2011 Year in Review

> "When national debts have once been accumulated to a certain degree, there is scarce, I believe, a single instance of their having been fairly and completely paid. The liberation of the public revenue, if it has ever been brought about at all, has always been brought about by bankruptcy; sometimes by an avowed one, but always by a real one, though frequently by a pretend payment."
> **Adam Smith-The Wealth of Nations Book V, Chapter III, Part V**

Adam Smith took ten years to write The Wealth of Nations, completing it in 1776, the year the U.S. began its existence. As a Scotsman, what Smith commented on in his writings were his viewpoints on Great Britain's economy and policies during that era, many of which have become the hallmarks of capitalism. In many countries, excessive debts, both private and public, are a major problem for the global economy. For the outlook to improve, the debt problem must be addressed. The tipping point has been reached in many hotspots, particularly in Europe. However, the U.S. is quickly approaching its own tipping point too. How this issue shakes out will dictate how global markets perform over the foreseeable future. As Adam Smith wrote 235 years ago, excessive debts have always brought about bankruptcy (default) in some form or other, and that is the point that has now been reached in the global credit crisis.

We're Rich!!!!!! …….in Acrimony

We're entering the fifth year of the Great Recession and the degree of acrimony in society rose to uncomfortable levels during 2011. Really uncomfortable levels, like getting stuck with Mary Fontanue as my square dance partner in 6th grade gym class. Everyone is looking for answers or scapegoats for the bind we are in. It's a highly complicated story of how we arrived here, which makes crafting a set of solutions a most difficult endeavor (ask the Super(ficial) Committee). If it were easy, we would have figured it out by now.

Add to the mix a government that always reacts after-the-fact with new legislation/regulation/tax policies to fix old ills (think Dodd-Frank Act), thus creating new headwinds, and a Federal Reserve forced to resort to extraordinary monetary policy measures to "fix" the unintended consequences of its old policy mistakes, and creating new unintended consequences in the process, and you get an idea of why the economy seems stuck in an extended period of malaise. It took a long, convoluted, run-on sentence to get that explanation out, further proof of the complexity of our present difficulties.

The Occupy Wall Street protesters are the most public symbol of the high level of acrimony that now exists in the U.S. On one hand, most can sympathize with what they are generally protesting, which is the inequality gap that has built up over decades between the haves and the have-nots. The famous line "be careful what you wish for" comes to mind here. Some of the key institutions they are protesting/targeting are the basic building blocks of a sound U.S. economy and its financial foundation. These entities need to function properly in order for America to prosper.

There are plenty of bad actors in this terrible play. The Fed via making money too cheaply available, the government agencies that did not enforce existing laws and regulations, the politicians who strong-armed government agencies to loosen standards, the people who took out loans without the ability to repay and later claimed ignorance, the mortgage lenders/banks doing deals to generate the fees and then dumping the crappy credits onto other investors globally, the homeowners taking out home equity loans to spend frivolously, and the local governments allowing overbuilding to increase tax revenues. There is plenty of blame to go around, but we are well beyond the point where finger pointing and retribution against any specific group will help our collective cause.

Unfortunately, our federal government is in massive disarray and is doing nothing to help facilitate the healing process for the economy. It was all partisanship, brinkmanship, and gridlock during 2011. In fact, government (in)actions have added to the poor economic outlook. The level of acrimony in Washington D.C. is as great as anywhere in the U.S. It's going to take a royal flush (as in toilet, not cards) in next November's election to reset the political will and direction of the country. As we said before, there are no easy solutions. To get back on the right path, it will require major sacrifices by **everyone** and across every demographic bucket.

Over There

You think we got problems in the U.S., huh? Well, there is an even bigger dose of reality coming to Europe. Rome pays an estimated €2 billion a year on 30,000 chauffeur-driven Alfa Romeos, Maseratis and Audis with tinted windows for their politicians. Greeks throw Molotov cocktails and public unions call national strikes weekly because outsiders have the gall to suggest the Greek retirement age needs to be raised above 55. Since Europe is and remains the Numero Uno macro risk, let's discuss the brat sitting over there in the corner in a timeout.

