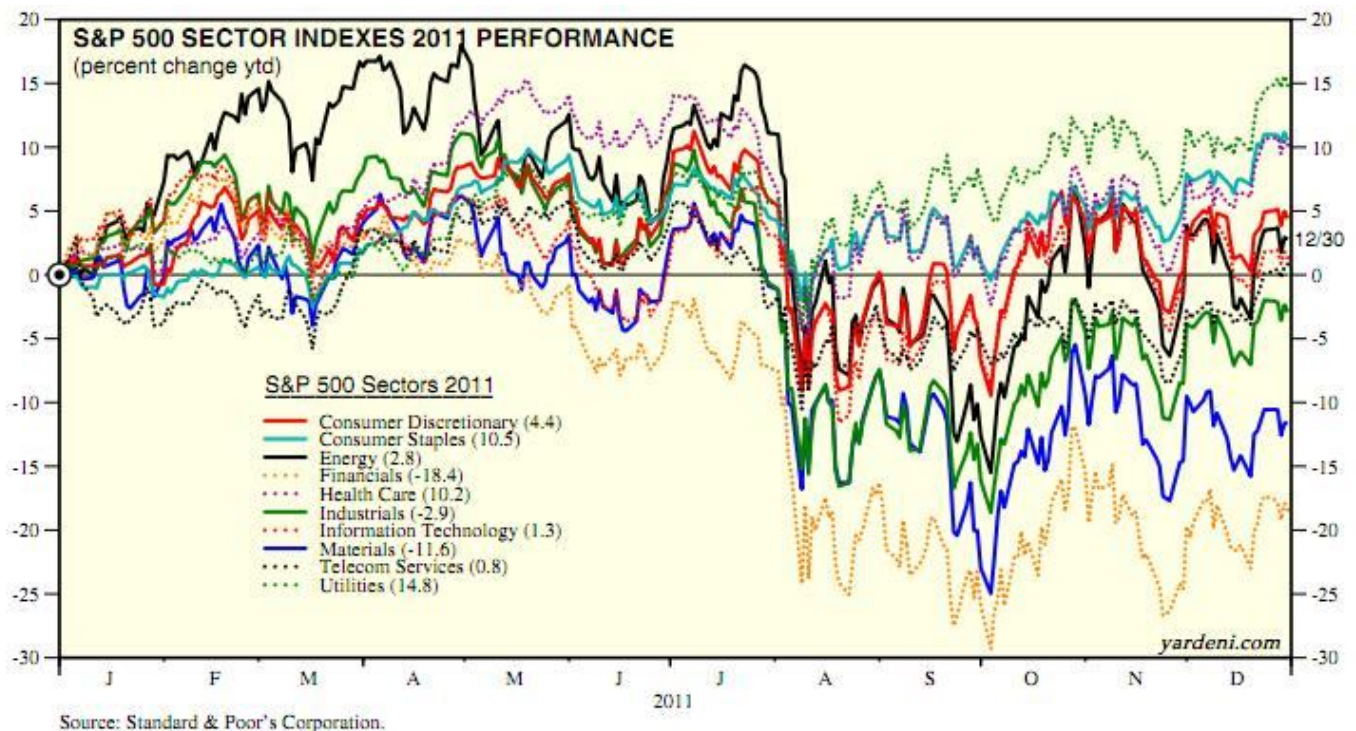


Given the barrage of bad news in the second half of 2011, it is impressive that the S&P 500 ended the year close to unchanged (up 2% counting dividends). Large-capitalization U.S. stocks, particularly defensive, dividend-paying stocks, proved to be the safe haven in global equity markets in 2011. As a result, the S&P 500 was a tough benchmark to beat. The majority of stock market investors underperformed the S&P 500, including approximately three-quarters of professional U.S. equity managers.

Most foreign stock indexes suffered declines of between 10% and 20%. The MSCI All-Country World Index (Ex. U.S.) lost 13.7%. In the U.S., the Russell 2000, an index of small-cap stocks, lost 4.2%. Within the S&P 500, there was a large disparity in sector performance. The defensive sectors - utilities, consumer staples, and healthcare - all managed to post double-digit positive returns. The worst performing sectors were financials (dragged down by the big banks), materials, and industrials.



### ECB Cranks Up The Printing Press

Markets in the second half of 2011 were held hostage to the continuing crisis and fear of systemic failure in Europe. The European Central Bank (ECB) resisted pressure to adopt an explicit policy of monetizing government debt on a large scale, such as the *quantitative easing* operations executed by the U.S. Federal Reserve. But in recent weeks, the ECB has implemented an *indirect* form of quantitative easing, which could backstop the European financial system for a period of time.

