

2012: THE ROAD AHEAD

EXECUTIVE SUMMARY

After a year of disappointing economic growth, meager stock market returns, and an intense global focus on sovereign debt levels and fiscal policy, 2012 is now shaping up to be a pivotal period for the current expansion. Recent economic data has pointed to better growth late in 2011, but some leading indicators suggest that this recent improvement may prove fleeting. The U.S. economy has been growing at a moderate pace, but the developed economies of Europe and Japan appear to be at the cusp of a recession, while other major countries such as China have been slowing. With a global slowdown well underway, it may be difficult for the U.S. economy to sustainably accelerate from here, causing the risk of a recession in the U.S. to rise.

In this environment, we believe that policymakers hold the key to navigating the next phase of the market cycle and addressing many of the sources of uncertainty. Monetary policy has remained very accommodative and the Fed remains active in its efforts to lower long-term interest rates and provide stimulus, which is positive for the economy and capital markets. Fiscal policy in Washington remains mired in disagreement about the role of federal spending vs. tax policy in how to best address the federal deficit. Whether in the U.S., Europe, or elsewhere around the globe, we anticipate that the need for leadership in fiscal policymaking will become increasingly important.

Given the significant structural issues that remain unresolved, we anticipate that 2012 is likely to be another volatile year in the capital markets. Capital market returns may ultimately be driven as much by whether or not confidence returns to the market as they are by the economic growth outlook, asset class valuations, and market fundamentals. In this environment, remaining committed to broad diversification within the context of one's strategic asset allocation, while making tactical changes geared toward reducing risk and/or enhancing returns, should allow investors to effectively navigate 2012 and beyond.

2011: A LOOK BACK

Each year, many market prognosticators put forth their views for the year ahead. Some focus on broad themes, while others may even forecast a closing level for a major market index such as the Dow Jones or the S&P 500 for the end of the year. In general, we feel that the precision implied by predicting a definitive index level on a

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specific date in the future is dubious at best. It would be easy to back into a projected index level based on certain assumptions, but the dynamics of the capital markets can and do change rapidly, particularly in an environment prone to the degree of uncertainty that has defined the past few years. Moreover, it's not clear to us what value that would provide,

given that most investors have an investment time horizon that extends well beyond one year.

As such, while we prepare this "Road Ahead" commentary annually, we prefer to look out over a multiyear period. While market volatility is driven by the short-term ebb and flow of economic data, policy decisions, and sometimes just rumors, long-term results tend to be much more closely influenced by durable fundamentals and discernible trends. As a matter of practice, the investment industry evaluates and reports investment results over comparatively short timeframes. As an investor, however, it's important to not fixate on results from a single quarter or year to the point that one loses sight of long-term results, which is ultimately much more important. A single year doesn't always tell the story. Similarly, 2011 was not a story unto itself, but the next act in the global economic story arc that began in 2007, if not before.

While some conditions build up over a period of many years or even decades, there are always "wild cards" that cannot be foreseen. Early in 2011, two wild card events occurred that had repercussions across the global economy. The first was the "Arab Spring" uprisings across much of the Middle East and North Africa. The unrest toppled regimes and further ratcheted up tensions in a region that has been historically

defined by relative instability. It also created anxiety about potential disruptions in the critical flow of oil, causing prices to spike. Coupled with what was relatively robust demand for other commodities, the uptick in oil prices helped to drive inflation higher through the first half of the year. The second wild card occurred shortly thereafter, when a severe earthquake struck off the coast of Tohoku, Japan, generating a tsunami that in turn caused further disaster at the nation's Fukushima Daiichi nuclear power plant. Beyond the sheer human toll of the tragedy, the resulting disruption in manufacturing activity in the region created a disruptive ripple effect in the global supply chain that cascaded through the industrial sector.

Two of the biggest market and economic stories of the year, however, were not wild cards, but arguably the next phase of the fiscal imbalance storyline that has been unfolding across the developed world over the past few years. On August 5, Standard & Poor's formally announced that it was downgrading U.S. Treasury debt. The downgrade, which was announced shortly after Congress reached a highly contentious eleventh-hour deal to raise the nation's debt rating, was a first for the United States, which had never previously had its sterling AAA credit rating cut. In its comments, S&P specifically noted that the decision reflected its view

that “the effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges.” Put simply, the decision didn’t result just from the U.S. borrowing too much, but from the rising risk that those with the power to address the nation’s fiscal imbalances lacked the will to do so.

The fiscal issues of the U.S. pale in comparison to those plaguing Europe, where policymakers appear to rapidly be approaching a point at which “kicking the can down the road” may no longer be an option. What first emerged as a Greek debt crisis spread well beyond Greece, drawing in other fiscally weakened members of the Eurozone to varying degrees. As developments accelerated late in the year, efforts to find a solution intensified. While a final resolution has not been reached, there is a sense that policymakers recognize the gravity of the situation and are committed to finding a workable solution. The recent decision by the European Central Bank to extend credit to European banks for up to three years was a positive development that helped to ease pressure on banks and alleviated fear of further near-term deterioration into a credit crisis. Nonetheless, lingering questions still exist. Will policymakers have the courage and conviction to act decisively to finally get out in front of the rapidly evolving crisis? Will voters in affected countries — and not just the political class — also

recognize the scale of the problem and support the painful policy decisions that may be needed? Will leaders be successful in their efforts to implement a more unified fiscal union? Will the Eurozone still exist in its current form in the years ahead? While market observers may have different views on the ultimate resolution to the crisis, no one believes the path ahead will be an easy one for the parties involved.

