

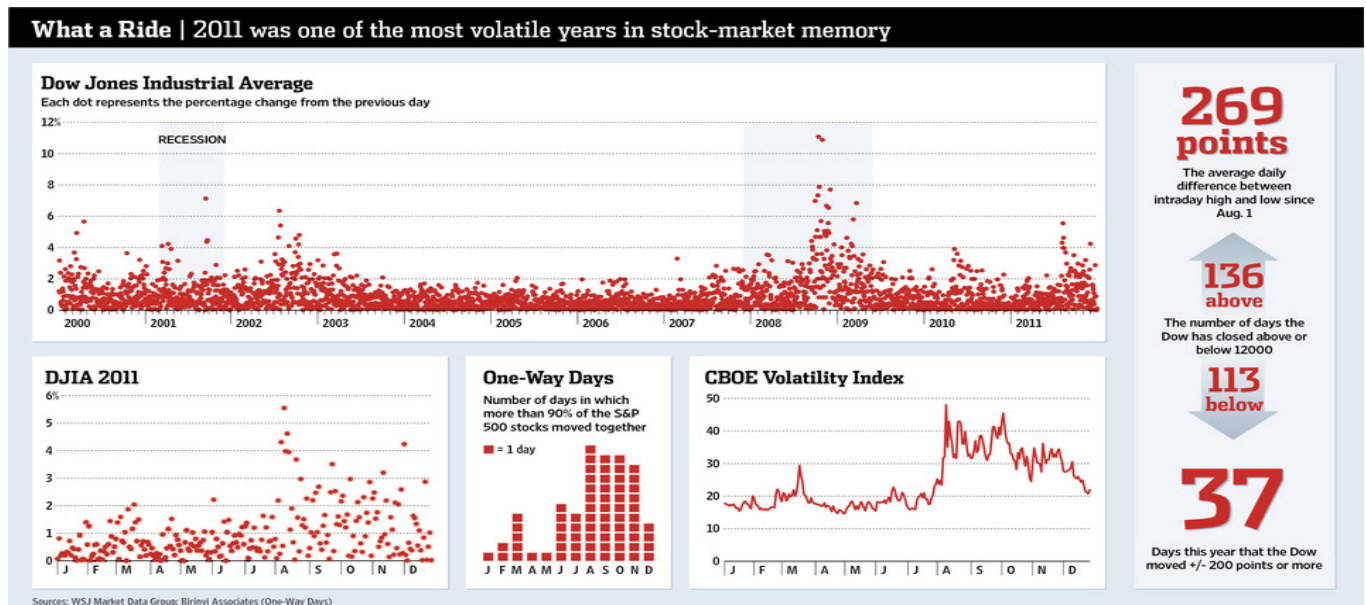
## Fourth Quarter Investment Commentary January 2012

“A country is bust when the markets decide.”

