdings. The Russell 1000® Index measures the performance of the 1000 largest companies in the Russell 3000 Index, which represents approximately 90% of the U.S. market. As of December 31, 2009, this index had an average market capitalization of \$33.1 billion based on a dollar-weighting of all holdings.

Investors should consider carefully the investment objectives, risks, and charges and expenses before investing. For a current [prospectus](#) which contains this and other information about the funds offered by Ariel Investment Trust, call us at 800-292-7435 or visit arielinvestments.com. Please read the prospectus carefully before investing. Distributed by Ariel Distributors, LLC, a wholly owned subsidiary of Ariel Investments, LLC.