

Investment Update



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WEALTH MANAGEMENT

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Turning the Page

To an investor returning from the proverbial deserted island, a cursory scan of financial markets and economic news might indicate that not much had changed in 2011. Given our ending point, it would be reasonable to presume that it was a year of light drama and low volatility. Those of us possibly wishing to trade places with this returnee — not just for the warmer climes — know otherwise. This last year was incredibly challenging for active investors. For this reason, while these *Updates* typically outline our forward-looking thoughts, it may prove instructive this time to take a closer look at the recent past. It is particularly important to understand the factors that contributed to a year that, in reality, was anything but smooth.

In our *2020 Vision: The Most Critical Decade* communications and in prior issues of this *Update*, we set forth issues that we thought would dominate economies and markets. Specifically, we suggested that lower and more volatile trend economic growth — stemming from multiple headwinds of consumer deleveraging, risk of policy errors and unsustainable government spending — would contribute to more volatile capital markets. Some readers have commented that these ideas were prescient given how greatly they dominated the 2011 landscape. In truth, we had expected these underlying factors to unfold over a longer period of time. We did not think they would be as pronounced or as concentrated as they were last year. Despite some bright spots, 2011

generally proved quite challenging and we are glad to see it in the rear-view mirror.

Reluctant Recovery/ Accidental Austerity

Like many investors, we embarked on the year expecting moderate economic growth from developed economies including the U.S., with stronger growth in emerging economies. This environment was anticipated to deliver strong profit growth, modestly rising interest rates and generally favorable conditions for risk assets. The fact that this view was ultimately born out is of little comfort, however, given the way the year unfolded.

Right out of the gates, terrible winter weather and the tsunami in Japan, with the accompanying risk of nuclear meltdown and supply disruptions, interrupted the benign outlook. Natural disasters then took a back seat to those man-made in nature. There was the debt ceiling “debate” and brinkmanship over potential U.S. default, resulting in the ratings downgrade on U.S. debt. In hindsight, this debacle paled in comparison to the inaction and unwillingness of European policy makers to contain, stem or even slow their debt crisis. Example after example reflected the failure of political will, even where there was a way. At the same time, policy makers in fast-growing emerging economies had to fight higher-than-expected inflation with tighter monetary policy. This, in turn, created challenges for equities in these regions.

The unfolding of last year’s events caused investors to lurch from risk-on to risk-off, as crisis reactions vacillated between fears of imminent collapse interspersed with moments of relief. On the economic front, expectations that the U.S. would avoid recession and experience even modest growth were sorely tested.

The conflux of these events yielded markets where the average stock performed far worse than the indices themselves. While the market-capitalization-weighted S&P 500 ended the year about flat, for instance, the equal-weighted Value Line Composite was down nearly 10%. Correlations between individual stocks and the entire market hit generational highs. Macro-political risks dominated markets, relegating fundamental analysis to the background. A focus on security selection went mostly unrewarded. Strong investor preference for safety and yield pushed numerous stocks occupying these sectors to levels many active managers felt were unwarranted.

In fixed income, expectations for moderately higher yields and an assessment, coming into the year, that Treasury yields were already unattractive resulted in many managers being more concentrated in shorter maturity bonds and underweighted in Treasury securities. The same factors noted above caused longer maturity Treasuries to be one of the top-performing asset classes of the year. Ten-year Treasuries were up by over 15%, with 30-year Treasuries up much more.

The extreme nature of events in 2011 relative to expectations and portfolio positioning caused active managers almost across the board to underperform their benchmarks, sometimes significantly. As of the end of November, despite some variations within asset classes, the indexes overall outperformed more than 80% of the investment managers in their respective peer groups.

While it is important to remember that each portfolio is unique and our recommendations need to be considered in light of individual clients' goals and circumstances, our asset allocation guidance yielded some bright spots as well as some challenges. A recommended emphasis on U.S. high quality, large cap companies, especially those of dividend paying companies, was helpful. Also, suggested underweighted allocations to smaller cap companies proved beneficial, as investors' risk appetites diminished and riskier asset classes suffered. An underweight to developed international equities also was directionally helpful. In the fixed income space, our confidence in carefully selected municipal bonds was rewarded, especially in light of the very negative headlines coming into the year.

However, these positives were offset by a number of issues. The most notable was our active managers' short-term underperformance relative to the indexes. Much of this was concentrated in the third quarter, notably from late July to late August. In several instances, these managers had their worst recorded quarter of relative performance. Our recommended overweight to emerging market equities, which fell under the combined weight of risk aversion, policy tightening and fears of significant future economic slowdown, also detracted from

performance. Our recommended underweight to fixed income in general, and Treasury bonds specifically, also proved a negative in the short term, as fear and uncertainty placed a premium on this asset class. Finally, some of the solutions we employed for purposes of diversification, potential downside protection or incremental return did not offer immediate benefits over much of 2011.

Although we are disappointed with last year's relative performance, it is important for investors to view these results in context of the longer-term. Market reaction to short-term macroeconomic news and events is often driven by extreme swings in sentiment, sometimes irrationally so. We continue to think it is more important to base our decision making on careful and thorough analysis, due diligence and disciplined adherence to strategy. However, in volatile markets, we believe that a time-tested, disciplined approach that relies on forward-looking market insights and opportunistic diversification strategies is particularly critical to helping investors navigate uncertainty and uncover opportunities over the longer term. While not immediately rewarded, we feel the actions we took were strategically sound, and should pay off over the long term. At the same time, we recognize the need to remain nimble and to be able to change as the future unfolds.

Hitting the Reset Button?

We will explore our outlook for 2012 in greater detail next month, but do not expect that 2012 will be a carbon copy of 2011. Despite entering the year with seemingly similar consensus expectations by economists and strategists, investors' expectations are lower. Thanks in part to recent dramatic

events, recognition of current market risks is greater while arguably some progress is beginning to be made against them. We think asset prices are more reflective of the focus on risk, rather than on areas of improvement, which by itself should provide some important opportunities.

While the U.S. economy shows signs of strengthening, it will not be able to completely avoid the gravitational pull of a weakening Europe. Prospects for emerging markets may improve as global inflation appears to be decelerating, allowing for more accommodative monetary policy. We expect a moderate U.S. economic growth, a mild European recession, and an economic soft landing by China.

However, we recognize — in this challenging decade — any base case must leave room for negative surprises. For this reason, we are not yet ready to move more towards risk assets despite the relative attractiveness of their valuation. Also, we think investors should consider, when looking forward, that what may offer an appropriate degree of safety, yield, growth or relative performance are not likely to be the same sources as last year. Selling the things that did not work and moving into those that already have has not been a successful strategy over the long term, and we don't expect that it will be in 2012 or beyond. In the short term, as witnessed in 2011, near-term factors can sometimes eclipse valuation or fundamentals. But over a longer period of time, discipline, good process and sound judgment will prevail.



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