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Review and Outlook
Fourth Quarter 2011

The S&P 500 Index fell 14% in the third quarter, only to rebound 11.8% in the third quarter. The fear of an imminent, unmanaged default by Greece and the possible resultant chaos in Eurozone economies sent equity markets in Europe and the US tumbling in the third quarter. In October we saw an overly-optimistic reaction to negotiations lead by Germany's Merkel and France's Sarkozy. In the end, the S&P 500 Index achieved a positive return of 2.1% for the year. S&P stocks were actually down 0.04% for the year, with the overall index up for the year due to the boost from dividends.

U.S. corporations have been enjoying strong earnings, but have been hesitant to hire with so many questions about stability of Eurozone economies, possible tax increases, health care costs, etc. In addition, productivity improvements have reduced the need for employees. These facts led to a mixture of good news (corporate earnings or GDP growth) and bad news (lingering high unemployment and a depressed housing market). A series of once-in-a-generation events overlaid this tenuous economic environment: the 'Arab Spring' with uprisings in Tunisia, Egypt, Libya and Syria; an earthquake and tsunami in Japan that damaged a country and rattled supply chains across the globe; a downgrade of U.S. debt; and the failure of the super-committee in Congress. The S&P 500 swung wildly as investors tried to sift through the changing environment.

Most forecasts are calling for 2-3% growth in U.S. GDP in 2012, with consumer prices increasing 1.5-3% over the course of the year. These forecasts suggest 2012 will look a lot like 2011, with a little less inflation. On the one hand, looking a lot like 2011 is fine. We might wish for faster growth to put the Great Recession farther behind us, but slow to modest growth with limited inflation would usually be considered acceptable. On the other hand, looking a lot like 2011 also means continued volatility.

We continue to believe that the long term prospects for equities are relatively good. Valuations are reasonable, particularly in an environment of growing earnings. A key challenge is handling the uncertainty and anticipated volatility. For example, high quality bonds have historically been a good tool for mitigating volatility. With the S&P basically treading water for the year, many bond indexes were up 5% or more. That is, bonds offered a reasonable rate of return and less volatility than the market. But we have to look forward, not backwards. And we see two factors that limit the ability of bonds to play their traditional role of offering acceptable returns while adding stability to a portfolio. The first factor is the yield on bonds. The yield on ten-year U.S. Treasury bonds is currently below 2%. With inflation running slightly above 2%, we will be looking for high quality bonds with better yields-to-maturity (including select municipal and high quality corporate bonds). However, it is unlikely that any high quality bonds will continue to be able to offer the combination of stability and return investors have been used to. The second factor is interest rate inflation. The blue chip consensus forecast does not call for notable inflation in 2012 or 2013, but we note how rapidly bond prices can fall (looking at Europe, for example). Given

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these factors, we will be focusing on shorter term bonds in the near future. We see too much downside risk with longer term bonds from rising interest rates.

As an aside, we understand the argument that inflation should be muted so long as the labor market and housing market are so soft. Aggregate demand in the economy is simply too weak to drive inflation. But we also understand the argument that yields on new bonds have to rise to attract buyers – and higher yields on new issues mean lower prices for existing bonds. Please let us know if you would like to see a longer discussion on this topic. We would be happy to add a 'Current Trends and Debates' section to our webpage.

A New York Times article in early November stated that voters in many developed countries, including the U.S., have yet to come to grips with the notion that they have promised themselves benefits that, at current tax rates, they cannot afford. What are policy makers to do? A recent issue of The Economist magazine, titled 'Nowhere to Hide', explained the corresponding challenges that investors face. The optimum balance of equities, bonds, and other investment options will depend on how the debt problems will be addressed. Economies can reduce their debt burdens through growth or inflation. They can also fall back into recession and risk deflationary pressures. Each path suggests a potentially different asset allocation approach. We appreciate the challenges that lie ahead.

We expect news headlines will reflect optimism one day and fear the next as policy makers search for ways to manage the debt while also addressing high unemployment rates. Headlines will also change from hope to fear and back to hope depending on the news from Europe or activity in the housing market. We expect indexes like the S&P 500 to swing with the news. Despite the volatility we are cautiously optimistic. We think opportunities exist for growth with well-chosen equities, select bonds, and diversification in other asset classes.

We are asking everyone to review their portfolio structure and to talk with us about both short and long term goals. We think reasonable growth is possible, but expect it will come with more volatility than was part of the puzzle in the past.

As always, we look forward to working with you.

Mike Ryan
President

Hart Hodges
Vice President

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