Despite these troubles, the U.S. corporate sector continued to do an outstanding job of strengthening balance sheets and improving profit margins. Profit per share of the S&P 500 is once again higher than at the previous peak in 2007, and profit margins are approaching their highest levels on record. Companies are lean, are carrying lower amounts of leverage, and continue to deliver results to shareholders that have surprised to the upside.

Against this backdrop, capital markets were again quite volatile in 2011. The equity markets ground slowly higher through the first half of the year, peaking in May before the sharp selloff that began in late July drove indexes well into negative territory for the year. The fourth quarter was largely kind to investors, as October returns for the S&P were the best monthly results in nearly 20 years, sufficient to drive positive fourth-quarter performance. Despite the late rally, and the excellent increase in earnings per share, U.S. stock market returns for the year were

flat, as investors decided that these higher earnings should not be rewarded with similar or higher price/earnings ratios. In fact, had 2012 earnings been priced at the historical average of 16 times earnings, the S&P 500 would be priced closer to 1600 today, rather than the year-end level of 1258. The lack of investor confidence has clearly weighed on P/E ratios while putting a lid on stock market performance. International markets were generally down, with higher than normal volatility around the globe.

At the same time, the fixed income market faced its own issues. Concerns about municipal default risk, the S&P Treasury downgrade, and the widening sovereign debt crisis were all major considerations. Early in the year the primary risk envisioned by investors was that of rising interest rates, although that risk proved toothless as the year progressed. Defying investors and market experts alike, Treasuries (especially long-term Treasuries) were the story as the European debt crisis widened and a global flight to quality again proved that the U.S. dollar (and Treasuries) still represents the “best house on a bad block.” There is no question that the risk posed by rising rates still exists and will pose a challenge for fixed income investors at some point down the road. Positive returns on long-term Treasuries and municipal bonds — both of which entered the year in a mostly negative light — are a great reminder that the market will

surprise not only to the downside, but also to the upside.

2011 will not be remembered as a year characterized by confidence, optimism, or favorable market conditions. The echoes of

the year's events will reverberate for some time, just as the fiscal crises of today were in part a result of the policy decisions made to combat the "Great Recession." The story that continues to unfold

didn't begin in 2011, and, while 2012 will begin the next chapter, it will take years to fully address the many imbalances that exist. Nonetheless, that final chapter will have to wait for another day.

2012: TRANSITION AND OPPORTUNITIES

As we turn the final pages on 2011 and look toward 2012, it is ironic to note that there is less optimism about the economic outlook for the next 12 months than was the case a year ago. A year ago, there was relief that the U.S. had successfully avoided a feared double-dip recession. There was a broad sense of relative optimism that the economy was poised to

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accelerate, perhaps even growing near the historically average 3.0-3.5% rate. That optimism was short-lived, as the economy stumbled early on, growing at less than 1% annualized in the first half of the year. Despite some improvement on the strength of better consumer spending in the second half, it appears that the economy grew at a disappointing pace of about 1.5% for the year.

The outlook for the next year may be just as unclear, but it is certainly less sanguine. Today, optimistic forecasts call for sub-par growth, while some forecasts are calling for a recession in the first half of the year. In recent months, alarm bells have again been ringing, as some leading indicators suggest that the potential risk of the economy stumbling in 2012 has risen considerably. Nonetheless, some recent data has been surprisingly positive, particularly related to

the jobs market. In the final two months of the year, the nation's unemployment rate dropped unexpectedly by 0.5% to 8.5%, while weekly jobless claims also eased. At the same time, improving consumer sentiment is buoying hopes that spending will follow. This data was encouraging, and economists and investors alike will be watching closely over the next few months to determine whether these positive results can build further momentum or not. There is still a great deal of anxiety that the economy may again stall out from its already slow growth pace, an understandable skepticism given the pattern over the past few years. The fact that this is a real risk less than three years after the end of the Great Recession that ended in June 2009 is not only telling, but indicative of a different environment than Americans had grown accustomed to in recent decades.

From 1982-2007, the economy was defined by three lengthy expansions averaging nearly eight years in length, punctuated by two relatively short and shallow contractions (1990-1991, 2001) that lasted only eight months each. That trend was abruptly halted by the Great Recession, which was deep and prolonged, and the slow recovery that has ensued. Certainly, the economy could surprise to the upside in 2012, but most economists are still calling for lackluster growth. If the economy does turn negative, such an event would not necessarily be as severe or protracted as the last recession. In fact, there is reason to believe that if a contraction occurs, it could be comparatively mild, given that some of the cyclical areas of the economy haven't fully recovered and are likely to hold up better than was the case in 2008 and

2009. Furthermore, the economy hasn't had years to build up excesses in the system, businesses remain relatively lean, and households are already working at paying down debt. Perhaps most importantly, the last recession was aggravated by a global credit and banking crisis. Today, policymakers around the world are focused on avoiding this outcome. Even though some leading indicators suggest that a recession may come, the downside may not be as severe as some fear.