Through its *Long Term Refinancing Operation (LTRO)* program, the ECB has committed to provide virtually unlimited funding to European banks at a very low rate of 1%, which is far below the cost of private market financing. At present, the program consists of two major, three-year bank refinancing operations. The first recapitalization occurred on December 21, and the second will take place on February 28, 2012. The scale of the December 21<sup>st</sup> recapitalization was impressive. In one day, the ECB infused 489 billion euros (the equivalent of about US\$630 billion) into European banks. Approximately 193 billion euros (the equivalent of about US\$250 billion) constituted newly printed money, while the remainder replaced existing credit facilities.

In addition to recapitalizing the banks with cheap, three-year funding, the hope is that the banks will in turn finance European sovereign debt markets, and allow governments to roll US \$1 trillion of debt in 2012. The LTRO program highlights the interdependence of banks and over-indebted governments, and the degree to which both are dependent on central bank support. While the program certainly addresses bank funding issues, it remains to be seen how effective it will be in shoring up sovereign debt markets and buying time for governments to implement fiscal and economic reforms.

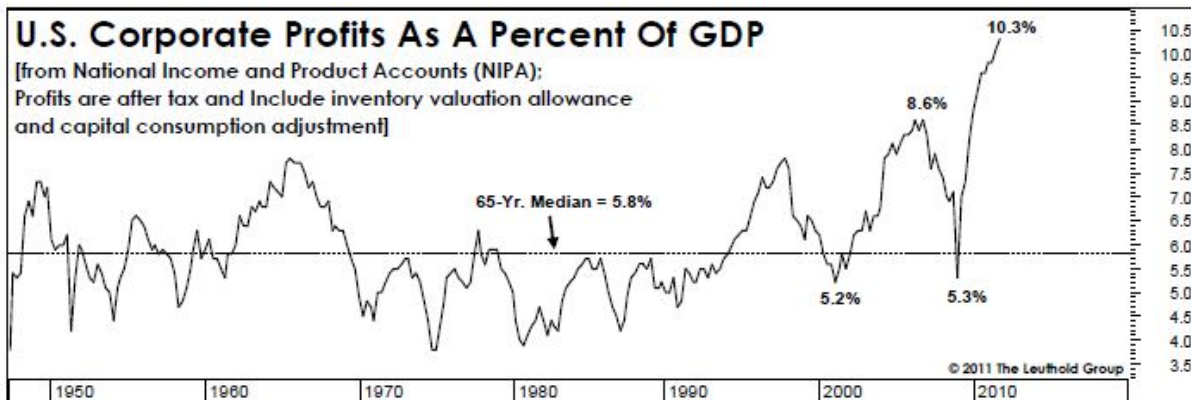
There are far too many moving parts and unpredictable variables to predict how the European crisis will play out in 2012. The sovereign debt crisis in Europe may have crossed a tipping point and could be headed towards a crescendo in the year ahead. Several countries already have unserviceable debt structures, and the contagion could spread to additional countries, depending on how their economies perform and how the market prices their debt. We learned in 2011 how quickly the market's perception of a county's solvency can change when a crisis of confidence takes hold. The European debt crisis will remain a major storyline in 2012. Investors should be prepared for the eventual prospect of some number of sovereign debt defaults and countries that exit the European Monetary Union.

The Economy In 2012

Another area of immediate concern has been the slowing global economy and the prospect of recession in the U.S. The consensus view on Wall Street is that the U.S. economy is not in imminent danger of relapsing into recession. I remain worried about the economy in 2012. The *Economic Cycle Research Institute (ECRI)* has not backed away from the recession call it issued on September 30. ECRI's leading indicators, which have an excellent forecasting record, continue to signal recession. ECRI expects the U.S. economy to be in recession in the first half of 2012. We will know soon enough whether ECRI is right or wrong. For now, it is fair to say the jury is still out.

It is difficult to identify sources of economic growth in 2012. Real disposable income is down over the past year due to a weak economy, higher consumer prices, and rising taxes at the state and local level, so consumption is unlikely to be a source of growth. Because people have tried to maintain their spending levels, the personal savings rate has fallen to 3.5%, from 5.5% just six months ago. The decline in the savings rate bolstered spending in the second half of 2011, but the savings rate is unlikely to fall further. Capital spending and manufacturing activity were supported in 2011 by 100% accelerated depreciation on capital equipment. This short-term tax break expired at the end of the year, so new manufacturing orders are likely to fall in 2012, at least in the early part of the year. Exports are under pressure due to a weaker global economy and a stronger U.S. dollar. Lastly, the economy remains dependent on unsustainable trillion dollar annual federal deficits. Businesses and consumers increasingly recognize that this gross imbalance cannot continue and are likely to be cautious until the direction of fiscal policy becomes clearer, which will not happen until after the 2012 election.