Euroland's bloated and unaffordable welfare state has reached the point of no return (queue the Kansas music). The socialist buffoons minding the shops over there have been told by global bond markets that the jig is up. Government bond yields skyrocketed during 2011 to unaffordable levels, putting the fiscal houses of the most distressed European countries into disarray and threatening the solvency of many European banks that own sizable amounts of government debt. The whole reason politicians are trying to keep everyone in the Euro (and throwing away good money to do it) is that a default scenario by Greece or others will put some banks under. Houston, we have a problem.

Politicians gathered numerous times in pleasant European locales to try to craft solutions to appease the bond markets and reduce the stress. The U.S. even sent Treasury Secretary Tim Geithner over there a few times to help shore-up the proceedings (given our own fiscal transgressions, some of them told him to go pound salt). Voters kicked out numerous governments, in vain attempts to find different players who could figure it out. None of the financial rescue programs (ESM, EFSF, LTRO) have worked to date, mainly because the amount of debt is too big and the economic growth outlook is too weak to fix the problem. The EU treaty signed many years ago has handcuffed the political establishment from coming up with timely solutions and the global markets are short on patience. The European Central Bank is also limited by its mandate (and by the Germans who are dictating the process) in terms of the policy actions it can implement to help. Unfortunately, Europe will continue to be a major risk for global markets in 2012 and perhaps for years to come. Remember, Rome wasn't built in a day, and dismantling it will take years. Some level of default is required to get the debt level down to a manageable level. Based on what the bond market is pricing in, a Greek default is a done deal. The question is what other countries will/should default and who survives in the Euro going forward or does the Euro survive at all? It all remains very uncertain at this point, and global markets hate uncertainty.

Volatility

Volatile is the one word that best describes the investment backdrop of 2011. The Volatility Index, or VIX, is a measure of market volatility. As shown in the next chart, market volatility was extreme in 2011, and increased significantly starting in July as the next phase of the European crisis and the U.S. debt ceiling drama hit global stock markets hard. The VIX has come back down, but given the major macro risks still on the table, volatility will be a major factor during 2012.

Active Manager WWE Smack Down

In 2011, there were many confusing crosscurrents, leading to numerous big rallies followed by huge drops and vice versa. Asset class correlations soared, limiting the benefits of diversification and the high level of volatility created a difficult backdrop to add value. Frustration/aggravation levels (tying nicely into the acrimony theme) are very high. It became very difficult to make sound, fundamentally based investment decisions in this type of environment. In a low return/high volatility world, one poorly timed entry point could potentially wipe out a year's worth of returns.

Against this backdrop, 2011 was a terrible year for many professional investment managers. Below is a short list of major categories of mutual funds, showing how the average fund performed in each category compared to a representative passive benchmark. With the exception of U.S. Small Cap, the average manager trailed its benchmark in every major fund category.

	Avg. Fund Return*	Benchmark Return
U.S. Large Cap Growth	-1.9	2.6
U.S. Large Cap Value	-2.3	0.4
U.S. Large Cap Core	-0.5	2.1
U.S. Small Cap	-3.6	-4.2
International Equity	-13.6	-12.1
Global Equity	-8.6	-7.4
Balanced	0.4	4.7
General Taxable Bonds	3.2	7.8

* Average Fund Return Data from Lipper

Many professional investors are biding their time, waiting for macro risks to fade and for a better environment to invest. Active managers have underperformed in the past, and when the disparity is as pervasive as it was in 2011, the year(s) following (and when asset class correlations decline) are often a big catch-up period for active managers versus passive benchmarks.

2011 Investment Performance – Pass the Dramamine

The last six months of 2011 had more than a dozen major moves for the stock market in both directions, ranging from 5% to 20%. For the year, the S&P 500 Index was barely positive on a total return basis (thank you dividends). It could have been much worse and it felt like it should have been worse. Unless one stayed defensive and focused on dividend yielding stocks, there was little to no return earned from stocks for the nerve fraying wild ride of 2011. Defensive sectors like Utilities (+15%) and Healthcare (+10%) outperformed cyclical sectors with Financials (-18%) the worst performing sector for 2011. Despite the stock market's wild gyrations and paltry returns, and considering the major macro risks the global economy still faces, investor sentiment is oddly optimistic. The Investors Intelligence (no jokes, please) survey at year-end registered Bulls at 50% and Bears at 29.5% while the America Association of Individual Investors registered Bulls at 40.6% and Bears at 30.9%. Hmmmmmmm……..