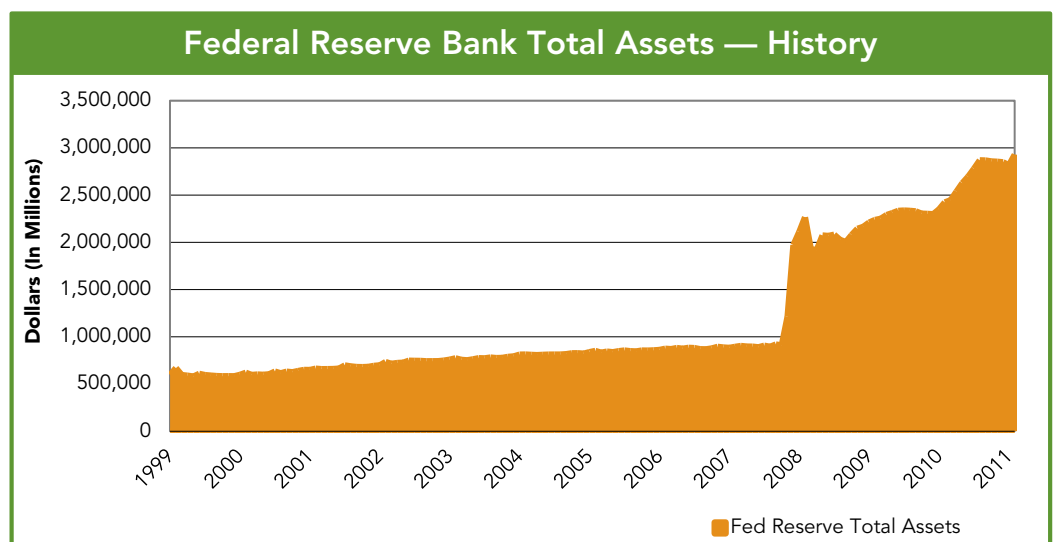
POLICYMAKERS HOLD THE KEY

Monetary policymakers have been particularly active in recent years, pushing beyond the bounds of traditional policy tools into uncharted territory. With short-term rates already exceptionally low, the Federal Reserve has resorted to various asset purchase programs to influence longer-term rates downward. Moreover, the Fed and other global central banks have taken steps to reduce systemic risk by ensuring that the global financial system has adequate liquidity.

Fiscal policy can provide a boost to the economy as well, but a lack of clarity around future fiscal policy also has the potential to create additional uncertainty and exacerbate the problems that already exist. Stimulative policies can come in many forms, but ultimately boil down to targeted spending programs or tax cuts, rebates, or holidays that put the coffers of the federal government to work. Despite providing a short-term boost to spending, temporary measures such as tax holidays or temporary credits are of very limited value in the long run. Policies that are likely to have a meaningful, sustained impact must be open-ended in nature, such as "permanently" setting tax rates and provisions, rather than

extending current policies for a brief period subject to expiration. Given the partisan divide in Washington, policymakers have found it increasingly difficult to find common ground on fiscal matters, driven by both genuine philosophical differences and campaign tactics in advance of the 2012 presidential and congressional elections.

Today, a multifaceted fiscal strategy is needed: one that incorporates a viable plan to reduce federal deficits over an intermediate timeframe while not putting the already fragile economy at immediate risk. That is a tall order, particularly for those eyeing re-election. Nonetheless, critical progress will be needed to avoid greater pain down the road. Look no further than the crisis in Europe to see what can happen when fiscal profligacy is allowed to persist unabated.



Source: PMFA, Bloomberg

In Europe, monetary and fiscal policy decisions today are increasingly intermingled. The European Central Bank, euro area member states, the European Financial Stability Facility, the International Monetary Fund, and sovereign partners outside the region are collectively working toward solutions to prevent the spread of the sovereign debt crisis, create a sense of stability, and develop a long-term strategy to institute fiscal discipline for member states, while stabilizing the European banking system. We anticipate the crisis in Europe will remain

center stage in 2012, with developments there impacting not only the outlook for Europe, but also reverberating throughout the global economy.

Even in China, which has been for some the definition of economic strength in recent years, policymakers are faced with many challenges. The secular transition from an agrarian to an increasingly industrial society requires that jobs continue to be created in industry, while the nation's internal consumer base

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gradually grows and develops. In March 2011, China formally acknowledged its drive to increase domestic consumption as part of the nation's Five-Year Plan. In the meantime, exports remain an important source of demand, even as American and European consumers have tightened their belts in recent years and may need to do so further. Their need to allow for only gradual appreciation in their currency, excessive inflationary pressures, and a seeming bubble in real estate create additional challenges for Chinese policymakers. While the growth in the Chinese economy over time has been remarkable and there is still a strong long-term story, China is not immune to economic challenges.

In short, the imbalances that exist have built up over an extended period, and policy challenges are not

limited to the U.S., but persist in different forms around the globe. In a global economy, events in Frankfurt, Paris, Athens, Rome, Tokyo, and Beijing matter not only to Wall Street, but Main Street. Nonetheless, history demonstrates that imbalances can and will persist for some time, while the global economy and capital markets advance. Opportunities for investors to profit still exist, even when the world is faced with significant challenges.

Investors should not underestimate the potential impact of both monetary and fiscal policy decisions in the U.S. and globally in 2012 and beyond. It's not unusual for policymakers to be behind the curve for some time, reacting to deterioration in confidence and overall capital market conditions. When policymakers disappoint, the markets can react harshly, as notably evidenced by the sharp August selloff, but also by the overall volatility of the markets through much of 2011. Likewise, policymakers can surprise the markets with unexpected and sometimes even aggressive moves that can be the spark for a sharp rally even when the outlook may look bleak.

In time, the pressure that is exerted will typically force policymakers to take more aggressive measures to get out in front of the problem. When that will happen and what form it will take is often difficult to foresee, but when it happens, the typically positive market response can be sharp, as asset prices adjust and the risk of the "worst-case scenario" diminishes. Thus, even with many sources of uncertainty yet to be resolved, markets can and do move quickly, creating the potential for sometimes surprisingly positive results.