Corporate earnings preannouncements in the fourth quarter of 2011 reflected a weakening economic backdrop. The ratio of negative to positive earnings preannouncements issued by S&P 500 corporations has been nearly 4 to 1. Corporate earnings in 2012 could turn out to be a negative surprise for the markets. The consensus expectation on Wall Street is that earnings will grow 7% to 10% next year, which seems far too optimistic. It is possible earnings will *decline* next year, due to a weak global economy and pressure on profit margins, which are currently at record levels and appear unsustainably high.



### 2012 Market Outlook

Navigating the financial markets for much of 2011 was like driving in a dense fog. In such conditions, when you don't really know what lies ahead, but you know there are major potential hazards, it is wise to proceed with caution. I think the environment in 2012 will remain challenging and highly uncertain. A multi-decade global credit bubble has reached a critical juncture characterized by fragility, unpredictability and increasingly desperate central banking and monetary policy. In addition to the troubling macroeconomic and monetary issues confronting investors, geopolitical tensions in the Middle East continue to rise, and the possibility of a military confrontation with Iran is growing. U.S. markets are obviously going to be heavily influenced by the presidential election, with all the accompanying partisanship and posturing. Against this backdrop, nothing constructive should be expected from Washington in 2012, leaving us with confidence-draining debt accumulation, gridlock, and policy uncertainty.

I suspect we are still a year or two away from the start of a more hospitable environment for long-term stock market investors, which will coincide with tangible progress towards policies that fundamentally address the debt crisis. My market outlook is admittedly colored by strong views about fiscal responsibility and monetary debasement for the purpose of bailing out banks and governments. Europe's debt problems have received most of the attention in recent months, but the state of U.S. government finances remains a major concern. I am surprised by the degree to which U.S. Treasury bonds have been considered a safe haven, given that we have done virtually nothing to address our fiscal imbalances and we have the most aggressively inflationary major central bank in the world. Our staggering current deficits are adding to the debt problem faster than the Fed can inflate it away!

Federal Reserve policy is a wildcard in the 2012 outlook, and we will respond to developments as they come. Two ideas appear to be on the table at the Fed: (1) signal to the markets that short-term interest rates could remain at zero for even longer than mid-2013 (the current timeline), and (2) restart the controversial "quantitative easing" (QE) program, which involves purchasing bonds with newly printed money. The prospect of another QE program will depend on what happens in the economy and markets in the coming months. One disturbing prospect under consideration is that the Fed could launch an open-ended QE program (i.e. a program without a defined size or timeline) that would be tied to a target for nominal GDP growth or the unemployment rate.

Based on cyclically-adjusted P/E ratios, stocks are reasonably priced, generally speaking, relative to history. But the problems and risks are very large, so it is easy to imagine stocks becoming cheaper. There are no obvious bargains among asset classes. Zero percent short term interest rates will continue to distort asset prices. Diversification, flexibility, and a healthy reserve of liquidity seem to be the best approach in this environment.

## Market Comment

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Given my cautious market outlook, our portfolios carry somewhat below normal stock market exposure. Our bias towards dividend-oriented stock ETFs was a bright spot in portfolios in 2011, and we are sticking with that theme, although I worry about it being too popular and perhaps overplayed in certain sectors. We are also sticking with our positions in gold, which rose for an 11<sup>th</sup> consecutive year, despite a deep correction since the August peak. The bullish fundamentals have not changed for gold. If anything, they have been reinforced in recent months as a result of reflationary actions by the major global central banks (e.g. the ECB's LTRO program, U.S. dollar swap lines to European banks, easing by the Bank of China, etc.) All indications point to more debasement of paper currencies in 2012. With gold back below \$1600, the risk/reward is attractive, and I anticipate a healthy positive return in 2012.



In addition to core positions in equities and gold, our managed portfolios also include allocations to agricultural commodities; investment grade corporate bonds (and municipal bonds where appropriate); emerging markets bonds; energy stocks; energy infrastructure MLPs (pipelines); and absolute return/hedged strategies. This last category consists of mutual funds, rather than ETFs, and includes hedged stock, bond and commodity strategies. Our foremost portfolio objective in this environment to be well diversified, manage risk, and be able to navigate a wide range of potential outcomes. Given all of the cross-currents, a range of 1000 to 1400 on the S&P 500 is conceivable in 2012. We aspire in 2012 to filter out the “noise” of shorter-term volatility and identify and capitalize on overbought and oversold extremes, and extremes in optimism and pessimism.