Major global stock market indices significantly underperformed the US market return. While it was not very pretty in the U.S., it was significantly worse overseas, as Europe severely underperformed and emerging markets came under increased pressure as the global growth outlook decelerated. Anyone who diversified into international stocks took a bigger hit with developed international markets recording mid-teens negative returns. Emerging markets were worse, down close to 20%.

As global stocks suffered, bonds thrived. Despite all the woes about government deficits and debt defaults, US Treasuries, particularly long maturity bonds, dramatically outperformed in 2011 due to a combination of slow growth outlook, benign inflation, and flight to safety effect (best house in a bad neighborhood). Yields on the 10 Year U.S. Treasury bond began the year at 3.3% and ended the year just under 1.90%. Both investment grade credits and high yield bonds posted mid to high single digit returns.

Late in the year, commodities (except oil) took a tumble, partly due to the decelerating economic growth outlook but also due to the bankruptcy filing of MF Global, a major commodities brokerage company. MF's bankruptcy filing shut down a whole swath of commodities traders and hedge funds whose (supposedly) segregated asset accounts seemingly disappeared into the great unknown, sending futures volumes plummeting. That such an event occurred three years after the collapse of Lehman Brothers speaks volumes about the prevailing risk environment.

The following chart is a snapshot of the key global market indices for the past year (price only) as measured by representative ETFs.

Key ETF Performance (%)

US Related ETF	Description	Last Week	This Month	This Year
SPY	S&P 500	-0.70	0.41	-0.20
DIA	Dow 30	-0.64	1.38	5.38
QQQ	Nasdaq 100	-0.45	-0.99	2.52
IJH	S&P Midcap 400	-0.78	-0.94	-3.40
IJR	S&P Smallcap 600	-1.16	0.90	-0.25
IWB	Russell 1000	-0.62	0.32	-0.70
IWM	Russell 2000	-1.07	0.03	-5.74
IWV	Russell 3000	-0.63	0.35	-1.03
NYC	NYSE Comp	-0.08	0.33	-5.93
IVW	S&P 500 Growth	-0.41	-0.09	2.71
IJK	Midcap 400 Growth	-0.75	-1.94	-1.98
IJT	Smallcap 600 Growth	-0.98	0.23	2.59
IVE	S&P 500 Value	-0.79	1.21	-2.95
IJJ	Midcap 400 Value	-0.61	0.32	-4.38
IJS	Smallcap 600 Value	-1.32	1.54	-2.96
DVY	DJ Dividend	-0.15	1.78	7.84
RSP	S&P 500 Equalweight	-0.86	-0.26	-2.18
FXB	British Pound	-0.37	-1.04	-1.07
FXE	Euro	-0.75	-3.68	-3.13
FXY	Yen	1.44	0.75	5.08
XLY	Cons Disc	-0.41	0.72	4.30
XLP	Cons Stap	-0.25	1.85	10.85
XLE	Energy	-0.68	-2.46	1.29
XLF	Financials	-1.14	1.48	-18.50
XLV	Health Care	-0.32	2.39	10.13
XLI	Industrials	-1.00	-0.41	-3.21
XLB	Materials	-1.21	-2.95	-12.78
XLK	Technology	-0.43	-0.66	1.03
IYZ	Telecom	0.33	-0.33	-10.14
XLU	Utilities	0.50	2.19	14.81

Global ETF	Description	Last Week	This Month	This Year
EWA	Australia	-1.61	-7.82	-15.72
EWZ	Brazil	-1.61	-2.76	-25.85
EWC	Canada	0.76	-3.13	-14.19
FXI	China	-1.25	-3.73	-19.08
EWQ	France	0.77	-4.67	-19.92
EWG	Germany	-0.41	-6.83	-19.72
EWH	Hong Kong	0.00	-3.25	-18.23
INP	India	-2.96	-10.48	-39.97
EWI	Italy	-0.91	-5.96	-26.80
EWJ	Japan	0.39	-3.39	-16.50
EWW	Mexico	-0.90	-2.31	-13.18
RSX	Russia	-1.26	-14.61	-29.70
EWU	UK	0.00	-1.52	-6.97
EFA	EAFE	0.04	-3.34	-14.93
EEM	Emerging Mkts	-1.42	-5.17	-20.36
IOO	Global 100	-0.45	-0.67	-6.95
EEB	BRIC	-1.02	-7.52	-24.08
DBC	Commodities	-0.59	-2.89	-2.58
USO	Oil	-0.99	-1.73	-2.28
UNG	Nat. Gas	-5.00	-17.92	-46.09
GLD	Gold	-2.76	-10.66	9.57
SLV	Silver	-4.74	-15.81	-10.74
SHY	1-3 Yr Treasuries	0.01	-0.05	0.62
IEF	7-10 Yr Treasuries	0.99	1.61	12.52
TLT	20+ Yr Treasuries	2.52	2.86	28.82
AGG	Aggregate Bond	0.44	1.11	4.58
BND	Total Bond Market	0.30	0.68	4.56
TIP	T.I.P.S.	-0.14	-0.04	8.53