CAPITAL MARKETS:

EXPECTATIONS FOR 2012 AND BEYOND

FIXED INCOME: LOW YIELDS PERSIST

As noted earlier, the expectation for better growth and rising inflationary pressures in 2011 led investors to believe that the primary risk was that of rising interest rates. Accordingly, being defensively positioned against that outcome by adding exposures to higher-yielding securities (e.g., corporate bonds and mortgage-backed securities) was widely viewed as a reasonable way to position a bond portfolio. Beyond defending against rising rates, this also provided for some sorely needed income in the face of historically low yields.

This positioning was reasonable given the market's expectations. However, weaker than expected economic data, the earthquake in Japan and related nuclear disaster, and the flare-up in the European debt crisis all contributed to a "risk off" mood for investors. Around mid-year, the Federal Reserve's quantitative easing program ended with the expectation that decreased demand (the removal of the Fed as the largest buyer of U.S. Treasuries) would lead to higher rates. Once again, a deterioration of conditions in Europe drove money from risk assets into Treasuries, pushing interest rates to record low levels. Investors even shrugged off S&P's downgrade of U.S. debt to AA+ and kept buying Treasuries. The Fed also announced further

easing in the form of "Operation Twist," which targeted the long end of the Treasury curve. This flight to quality and correspondingly lower yields was positive for portfolios with heavy allocations to U.S. Treasuries, while those with limited exposure to Treasuries, below benchmark duration, or allocations to lower quality bonds underperformed.

MIXED OUTLOOK FOR 2012

Looking forward, investors are likely to continue to find the upside for bonds (particularly high-quality issues) to be limited, as interest rates hover near historic lows. The debt burden of developed countries and the austerity measures required to alleviate the fiscal pressure will take some time to work out. These problems didn't arise over a short period, and will require an extended time to have a meaningful impact, contributing to a protracted period of slow growth. In the United States, slow growth prospects and the lack of fiscal resolve in Washington, D.C., suggest that current conditions (low yields and high volatility) are likely to persist for some time. Emerging markets are expected to grow more rapidly than developed countries, but at a slower pace than in recent years, as the effects of the slowdown in the developed economies trickle into those

economies that still rely heavily on exports. Given the low yield environment and the heightened risks to the global economy, fixed income managers will likely be focused on managing risk, while returns are likely to be very limited.

"Risk-free" U.S. Treasuries are most vulnerable to increases in yields but will perform well in periods when risk assets are out of favor. Despite stated concerns about the dollar and the U.S. fiscal situation, Treasuries remain the "safe haven" in times of crisis. However, given the absolute low levels of interest rates and the fact that Treasury yields are bound by 0%, an asymmetric risk/reward sce-

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nario has been created. In addition, negative real yields (nominal yields less inflation) on the front end of the yield curve make U.S. Treasuries even less compelling for investors. Nonetheless, on a

relative basis, Treasuries could outperform if investors conclude to continue to reduce portfolio risk in a global flight to quality.

The municipal bond market was one of the best performing sectors of 2011. Early in the year, municipalities rebounded from an autumn selloff after a noted Wall Street analyst projected that the municipal market would experience hundreds of billions of dollars in defaults. As the year progressed and this prediction did not come to fruition, investors benefitted from a recovery in prices to more normal levels. Defaults have been limited. Two fairly significant defaults did occur in 2011, as Har-

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risburg, Pa., and Jefferson County, Ala., each defaulted on debt issues. While these are noteworthy, both resulted from obligations beyond the “normal course of business” for most municipalities. We certainly do not trivialize the significance of any municipal defaults and understand that economic pressures continue to provide significant challenges for

municipal budgets. As such, we prefer municipal managers with deep experience and research resources and who focus on capital preservation. For 2012, the outlook of generally lower return expectations and a bias toward favoring high quality securities remains unchanged. Earlier in 2011, we prepared a more robust analysis of the municipal market. That research paper — “Municipal Bond Market Outlook: Stay the Course, but be Prudent” — is available at our website (www.pmfa.com).

Corporate bonds may offer some of the best opportunities for 2012. U.S. corporate bond spreads began the year near historically normal levels. But as the European debt crisis worsened near mid-year, investment-grade and high yield bonds yields rose to levels that have historically signaled long-term value. Despite this increased risk premium in bond pricing, corporate balance sheets have improved since the Great Recession, as efforts to refinance debt, cut expenses, and maintain leaner operations have preserved capital. Capital investment has been comparatively minimal due to economic uncertainty, while cash on corporate balance sheets has increased to record levels. This could serve as “dry powder” for capital investment or provide a cushion in the event of a more pronounced economic slowdown. The improved financial strength of corporations is reflected in the relatively low default rate of 1–2% for 2011 (Fitch Ratings), well below

the 5.1% average over the past 30 years. Fixed income portfolios may benefit from the yield cushion offered by investment-grade and high yield corporate bonds and, at the same time, provide positive “real” (inflation-adjusted) yields.

Europe is probably the single largest question mark going into 2012. What was originally a debt problem in Greece has become a crisis for all of Europe, and a problem that threatens to impact economies outside the region as well. While European policymakers attempt to resolve the crisis before a more pronounced contagion appears in countries throughout the European Union, the world awaits a substantive agreement. However, even if a resolution is reached in principle, the execution of any plan to provide fiscal support to sovereign debtors and strengthen European banks exposed to those debtor nations will not be a simple endeavor. From a fixed income investment standpoint, portfolio managers indicate that they will maintain lower than average exposures to core Europe until real progress is made. In the meantime, investments in non-core Europe and emerging market nations with relatively low debt burdens and higher growth prospects may provide better opportunities for bond investors.

