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Market Update for the Quarter Ending December 31, 2011

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Another volatile year for investors

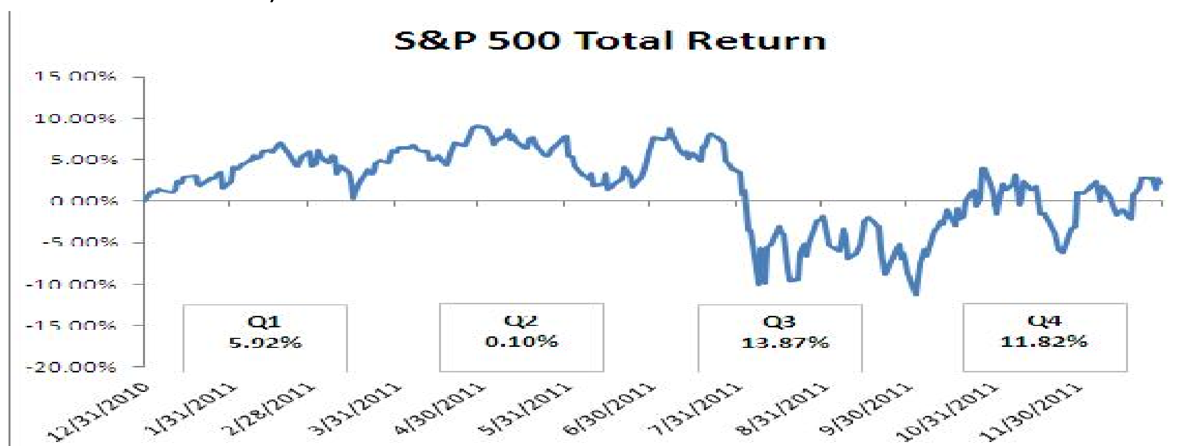
- Markets ended 2011 on a strong note, after what had been a volatile year by historical standards.
- Domestic equity markets were helped by strong gains in the fourth quarter but still ended the year only modestly higher than they were last January.

Across asset classes, there was considerable diversity of return

- Bright spots for investors came from defensive sectors, such as utilities and consumer staples, which tended to outperform in 2011.
- Financials had a rough year, losing 17.09 percent on worries over Eurozone debt troubles.
- Large-cap stocks outperformed small-caps, and growth outperformed value in 2011.
- The best-performing asset class in 2011 was long-term U.S. Treasuries, which gained almost 30 percent, according to the Barclays Capital U.S. Treasury Long Total Return Index.
- REITs returned 8.48 percent for the year, as represented by the S&P U.S. REIT Index.
- Gold continued to be a good portfolio diversifier, rising in price from $1,412 per ounce to $1,572 per ounce for the year, according to Bloomberg.
- International stocks, particularly financials and some riskier emerging markets, underperformed.

U.S. equities benefited from a strong fourth quarter

- Headlines drove market volatility in 2011, creating a risk-on/risk-off environment.
- The Dow Jones Industrial Average gained 8.38 percent for the year, benefiting greatly from a fourth-quarter return of 12.78 percent.
- The S&P 500 Index, with dividends reinvested, returned 2.11 percent, as its heavy weighting in financials hurt performance relative to the Dow.
    - A fourth-quarter gain of 11.82 percent pushed the index above breakeven on an annual basis (see chart).



Source: Bloomberg

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International equities struggled

- The MSCI EAFE Index gained a modest 3.33 percent in the fourth quarter, leaving it down 12.14 percent for the year.
    - For the fourth quarter, the MSCI Emerging Markets Free Index gained 4.08 percent but still lost 20.41 percent for the year.
- Eurozone debt trouble weighed heavily on stocks and added significant volatility—particularly in the hard-hit financials.
    - With substantial sovereign debt refinancing expected in the first quarter of 2012, we could see pressure on European stocks early this year.