Source: Bespoke Investments (http://www.bespokeinvest.com)

2012 Investment Outlook – Thank You, Sir, May I Have Another!?

Big picture, the global economy is in the midst of the credit bubble shakeout and time may be the only solution to solve the problem. The situation is playing out in real time in Europe. Unfortunately, the credit crisis is not exclusive to Europe but a global problem for major developed markets. Japan is facing a major debt crisis in the years ahead, the U.S. has a $15 trillion deficit (and growing), and China is likely to have credit issues as well. In addition to European governments having to refinance large amounts of debt during 2012, European banks have nearly $1 trillion of debt to refinance during 2012. That is a whole lot of debt (and indigestion) for financial markets to swallow. What is the most likely outcome of this backdrop? A global economy that is more susceptible to unexpected shocks, lower and more volatile trend growth, and a choppy investment environment.

The consensus opinion embedded in the stock market today is for the U.S. to have a muddle-through economy with 2012 real GDP growth of around 2.0%, Europe will be in a recession in the first half of 2012 with an improving second half, and China will have a soft landing but still generate real GDP growth near 8.0%. The consensus view of Wall Street strategists is for the U.S. stock market as measured by the S&P 500 Index to generate modest earnings growth in the mid-single digits and for index level to reach 1340 by year end.

A few downside risks to consensus opinion include: 1) the European sovereign debt and banking situation deteriorates further, creating a deeper and longer recession, and causing the Euro to drop; 2) China has a hard landing with GDP growth below 7%; 3) bond vigilantes set their sites next on U.S. debt (driving yields higher) before the next election can set a new course for getting our own fiscal house in order; 4) the inevitable, unexpected shocks that occur every year (Japan tsunami, Arab Uprising, etc.). Upside risks (+) to consensus opinion include: 1) Europe expeditiously develops a sound plan for resolving its debt crisis and for fixing its banks; 2) Major emerging markets aggressively cut rates to stimulate economic growth, helping developed market economies grow better than expected; 3) Policy maker fatigue evaporates, leading to improving business confidence which unleashes pent-up demand and reduces cautionary consumer spending patterns; 4) Monthly non-farm payroll data in U.S. improves and job gains consistently hit 200,000 per month or better.