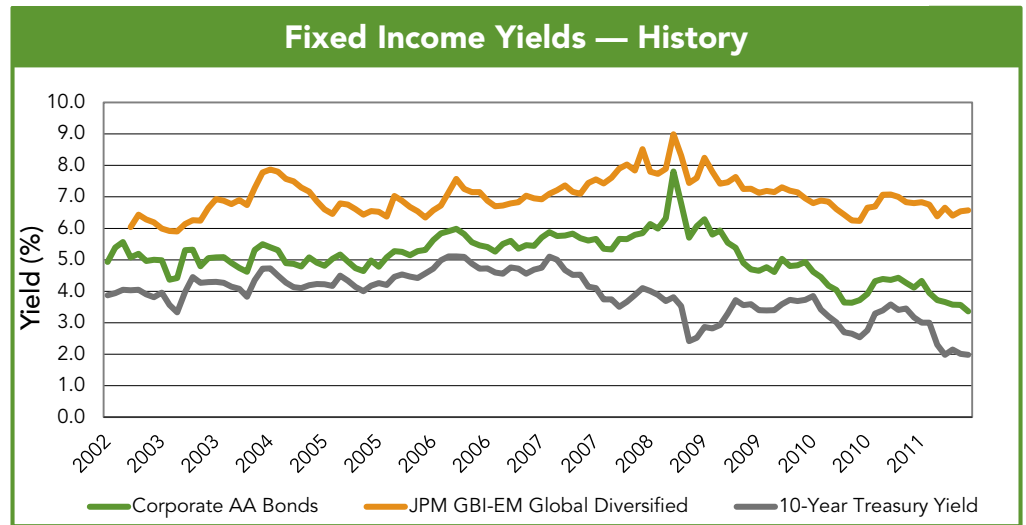
Looking to 2012, we are hopeful for some relief in global uncertainty, but we remain cautious. In an environment of increased volatility and uncertainty, we believe that active bond management

gives investors the best opportunity to outperform the broad market with downside protection. We believe that maintaining a core, high-quality position remains appropriate. Supplementing that position with flexible strategies can add value, particularly in volatile market environments that may not be favorable to a traditional portfolio structure. Looking beyond the United States for opportunities abroad can also add valuable diversification benefits.

In general, we believe that bond investors should maintain a higher-quality

bias while emphasizing income, and remain guarded against the potential for further volatility in interest rates. Finally, fixed income investors should maintain a long-term perspective, which should

help guide them through periods of short-term volatility and underperformance, recognizing that the more critical measurement of performance and success is over a multiyear timeframe.



Source: PMFA, Bloomberg

EQUITIES: MACRO ENVIRONMENT CHALLENGES

Against a backdrop of risk and uncertainty in 2011, stocks took investors on a bit of a wild ride, only to end the year virtually flat. It was a classic example of why stocks are considered “risk assets” and a poignant reminder again to investors that one is not always rewarded for taking risk over short periods of time. Looking toward 2012, the potential exists for more of the same.

In his book “Security Analysis,” Benjamin Graham, the famous father of value investing, noted that in the short term, the stock market behaves like a voting machine, while over the long term it acts as a weighing machine. He used the analogy to make the point that long-term stock investors shouldn’t concern themselves with the short-term fluctuations in stock prices, because the true value of a company (the discounted value of its long-term cash flows) will ultimately be reflected in its stock price. Investing in stocks requires maintaining an appropriately long-term time horizon while having a well-defined investment strategy to help during periods of turmoil.

At the same time, ownership of risk assets can present challenges to the investor. Data suggests that

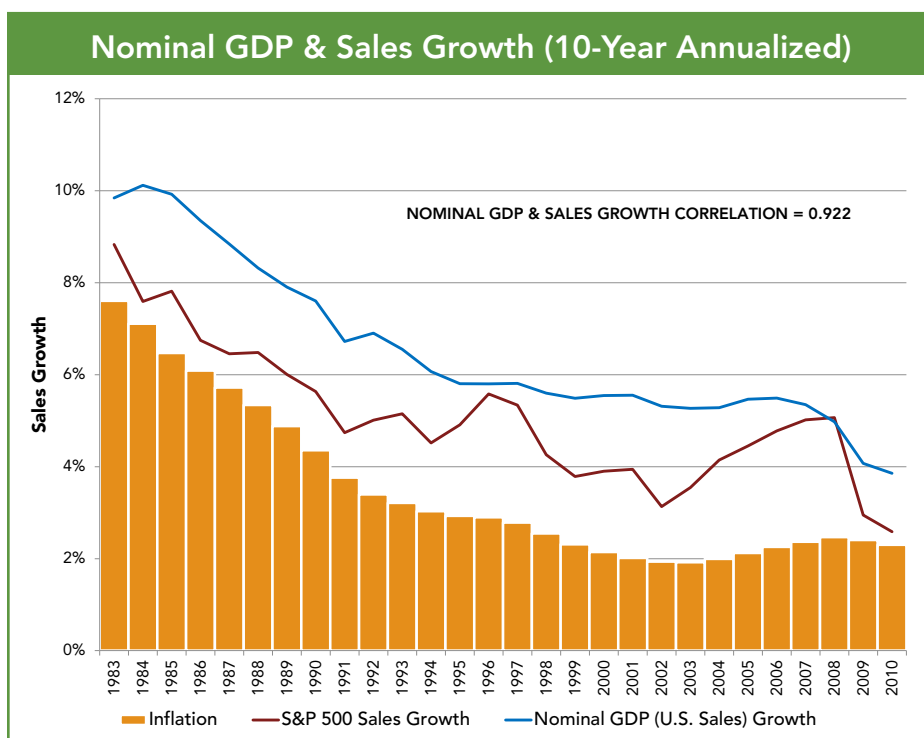
stock market P/E multiples (what an investor is willing to pay for a dollar of earnings) are closely correlated to consumer confidence — arguably a reasonable proxy for investor confidence. With confidence in the U.S. still at levels comparable to recent “typical” recessions (the Great Recession notwithstanding), it’s understandable that stock price multiples have fallen to below average levels. There remains a pervasive lack of optimism about the economy and market returns, and investor enthusiasm for stocks remains subdued as a result.