I wish clients and readers a very successful (in all ways) 2012!

## Asset Class Returns

<b>Broad Equity Index Performance, Ranked by Year to Date Total Return</b>							
<b>Through December 30, 2011</b>							
<b>Asset Class</b>	<b>Representative Index</b>	<b>December</b>	<b>Year to</b>				
			<b>Date</b>	<b>Annualized</b>			
				<b>1-year</b>	<b>3-year</b>	<b>5-year</b>	
U.S. Large Cap Stocks	S&P 500	1.0%	2.1%	2.1%	14.7%	-0.3%	
U.S. Small Cap Stocks	S&P SmallCap 600	1.3%	1.0%	-0.1%	18.2%	1.9%	
U.S. Mid Cap Stocks	S&P MidCap 400	-0.4%	-1.7%	-2.4%	20.6%	3.3%	
Foreign Large Cap Stocks	MSCI EAFE	-1.0%	-12.1%	-11.7%	7.4%	-4.7%	
Foreign Small Cap Stocks	MSCI EAFE Small Cap	-1.9%	-15.9%	-15.0%	14.4%	-4.1%	
Emerging Markets Stocks	MSCI Emerging Markets	-1.2%	-18.4%	-18.0%	20.2%	2.4%	

<b>Fixed Income Index Performance, Ranked by Year to Date Total Return</b>							
<b>Through December 30, 2011</b>							
<b>Asset Class</b>	<b>Representative Index</b>	<b>December</b>	<b>Year to</b>				
			<b>Date</b>	<b>Annualized</b>			
				<b>1-year</b>	<b>3-year</b>	<b>5-year</b>	
Intermediate Term Treasuries	Barclays Capital 7-10 Year Treasury	1.8%	15.6%	16.2%	5.5%	9.1%	
Inflation Protected Bonds	Barclays Capital U.S. Treasury TIPS	0.0%	13.6%	14.1%	10.0%	8.0%	
Municipal Bonds	S&P National Municipal Bond	2.0%	11.2%	11.2%	8.6%	n/a	
Intermediate Term Corporates	iBoxx \$ Liquid Investment Grade	2.7%	9.2%	9.5%	10.7%	7.2%	
Emerging Markets Bonds	JPMorgan EMBI Global Core	1.2%	8.0%	8.1%	16.0%	n/a	
Broad U.S. Bond Market	Barclays Capital U.S. Aggregate	1.1%	7.8%	8.2%	6.7%	6.5%	
Agency Mortgage Backed Bonds	Barclays Capital U.S. MBS	0.7%	6.2%	6.6%	5.9%	6.5%	
High Yield Corporates	iBoxx \$ Liquid High Yield	3.7%	5.9%	6.1%	20.0%	6.1%	
Short Term Corporates	Barclays Capital 1-3 Year U.S. Credit	0.2%	1.8%	1.9%	5.8%	4.7%	
Short Term Treasuries	Barclays Capital 1-3 Year Treasury	0.1%	1.6%	1.6%	1.6%	3.7%	
T-Bills	Barclays Capital Short U.S. Treasury	0.0%	0.2%	0.2%	0.3%	1.8%	
Foreign Government Bonds	S&P/Citigroup Int'l Treasury	0.0%	-0.1%	1.0%	2.1%	n/a	
Foreign Gov't Bonds Short Term	S&P/Citigroup Int'l Treasury 1-3 Yr	-1.5%	-2.7%	-1.7%	1.2%	n/a	

<b>Alternative Investments Index Performance, Ranked by Year to Date Total Return</b>							
<b>Through December 30, 2011</b>							
<b>Asset Class</b>	<b>Representative Index</b>	<b>December</b>	<b>Year to</b>				
			<b>Date</b>	<b>Annualized</b>			
				<b>1-year</b>	<b>3-year</b>	<b>5-year</b>	
Gold	London Gold PM Fix Price	-12.3%	8.9%	8.9%	20.7%	19.4%	
U.S. REITs	Dow Jones U.S. Real Estate	4.1%	6.1%	5.7%	22.7%	-2.9%	
Natural Resources Stocks	S&P North America Nat. Resources	-4.5%	-7.4%	-7.2%	17.0%	4.0%	
Diversified Commodities	Dow Jones-UBS	-3.6%	-13.4%	-13.4%	n/a	n/a	
Foreign Real Estate	S&P World Ex-US Property	-2.0%	-15.3%	-14.8%	12.2%	-7.8%	