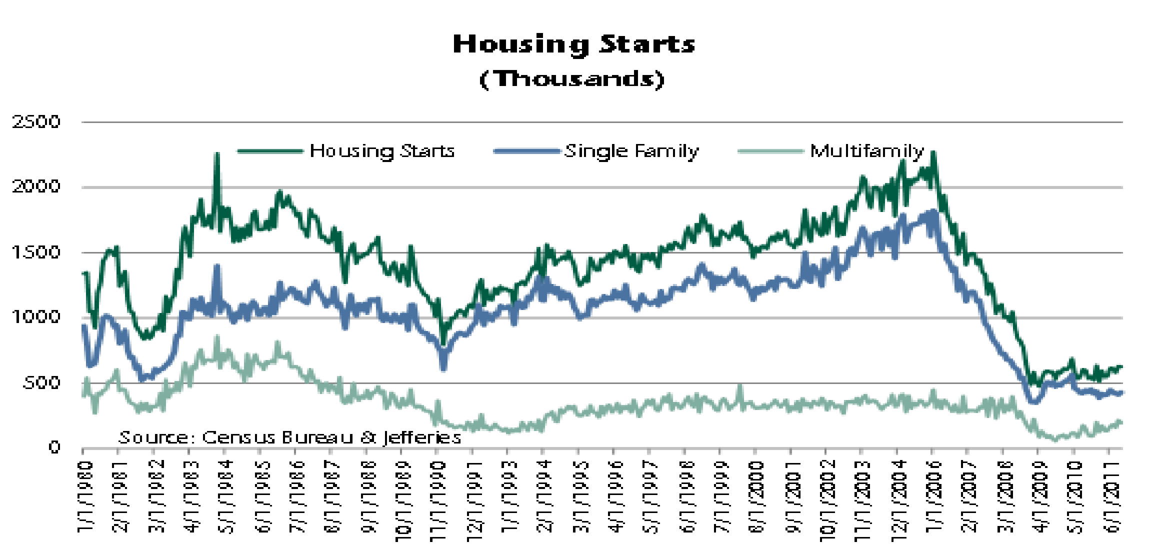
The most likely outcome for 2012 is to expect more of the same kind of environment that global market's experienced in the second half of 2011. For now, it remains a trader's market, not an investor's market. The big macro risk overhangs remain potent forces and should continue to dominate investor sentiment. We're in an environment where correctly predicting what politicians and central bankers do, especially in Europe, will be a key factor on investment returns. This is not a great setup for fundamentally driven investors.

The Winds of Change Are Blowin'

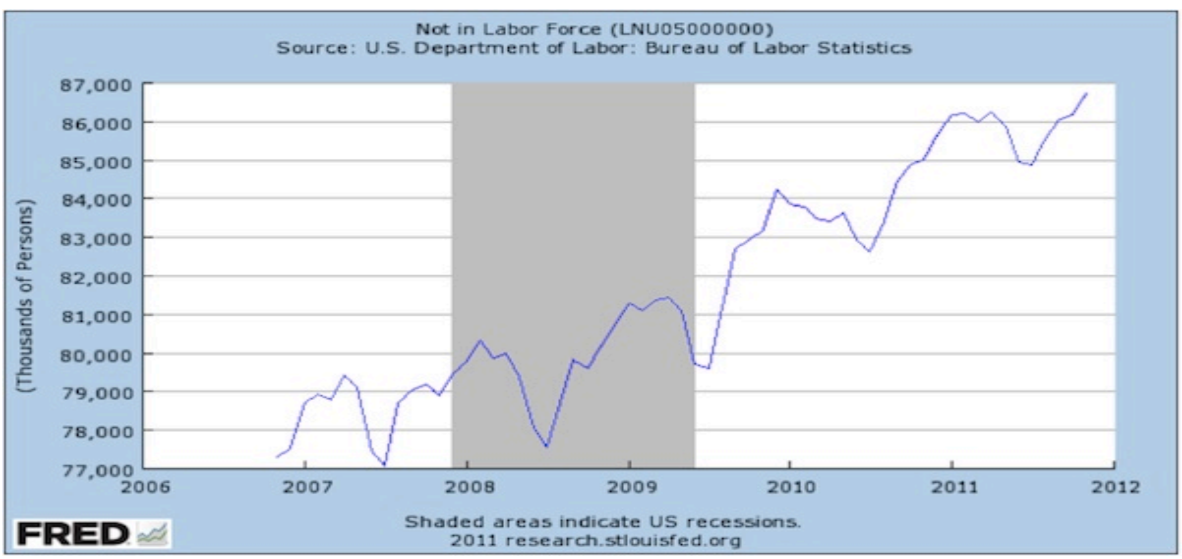
Crisis often leads to change and political change is at the top of the list. The crisis in Europe brought down four governments in 2011 with more changes likely in 2012. The U.S. has a major election in November and it should (hopefully) be a watershed year for political change. We need more Barney Frank's of the world to move on, to remove the old and tired embedded base of politicians entrenched in their staunch beliefs who clearly have failed the American people. Could this Congress or President have mismanaged the situation any worse? With 10%/45% approval ratings, respectively, you be the judge. Experienced Politician now competes with Military Intelligence for the greatest oxymoron ever.

Jobs and Housing

Two big factors continuing to weigh on the U.S. economy are housing and jobs with consumer confidence a related issue. In housing, the big pricing reset has run its course in most markets. New home sales (next chart) are at depressed levels. Given very low mortgage rates and price declines, housing affordability is vastly improved. However, housing activity is stagnant due to low consumer confidence and the difficult employment situation. Existing home inventories remain elevated, as activity is low. Banks continue to slowly work through their foreclosure backlogs, which have the effect of adding supply and undermining pricing.