A second reason arguably exists for P/E multiples that appear to be low, and that is skepticism about the underlying earnings assumptions. According to Standard & Poor’s, at the end of December, stock analysts were still projecting earnings growth for 2012 of about 8.4% for the S&P 500, even as profit margins are already near all-time highs. Even with a moderately growing economy, the pace of earnings growth has already been slowing, and analyst expectations have become less aggressive. As we have outlined in our numerous papers about equity return expectations over the past few years, corporate revenue

growth is closely tied to nominal GDP growth (real growth plus inflation). In the event of even a mild recession, top-line growth will be challenged, while history shows that profit margins will fall. Thus, such an event would almost certainly result in earnings actually falling rather than growing as projected.

Markets struggle to differentiate between a sharp slowdown in the pace of economic growth that results in a soft landing and one that results in a hard landing. Consequently, risk assets tend to sell off when evidence of a slowdown is present, well before it’s clear that a recession has actually started.

As such, being more defensively



Source: PMFA, Standard & Poor’s Compustat

positioned when the economy shows signs of slowing may be appropriate.

Given indications that the economy may grow slowly in 2012, stocks are vulnerable to earnings expectations not being met, and we are therefore defensively positioned heading into 2012. We have reduced exposure to traditional long-only equities in favor of other risk assets that may provide better downside protection, while providing for potential returns that may be comparable to equities over a multiyear period. (Specific strategies that may meet these criteria are addressed later in this paper in our discussion of alternative investments.)

Additionally, these conditions also support being more defensively positioned within an equity portfolio. Large, blue chip companies should fare comparatively well given their global sources of revenue, greater access to capital, and valuations that are more reasonable than those of smaller companies. By comparison, small cap stocks today have higher P/E ratios, as analysts are projecting even stronger earnings growth in 2012 to justify those valuations. Likewise, in light of the weaker economic environment in major developed economies outside the U.S. and the potential for the dollar to rally further against foreign currencies in the event of a global downturn, we also remain underweight to foreign stocks. While these are our current views, we will adjust these

positions as our view of these conditions change.

Ultimately, stock market returns over shorter periods are often driven by the comparison of actual results (economic data, corporate earnings, etc.) with expectations. When expectations are optimistic and are not met, the market is likely to sell off. Conversely, when expectations are low and results are better than anticipated, the market tends to rally. Today, we believe there is a risk that expectations may be optimistic, though not nearly as optimistic as in 2007 when subsequent earnings came in dramatically below expectations. Five-year returns, as shown in our quarterly Equity Market Outlook (available at www.pmfa.com), may be below average, unless growth, profit margins, or P/E ratios surprise to the upside. They should, however, most likely outperform the returns afforded by cash and high quality bonds over a multiyear timeframe, rewarding investors with the tolerance to accept the risk associated with investing in stocks. Single-year returns may be dramatically different (either positively or negatively), and are highly dependent on the near-term direction of the economic cycle or policy developments. This is yet another reason that making a correct prediction for the level of a particular stock index at the end of 2012 is more luck than skill, in our opinion, and suggests a level of precision that is not possible to consistently achieve.

ALTERNATIVES: EXPANDED OPPORTUNITIES

There was a time — notably the period of 1982–2007 — in which a portfolio of just stocks and Treasury bonds provided attractive returns. Interest rates in 1982 were at secular highs, as inflation had become a huge problem in the U.S. The Dow Jones Industrial Average Index was at 823, the same level it was at in 1964. During the subsequent 25 years, interest rates and inflation moved

steadily lower, providing a tailwind to a secular bull market that was very rewarding to investors. From 1982–2007, Treasuries (as measured by the Barclays Capital Treasury Bond Index) provided an average annualized return of 9.0%, while the S&P averaged a return of 13.1% per year.

Today, conditions are different. Cash and Treasury yields are

exceptionally low and corporate profit growth appears likely to be less robust going forward in an economy that doesn't appear poised for the strong growth that characterized much of the 1980s and 1990s. In a lower-growth, lower-return, higher volatility environment, the door has been opened for investors to benefit from other asset classes to improve portfolio diversification,

reduce overall portfolio volatility, and/or enhance returns. In a challenging capital market environment, we believe that value can be added through an expanded opportunity set. Put differently, since the returns for stocks and high quality bonds may well be below the long-term historical averages, it pays to turn over a few rocks in other parts of the capital markets looking for some hidden gems.

