



Fourth Quarter Commentary



OUR INVESTMENT PHILOSOPHY

MINIMIZE COSTS

Since taxes and transaction costs are every investor's largest expense, we minimize tax liability while utilizing low and no-cost investment vehicles.

PORTFOLIO CONSTRUCTION

Proper asset allocation is essential to aligning your investments with your objectives, time horizon and risk tolerance. Proper diversification within asset classes can reduce volatility and manage risk.

INDEX INVESTING

We adhere to a prudent, proven and profitable investment strategy known as index investing. We are not stock pickers, market-timers or active traders.

STRATEGIC MANAGEMENT

We seek to identify macro trends and invest accordingly.

Year in Review

If you were away from the planet for the past year, you would be excused for assuming nothing significant had happened in 2011; the S&P 500 finished the year at exactly the same level as it started. As you know, 2011 was anything but boring in the geopolitical and financial departments. The past year was fairly typical in some ways and quite unique in others. The domestic stock market had a very typical year in that we had some rallies, a 15% decline, and a lot of geopolitical uncertainty. It was a very unique year in that nearly half of the trading days saw market moves in excess of 1%. Many of those moves were in the opposite direction on consecutive days! It is these types of years that test investors' stomachs and allow us to earn our stripes.

Evaluating ourselves over the past year has been very enlightening. We entered 2011 with above-average cash positions, which we implemented into the run-up during the spring and early summer. As summer approached, we rotated into safer, larger-cap stocks as well as dividend-payers. Perhaps our best move of the year was to have taken a fair amount of risk and profits off the table, prior to the markets' mid-summer meltdown. We sold all of our "high yield bond" ETFs and "preferred stock" ETFs when we concluded that the downside risk outweighed the upside potential in these specific holdings. On the other hand, we wished we had better estimated the magnitude of the correlation effects that the European debt crisis would have on other developed markets around the world.

We have not had any European holdings since the spring of 2010, but have maintained international exposure in countries with strong fundamentals and solid balance sheets, such as Canada, Australia, and Korea. However, these markets sold-off considerably in the wake of Europe's credit crisis, as investors dumped international holdings indiscriminately during the panicked selling of 2011. This had an adverse effect on our equity performance for 2011.

Outlook and Risks

Since late-spring of 2009, we have consistently called for a slow and steady (and sometimes) painful recovery. When economic indicators signaled slowing growth in 2011, our research indicated the domestic economy would reaccelerate. The US economy has indeed picked up, although it continues to be slow and fragile. We expect a continued bumpy, but steady recovery in the US. Overseas, Europe is slowing quickly and will likely experience a recession in 2012. This will slow global growth, which the export-centric emerging markets are heavily reliant upon. The silver lining is that inflation is decreasing in many emerging markets, which should boost domestic demand in their respective economies. The real question regarding our 2012 market outlook is: will corporate earnings continue to climb or will global issues pull them down?

Like any other household, business, or government, European economies will be depressed for some time as they pay off the debt from past excesses.



Although each nation is facing a unique set of economic difficulties and market pressures, most economists predict that the coming austerity measures will pull most of Europe into a recession this year. Since this is economists' consensus, we believe the markets have already priced this in. However, a deeper-than-expected recession would adversely affect corporate profits more than currently anticipated. Furthermore, any currency fragmentation within the Eurozone would precipitate a panic in the financial markets; an unlikely event, in our view, but the possibility of it occurring is enough that we need to monitor and perhaps anticipate such an event.

In our view, the biggest question mark for 2012 will be the degree and effects of a Chinese slowdown. A European recession would almost certainly hurt Chinese exports, while the deflating property bubble will likely depress China's domestic demand. Between the opacity of official Chinese economic data, the complexities surrounding the Renminbi and monetary policy, the inability to predict the breadth or depth of a European recession or Chinese property bust, it is anyone's guess what will happen in China this year. Obviously, just like the US or Europe recently, China's future will largely be determined

by the actions and reactions of its' central government.

As we have said before, no one has a crystal ball. Who could have predicted the so-called Arab Spring, the Japanese earthquake and tsunami, or the utter failure of our legislators (okay, maybe you could have predicted that one). Despite what we know and can anticipate, there are forces that are beyond our control. Thus, we continue to use asset allocation to manage risk and capture returns. Although various portfolios held different investments, the primary determinant of risk and return was asset allocation.

Clients in Core or Balanced Portfolio

You may have noticed that your account is holding a relatively high cash position, and it's something worth elaborating on. The cash positions we hold are in lieu of bonds and do not materially change the equity allocation we have in each portfolio. We continue to manage each portfolio with a target asset allocation. For Core, we aim for 60% stocks and 40% bonds/cash; Balanced is 50% stocks, 50% bonds/cash.

As you probably know, interest rates from the very short-term all the way out to thirty years are at historic lows. What you might not know is that bonds lose value when rates rise. The longer the maturity,

the more a bond stands to lose when rates rise. Given this dynamic, we are extremely reluctant to hold anything other than short-term bonds, especially given that today's low yields are not ample reward for taking the risk. We are forgoing some return in the form of interest payments (and appreciation if rates fall further), but we are unwilling to chase this riskier return. This is why we would rather hold cash than bonds at the moment.

Final Words

We continue to wrestle with what the true market risks are, but at the same time believe the stock market has priced-in most of the dire economic news. Our objective remains the same which is to manage the risk and reward of each investment so that it will endure the market's bumpy and sometimes scary ride. During the last few years, our clients have recognized how important it is to have a proper financial plan in place. By having a financial plan and annual reviews, we can ensure your finances are aligned with your future goals, and it also allows you to make prudent choices during volatile times like these few years.

We wish you a healthy and safe new year.

Sincerely,

Your MFA team