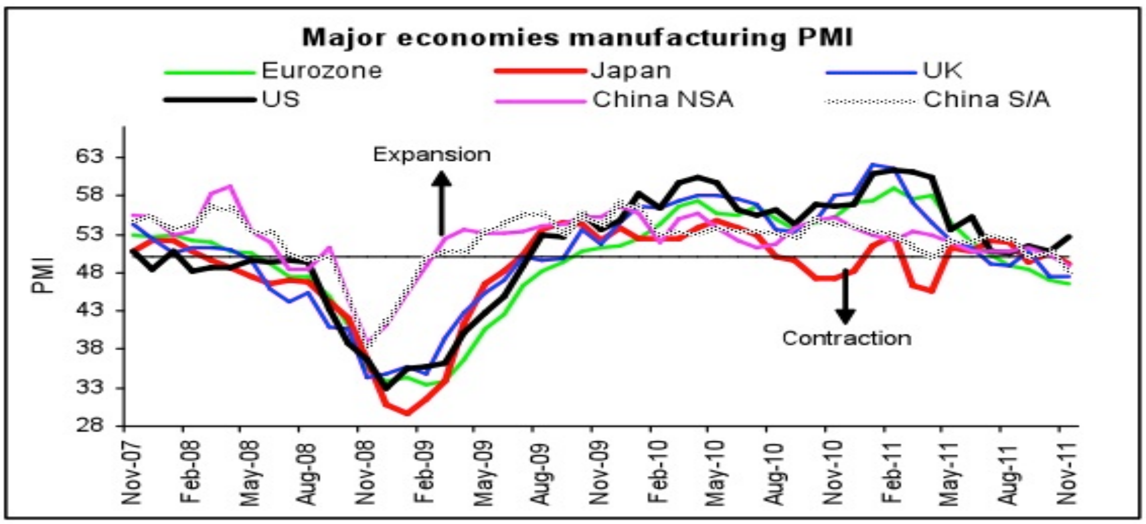
On the employment front, economic growth is not high enough for businesses to have the confidence to expand and hire. There is no doubt that policies and gamesmanship emanating from Washington D.C. have had a major negative impact on business confidence and hiring decisions. Below is a chart from the St. Louis Fed database that shows the number of citizens not in the labor force, rising from 77 million in 2007 to 86.5 million today. Part of the increase can be explained by population growth, but it would be less than half of the nearly 10 million increase over the past four years. Monthly job gains need to exceed 200,000 per month for an extended period of time before the unemployment rate improves from its current elevated level of 8.5%.



Source: St. Louis Federal Reserve Bank

Global Growth

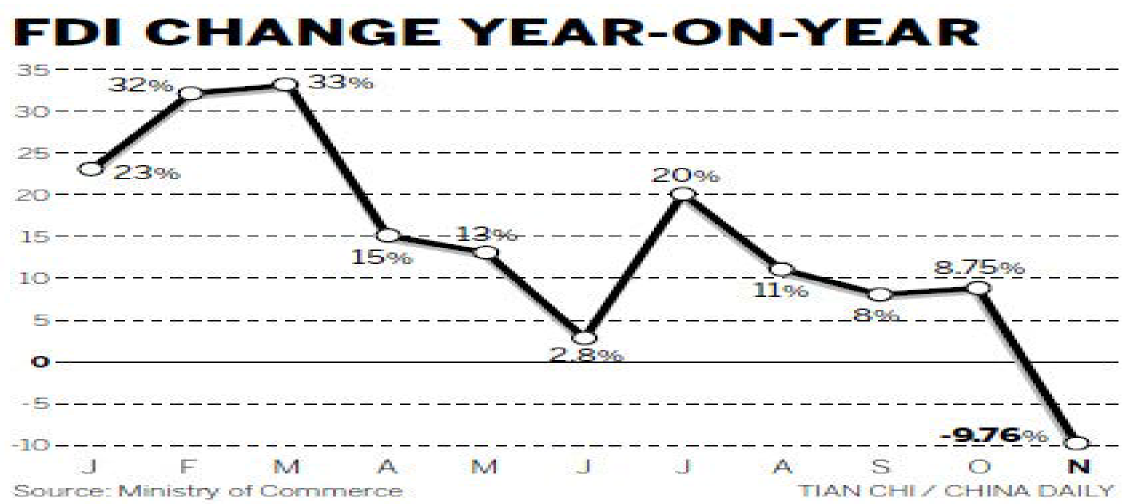
The global debt overhang is forcing austerity measures to be taken and creating uncertainty in the economic outlook. Global economies are struggling to generate decent growth, a major factor on the jobs situation. The next chart (through November) shows global Purchasing Manager Index (PMI) readings and indicates that every major region has slipped into contraction (<50) except the U.S. The current PMI level for the Eurozone is equivalent to a -1.0% real GDP profile. However, it should be noted that in December global PMI data ticked modestly higher in every region.