The case for alternative investments is varied, just as the universe of alternatives is relatively broad. Although we've seen the dollar rally in recent months as the fear trade drove a flight to safety, the long-term outlook for the dollar remains largely unchanged. Over time, the greenback is expected to weaken, helping to make the case for allocating to investments that should perform well through a period of dollar depreciation. Gold fits the bill, not only for that reason, but also because it has proven to be an effective diversifier to traditional

financial assets during times of turmoil. Commodities also tend to benefit from a weakening dollar, as reduced purchasing power of the currency means that the buyer can't buy as much of a real asset. Moreover, the long-term growth story in emerging markets should continue to drive demand across much of the commodity complex, including energy and industrial commodities used for building and industrial activity and soft commodities including food-related commodities as the growing consumer class in the emerging world understandably desires better diets and living conditions.

Finally, other strategies can provide intriguing benefits:

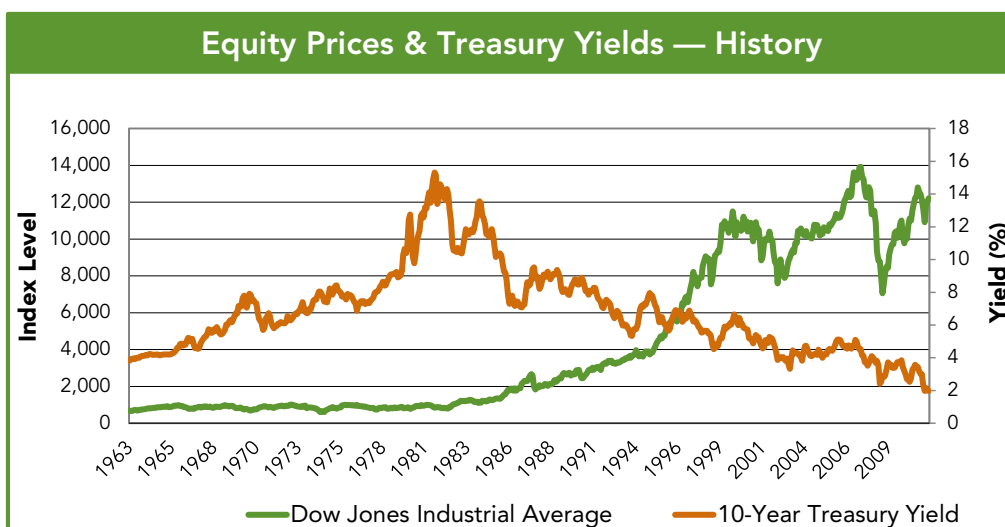
- Flexible strategies that have the ability to invest across various asset classes (e.g., global tactical asset allocation)
- Strategies that adjust their overall exposure to equities by being either long or short specific stocks (e.g., long/short strategies)

- Strategies that look for pockets of relative opportunity within a single asset class but in a global context (e.g., global fixed income)
- Opportunistic strategies that result from pricing discrepancies across markets (e.g., high-yield bonds as equity alternatives)

These can provide not only additional diversification, but can also allow managers with outstanding long-term track records to express their views in ways that many traditional funds cannot, demonstrating value over the course of a market cycle.

Ultimately, we still believe that the principles of strategic asset allocation and broad diversification within the context of an investor's goals and tolerance for risk remain critical to portfolio decision making and structure. While volatility and uncertainty can result in losses over some periods of time, the fundamentals of global growth over long periods of time still present investors who have a long-term time horizon the opportunity

to build wealth and profit from investing in risk assets. Most importantly, a well-conceived plan that takes into consideration economic, market, and policy considerations that may impact the value of a portfolio over both short- and long-term periods should allow the investor to navigate the current environment, while remaining appropriately focused on their ultimate investment horizon.



Source: PMFA, Bloomberg

LOOKING AHEAD: LONG-TERM OPPORTUNITIES STILL EXIST

“Uncertain” may still be the single term that best describes the global environment. Whether it be the economy, capital markets, monetary policy, or fiscal policy, or any number of elements thereof, little consensus exists and the potential for surprises (either positive or negative) remains high. With uncertainty at such a high level, it cannot be surprising that confidence remains scarce. Recent surveys suggest that confidence in government is near all-time lows. Various surveys of consumer confidence remain at levels typically associated with a recession, while other surveys of business are mixed.

Some things remain certain, however, such as the existence of the business cycle. Economies expand and, in time, contract for a period. It's a natural pause in long-term growth sometimes needed to purge the excesses that have built up in the system. A typical business cycle recession in and of itself isn't a bad thing, although it can create some short-term pain. The greater risk to investors is an atypical recession — one that is accompanied by a true crisis, such as the global credit crisis that unfolded in 2008. In either case, no one can control whether or not a recession or recovery will occur. Instead, we believe investors should focus on what they can do: develop an investment strategy that recognizes the risks that exist as well as the opportunities that are created during periods of uncertainty.

Investors shouldn't overlook the fact that recessions, and the bear markets that typically accompany them, also create windows of opportunity to invest in risk assets (such as stocks) at comparatively attractive prices. The best long-term investment opportunities are often born in periods of extreme fear. Thankfully, that's not where we find ourselves today, but even in times like this, it is not unusual for different segments of the capital markets to price in different scenarios. Treasury yields, for example, are exceptionally low, while real (inflation-adjusted) yields are negative across much of the curve — a state much more likely to exist in a highly troubled economy. Relative to

Treasuries, junk bond yields are near levels associated with a moderate recession. Municipal bonds also look like a relative bargain compared to Treasuries, as recent defaults (and “doomsday” prognostications) have shaken the market and the perceived risks associated with municipals remain elevated. Meanwhile, some equity analysts are trumpeting the relative value of stocks based on expectations that 2012 earnings will grow. At the end of the year the average analyst estimate of earnings growth for the S&P 500 companies was 8.4%, according to Standard & Poor's. As noted earlier, if the bond market is right, and a recession does occur, the probability that corporate earnings would grow this much during 2012 is low. Herein lies one of the relative opportunities that exist when the markets are not consistently priced for the same outcome.