Treasuries dominated fixed income markets

- The Barclays Capital U.S. Aggregate Bond Index returned 7.84 percent for the year, helped in large part by Treasury exposure.
    - Many bond managers fell short of the index, as they entered the year with a short-duration, underweight Treasuries bias.
    - Expectations that rates would rise on inflation and growth proved unfounded.
    - Instead, renewed fears of weak global growth, high debt levels, and intervention by the Federal Reserve (the Fed) caused a rally in long-duration Treasuries.
- The riskier Barclays Capital U.S. Corporate High Yield Index performed less well.
- The Barclays Capital Municipal Bond Index gained 10.70 percent in 2011, providing good diversification for tax-sensitive investors.

Event risk played a role in 2011

- Unforeseen risks produced most of the market volatility in 2011.
    - The Japanese earthquake and unrest in the Middle East come to mind.
    - Ongoing debate in Washington over the debt ceiling, as well as renewed fears of recession, contributed to a single-day plunge in the Dow of 512 points in August.
    - The resultant S&P downgrade saw the Dow trade 635 points lower on its first trading day after the announcement.
- Europe fell victim to its own mounting debt problems, which weighed heavily on markets late in the year, leading to significant market underperformance.
- The U.S. Fed announced Operation Twist in September, decreasing yields on the long end of the curve to help support the housing sector and ultimately economic growth.
- Central banks around the world intervened in the currency market in November, in a concerted effort to provide liquidity and help bolster confidence in financial markets.
    - Policy interventions provided short-term support for markets, but these actions may be less helpful in the long run.

The U. S. economy grinding along, but global growth a concern

- U.S. gross domestic product (GDP) managed to expand in 2011, at an estimated rate of 1.8 percent in real terms.
- Home prices continued to fall in 2011.
- Manufacturing and industrial production growth also slowed but moved in a positive direction.
- The most encouraging development was a decrease in the unemployment rate, from 9.4 percent to 8.6 percent, the lowest it has been since the beginning of 2009.
    - Changes in the employment situation tend to lag the overall economy and shouldn't be interpreted as predictive of future economic growth.
    - That said, an increase in the number of working Americans may help boost consumer confidence and spending.
- The biggest threat to continued U.S. growth may come from overseas.
    - The consensus among economists, according to Bloomberg, is that Eurozone GDP will contract 0.2 percent in 2012, as many European countries fall into recession.
    - Due to the level of U.S. trade with Europe, a slowdown in Europe could have a significant impact on our domestic economy.
- Despite this, consensus expectations are for U.S. GDP to grow 2.1 percent in 2012.

Looking ahead

- Looking ahead into 2012, we are bound to see an increased focus on domestic politics with the coming of the presidential election cycle.
    - Differences between Republicans and Democrats on subjects such as entitlement spending and tax levels will once again come to the forefront.
- The European debt situation may soon intensify.
    - Italy must refinance €118 billion in bonds in the first quarter, according to estimates from the Royal Bank of Scotland.
    - The bond sales will test investor willingness to continue lending to the debt-plagued nation and to European peripherals as well.

A new year

For many investors, finding positive returns was challenging in 2011, while finding volatility was far too easy. Yet this is the start of a new year, and last year's winners and losers may perform differently going forward. We view portfolio changes at this time should as more of an adjustment to long-term planning goals rather than an attempt to chase past performance.

Disclosure: *Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. Diversification does not assure a profit or protect against loss in declining markets. All indices are unmanaged and investors cannot invest directly into an index. The Barclays Capital U.S. Treasury Long Total Return Index includes fixed income securities issued by the U.S. Treasury (not including inflation-protected bonds) and U.S. government agencies and instrumentalities, as well as corporate or dollar-denominated foreign debt guaranteed by the U.S. government, with maturities greater than 10 years. The S&P U.S. REIT Index measures the securitized U.S. REIT market, covering approximately 89 percent of the U.S. REIT market capitalization and maintaining a constituency that reflects the*

market's overall composition. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The MSCI Emerging Markets Free Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. It excludes closed markets and those shares in otherwise free markets that are not purchasable by foreigners. The Barclays Capital Aggregate Bond Index is an unmanaged market value-weighted index representing securities that are SEC-registered, taxable, and dollar-denominated. It covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Barclays Capital government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities. The Barclays Capital U.S. Corporate High Yield Index covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The Barclays Capital Municipal Bond Index includes investment-grade, tax-exempt, and fixed-rate bonds with long-term maturities (greater than two years) selected from issues larger than $50 million.

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