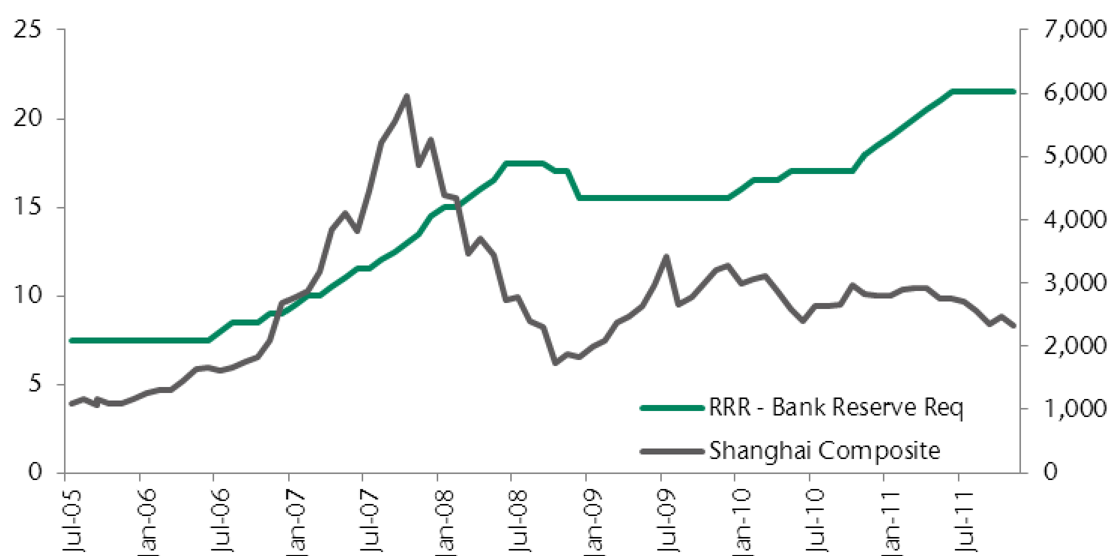


Source: Prieur du Plessis, editor of the Investment Postcards blog.

The rest of the world has relied heavily upon China growth to make up for weaker growth elsewhere. China is now experiencing its own growth challenges. The next chart shows Foreign Direct Investment (FDI) in China through November 2011 on a rolling year-over-year basis. It has fallen sharply and is now in negative territory. Part of the explanation here is the developed markets slowdown but another important factor is that China is becoming less competitive than it used to be in some industries. The long-term secular trend of outsourcing to China to capture cost synergies is ending in some industries, a potentially good sign for U.S. job growth down the road, particularly in manufacturing. High inflation in China has forced regional governments to dramatically increase minimum wage rates. An interesting stat: minimum wage in Shenzhen China is now $6.00/hour, in the U.S. its $7.25/hour. China's super charged economic growth has been due to its export driven economy. Europe is China's largest export market, which is clearly a headwind given the European slowdown.

China has significantly more flexibility than western economies to take actions to stimulate growth. The second chart on the next page shows that China has ample room for banks to cut rates (RRR) to support economic growth. This process has already begun and is likely to continue in 2012. Note that the Shanghai stock index ended 2011 at its lows, a reflection of decelerating growth expectations.