While we would not choose the economic circumstances that we find ourselves in, investors cannot dictate market conditions. If a recession were to occur, we do not fear it. Instead, we recognize that our role is to do our best to identify the risks and opportunities that exist and provide recommendations that we believe will protect our clients and their capital, while maintaining an eye on the fundamental factors that will have the greatest influence on long-term market risks and return. Markets do not always

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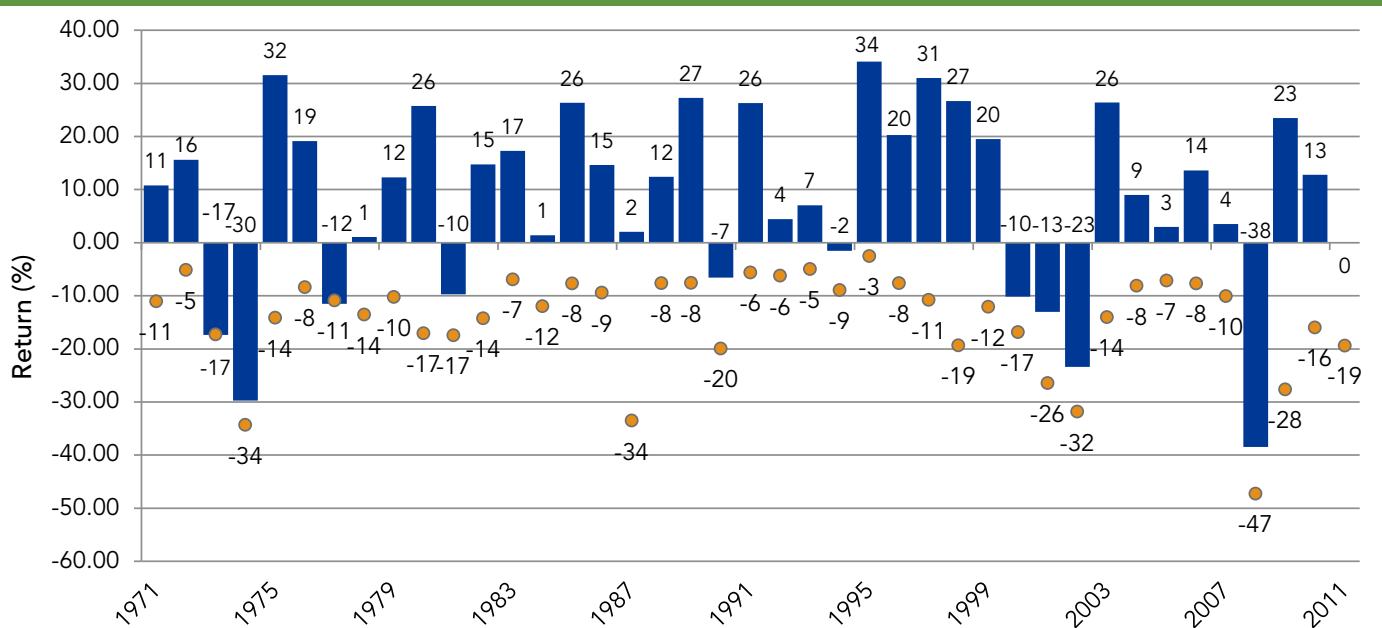
recognize those factors and can move irrationally for some time.

Since 1980, the S&P 500 has experienced intra-year declines of an average of nearly 15%, but still rallied to end the year positive about 75% of the time. We saw this again in 2011, as the S&P 500 lost nearly 20% from the beginning of the year before rallying sharply to end the year up 1%. Today, we don't believe that we are at the precipice of another 2008, particularly since policymakers around the world are actively engaged in attempting to find solutions to the structural issues that exist. As we've seen in recent months, even rumors of positive developments from a policy perspective can generate a sharply positive reaction in the market. In time, the right combination of political and economic levers will provide a boost to investor sentiment. The timing of this, as always, is uncertain.

For the investor, it is critical to maintain a long-term perspective while positioning a portfolio to allow for the achievement of stated goals. Investors should maintain enough liquidity (cash and short-term instruments) to provide for near-term needs while allowing risk-oriented investments enough time to appropriately season, and bear fruit. Short-term volatility is to be expected; risk and uncertainty will always exist in some form and long-term investors must be willing and able to accept that volatility. Over the long term, investors in stocks and other risk assets should be rewarded through returns that exceed those provided by cash or Treasuries.

For our part, we remain resolute in our commitment to our clients to remain rational and unbiased in our ongoing analysis of the global economy, capital markets, and policy developments. We continue to look for opportunities to identify relative values in the market, protect against unnecessary risk, and seek tactical opportunities to invest in asset classes and strategies that present attractive long-term values. We continue to "do the right things for the right reasons" — all geared toward a primary focus of serving our clients. That is a certainty, and a key tenet of our firm philosophy of unparalleled service to our clients, as we continue to navigate the Road Ahead.

S&P 500 Calendar Year Returns vs. Intra-year Declines (1971–2011)



Source: PMFA, Bloomberg, Standard & Poor's

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