Albert Edwards, Societe Generale Cross Asset Research

### The Quarter/Year in Review

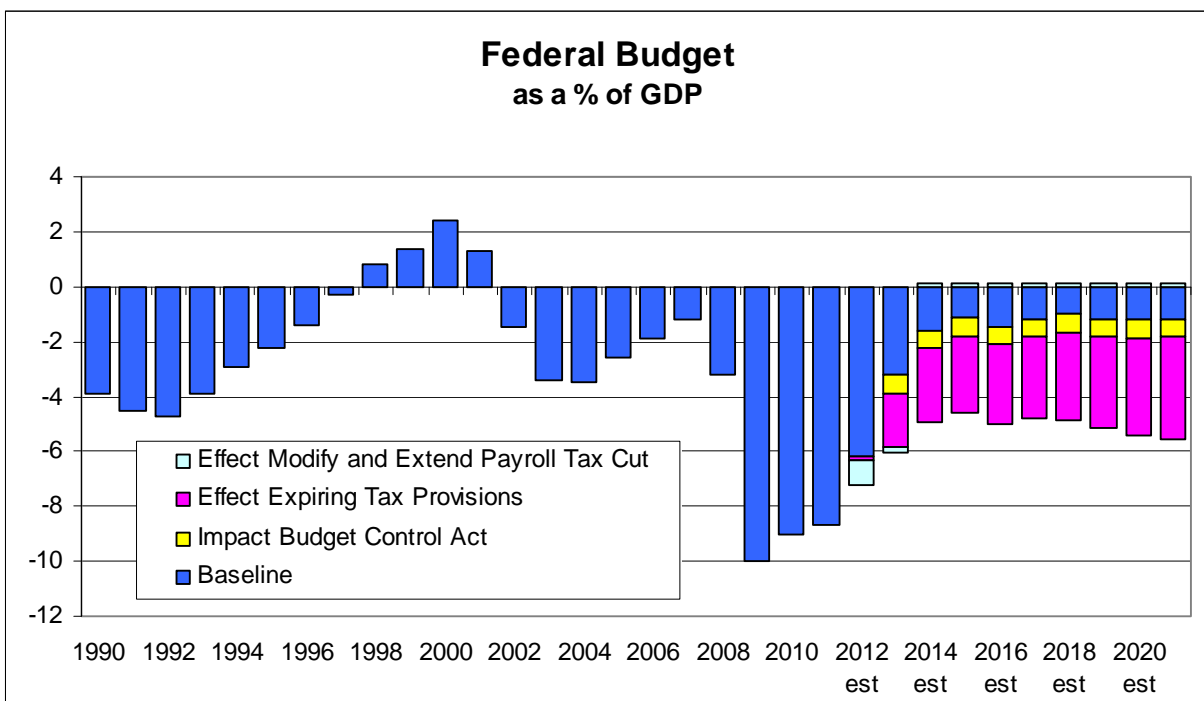
- Global risky assets rallied hard in October, after a dismal August and September. The S&P 500 was up about 11% in the month, while emerging markets were up over 13%.
- Silvio Berlusconi of Italy and Georges Papandreou of Greece both stepped down as leaders of their respective countries. Global stock markets initially showed optimism over these changes, but then wondered if changing the captain of the *Titanic* in mid-voyage would really make a difference.
- While the S&P 500 was essentially flat for the year, the Dow Jones Industrial Average (made up of only 30 stocks) was up almost 6%, on big gains from McDonalds (31%) and IBM (25%). In stark contrast, most non-U.S. markets were deep in the red. Declines ranged from just under 6% in the U.K., to a near 15% decline in the German DAX, to a 52.0% plunge in the crises-centered Greek market. In Asia declines were also steep: Japan lost 17% as the Nikkei closed at its lowest year-end level since 1982. The Chinese Shanghai Composite lost 22% of its value in 2011.
- Volatility was rampant in 2011. The rather busy graphic (below) from *The Wall Street Journal* illustrates how 2011 produced a lot of gray hair, but little in the way of returns.



## Looking Ahead

During the fourth quarter we reduced risk in client portfolios by liquidating a global equity fund and swapping a non-hedged global bond fund for one that hedges currency exposure, which is important in the current environment. We did this because European leaders have failed to develop a comprehensive plan to deal with the debt/currency crisis on that continent, and we have no confidence that they will do so in the near future. They have shown a pattern of over-promising and then under-delivering. So, we are now giving greater weight to the possibility of a severe scenario playing out while still not counting on it as the most likely outcome. We recognize that if European policy makers, or the European Central Bank, make a significant announcement in the near term that leads to another market rally, our decision to reduce risk exposure will likely hurt our short-term relative performance. But, given the increasing risk of contagion and the implications for the global economy and stock markets, we believe the cost of being wrong is acceptable to potentially reduce the amount of losses in client portfolios should the more negative scenario continue to play out. Additionally, while such policy-induced rallies lasted a few weeks in mid-2011, lately they have the shelf life of ripe fruit. Creative fiscal sleight of hand may buy time for the Europeans, but in the end, the realities dictate that any solution that does not include both a monetary and political union will prove to be inadequate.

In our own country, we are not optimistic about anything of consequence being done in Washington during 2012 that will have a positive effect on the economy, other than billions spent on the upcoming presidential campaign. Should the current tax structure put in place by George W. Bush be allowed to expire, this will result in higher taxes for the majority of people and may slow the growth in the economy. See the chart below.



Source: Congressional Budget Office

2012 looks to be another year of uncertainty elicited by policy changes and politics around the globe. European leaders continue to be the focus as implementation of a greater fiscal union is a daunting task. The survival of the euro will be a critical issue in 2012. The euro was established in the late 1990's to unify Europe as a major trading block and a significant financial region; however, the region lacks a unified fiscal policy. As Frits Bolkestein, past EU commissioner and head of Dutch government, stated, "The euro was a victory of political romanticism over economic thinking and reality."

Presidential elections will take place not only in the U.S., but also China, Russia, and France next year. Furthermore, leadership changes in North Korea and several Middle Eastern countries add to the global uncertainty.

Economic growth is slowing. Fiscal austerity, past monetary tightening, political turmoil, and financial uncertainty has likely pushed Europe into recession. China and other emerging economies have been hurt by monetary tightening and weakening exports. While growth is slowing in these economies, they are expected to avoid recession. The U.S. economy continues to grow but at a slow pace. Growth in developed economies is expected to be held back by continued deleveraging and aging populations. Emerging economies are expected to experience faster growth but are slowing near term as a result of tighter monetary policies and weaker exports to developed economies.

But despite all this uncertainty, let's not forget our great country and its economic strength and promise. There have been economic problems from time to time, but America has met its challenges. Milton Friedman, noted economist, stated, "So that the record of history is absolutely crystal clear. That there is no alternative way, so far discovered, of improving the lot of the ordinary people that can hold a candle to the productive activities that are unleashed by a free enterprise system."

The U.S. continues to be number one in manufacturing, the country of innovation and high quality engineering. Companies have been relocating their manufacturing facilities to the United States. Corporate profits are at record highs, and capital spending has been strong.

As we head into 2012 and all the uncertainties the year brings, we leave you with this positive thought from financial advisor John Bodnar: "I suggest we resurrect the American spirit and align ourselves with the economic realities instead of the political headlines. American businesses are doing well. They are well capitalized, sitting on loads of cash, increasing their dividends, and buying back their own stock. It is a great time to be an investor in some of the greatest companies in the world."

## **Closing Comments**

Although we can argue about the real objectives of the Occupy Wall Street (OWS) movement, or the purity of the motives of the participants, the truth is that our country and the world suffer from income inequality. However, it is important to realize that this has always been the case. We discuss this from time to time in our office, and Diane recently noted that many high incomes are due to scalability, i.e., the ability to reach large audiences at a time. This helps to explain why actors, singers and professional athletes (most recently, Albert Pujols and his \$254 million contract) can command such high salaries, while a pediatrician practicing in rural

Kentucky can be underpaid. However, an actor cannot sink a company like Ken Lewis did at Bank of America, or John Corzine did at MF Global. Also, you have to ask how hedge fund managers can make so much money when what they are really doing is trying to move those already in the .01% of wealth up to the .001% level. One reason is that they have personal capital at risk, where the CEO of a public company often may not. I (Kevin) do not subscribe to the theory that America has adopted a caste system and that the "American dream" has been relegated to the dust bin of history, as has been proclaimed lately by the media.

Over the last year or so, we have been talking quite a bit about a wide range of outcomes in the market, and we see that continuing over the near term. However, as we have said earlier in this commentary, there are some positive aspects to the financial markets, particularly with regard to the U.S. equity markets. For each of the past 10 quarters, 70%-plus of the companies in the S&P 500 have delivered positive earnings surprises. S&P 500 earnings are on target for a record \$96.50 per share for full-year 2011, and could be higher in 2012. U.S. manufacturing continues to show positive momentum. It has expanded for 28 consecutive months, driven by global trade and, in particular, emerging market growth. U.S. exports surged to an all-time high of \$180.4 billion this past September. Recently passed free-trade agreements should help this trend to accelerate. Unless there is a complete collapse in the Eurozone, the U.S. should avoid a recession in 2012. We will be looking for opportunities to add to U.S. equities during the year.

We look forward to working with all of you in 2012.



Kevin S. McGrew   Bruce E. Bower   Paul L. Watkins   Patrick L. Warren   Matthew D. Ison   Diane Dercher

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