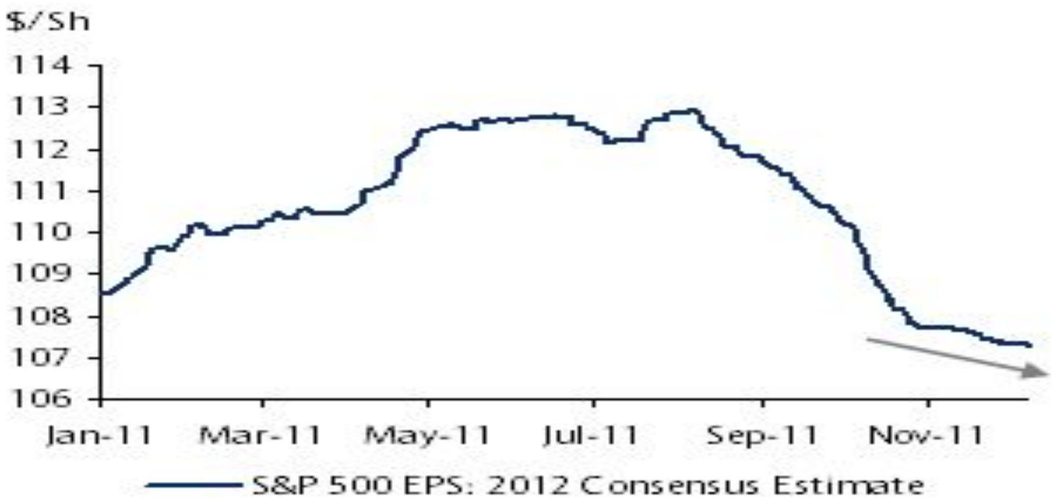




Source: Bloomberg

Earnings Outlook

Decelerating global growth is leading to downward earnings revisions for 2012. The following chart shows how S&P 500 consensus earnings estimate for 2012 peaked in August 2011 and has since rolled over. The stock market typically struggles to move higher when earnings revisions are negative. One big problem for 2012 S&P 500 earnings growth expectations is that the financial sector is expected to contribute 35% to the total earnings growth outlook for 2012, up from 3.3% in 2011. Is the financial sector of the economy really going to improve that much in 2012?



Source: Factset, Barclays Research

Strategy

In a volatile and challenging year, the defensive posture of our investment strategies during 2011 was beneficial to portfolio returns. The major decision for 2012 is when (or if) it makes sense to reduce defensive positioning and increase the risk profile of a portfolio. For now, the answer is not yet. Global macro risks remain large and have the potential of severely hitting the stock market (fat tail risks). In addition, market fundamentals at this time appear less likely to surprise to the upside. Of course, if the European situation improves, it will be very beneficial to investor sentiment and global stock markets and riskier assets will outperform. It is difficult to make that call at this time. The stock market can move higher either through higher earnings or multiple expansion. For 2012 to be a decent year for stocks, it is more likely to come from multiple expansion than from earnings. With money markets offering zero return and bond yields at historical lows, where else can investor turn? Volatility should remain a dominant theme this year so tactical investment decisions can be another potential source of return opportunity. 2012 should be another year of hard work to add value and where dividends and income remain an important component of return.

Conclusion

Let's end this year's Investment Outlook with another quote from Adam Smith. We are facing very challenging times, and it is easy to think America has reached an age where it is now in a perpetual state of decline. Similarly, during the time of Smith's writing, pessimists decried the ongoing declines in Great Britain. To counter these calls of ruin, Adam Smith offered a case for optimism, observing that constructive economic change can often be mistaken for decline.

> "The uniform, constant, and uninterrupted effort of every man to better his condition, the principle from which public and national, as well as private opulence is originally derived, is frequently powerful enough to maintain the natural progress of things toward improvement, in spite of the extravagance of government, and the greatest errors of administration. Like the unknown principle of animal life, it frequently restores health and vigour to the constitution, in spite, not only of the disease, but of the absurd prescriptions of the doctor."

Government and politics in America are at the height of dysfunction. But, we have finally reached the tipping point of being forced to address our long-term structural problems. It will not be an easy or painless process. Through the strong will and effort of the American people, the tide will eventually be reversed, despite all that dysfunctional governments are doing to stand in the way of achieving this goal. Smith believed that the best way to solve Great Britain's problems was to let market forces work and that government should get smaller and get out of the way. 235 years later, this is sage advice.

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IMPORTANT DISCLAIMER: