Independent Wealth Management

Investment Insights

IWM

A Quarterly Newsletter | 4th Quarter | 2011

4Q11 Benchmark Returns

	4Q	YTD
Large-Cap Benchmark		
Vanguard 500 Index	11.8%	2.0%
Russell 1000 Growth iShare	10.5%	2.5%
Russell 1000 Value iShare	13.0%	0.2%
Mid-Cap Benchmark		
Russell Mid-Cap iShare	12.3%	-1.7%
Russell Mid-Cap Growth iShare	11.2%	-1.8%
Russell Mid-Cap Value iShare	13.3%	-1.6%
Small-Cap Benchmark		
Russell 2000 iShare	15.4%	-4.2%
Russell 2000 Growth iShare	15.0%	-2.9%
Russell 2000 Value iShare	15.9%	-5.6%
Other Benchmarks		
Vanguard Total Intl Stock Index	4.2%	-14.6%
Vanguard REIT Index	15.2%	-8.4%
Vanguard Total Bond Mkt Index	0.9%	7.6%
Merrill Lynch High-Yield Master	6.2%	4.5%
Citigroup World Govt Bond Idx	-0.1%	6.3%
DJ-UBSCI (Commodity Futures)	0.3%	-13.3%
JP Morgan Emg Local Mkt+	0.5%	-1.7%

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Executive Summary

- After huge volatility, the S&P 500 index ended 2011 where it started, with its 2% return coming from dividends. Smaller and mid cap stocks closed the year down -4.2% and -1.7%, respectively, despite also posting double digit fourth-quarter gains. Fear over Europe and slowing growth in China dragged foreign stocks down -14.6%, with China concerns and a flight from risk hitting emerging markets stocks even harder; they fell -18.8%.

- High quality bonds were on the other side of the volatility, with sharp flight to safety rallies that helped net the Vanguard Total Bond Market Index a 7.6% full year gain.

- Risk On / Risk Off is a phrase that has developed to describe the recent activity of the financial markets. Risk On describes activity where investors are buying risk assets (i.e. stocks, commodities, etc.) and selling lower risk assets (i.e. US Treasury bonds, etc). Risk Off describes activity where investors are selling risk assets and buying lower risk assets. This Risk-On / Risk-Off trade changes frequently and quickly, even from day to day, and is often driven by news headlines. The result is volatile financial markets where all risk assets tend to move in lockstep. Diversification within risk assets is not as helpful as it is in more normal times. This creates long term opportunities, but can be frustrating over shorter periods.

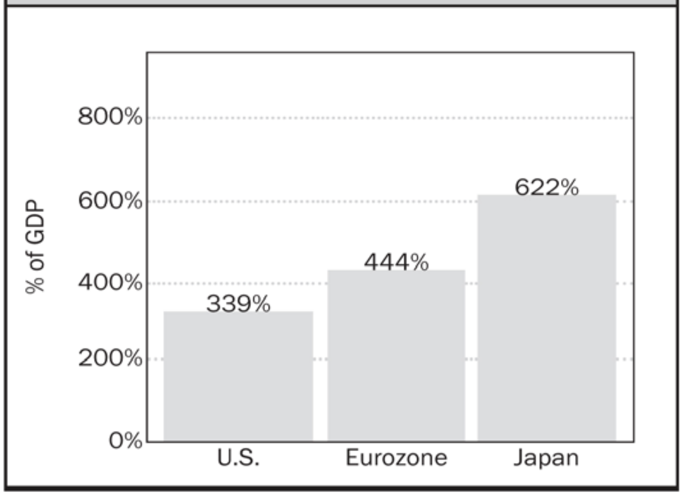
- The huge amount of debt in the developed world continues to drive our expectations about the years ahead. As most of the developed world struggles to dig out from under a mountain of debt, all options involve economic pain that is compounded by political uncertainty.

- The likelihood of a deepening financial crisis in Europe which would lead to a global recession increased during the fourth quarter. While we still believe this is somewhat unlikely, it is influencing the construction of our portfolios.

Fourth Quarter 2011 Investment Commentary

As most of the developed world struggles to dig out from under a mountain of debt, all options involve economic pain that is compounded by political uncertainty. Having hit debt levels that are unsustainable, deleveraging (debt reduction relative to GDP) is necessary. Ideally this comes from economic growth increasing the denominator in the debt/GDP ratio. But when debt is so high, it becomes a headwind to growth. Governments try to use fiscal stimulus to counterbalance the private sector's retrenchment, but this can only continue for so long, as increased government spending/stimulus adds to the growing burden of public debt. So, that leaves spending reductions and tax increases as solutions at the government level (austerity), or some degree of debt default. Default can happen in two ways: (1) not repaying debt, or (2) creating inflation by "printing" money so that money is devalued. Both of these options create other problems.

Drowning in Debt: Domestic Debt Outstanding as a % of GDP (6/30/11)



Sources: U.S. Federal Reserve, Bank of Japan, and Eurostat.

Governments can also attempt to force "financial repression," where they use all possible tools to keep interest rates low. This serves several purposes including keeping their borrowing rates low so that the debt service burden does not explode to impossible levels. For investors, this means low returns from fixed income investments.

The lesson from economic history is that, without exception, a debt induced financial and banking crisis results in a lengthy period of subpar economic growth. This is exactly what has been happening throughout the developed world economies since the 2008 financial crisis. Weak economic growth leads to periodic recession fears and unacceptably high unemployment. Moreover, high debt levels mean that we will likely be living with huge macro level risks for a few more years at least.

Russian Roulette?

There are many debt related risks in the world today. Europe is an obvious big risk in the near term. What we're seeing in Europe is that investors are afraid that the region lacks the political unity and possibly even the financial capacity required to provide a sufficient financial backstop for the Euro-zone. That increases the risk of weaker governments defaulting on their debt, which makes investors demand higher yields for taking on that risk. Those higher yields contribute to an adverse feedback loop that makes a default even more likely, because governments can't sustain interest payments above a certain level, so only some type of unified policy action and intervention can allow governments to roll over all the debt that is coming due.

It is very possible that we will find out during the next year whether Europe can keep the EU together and get through the crisis with a mild recession or, at the other extreme, whether we will see an EU collapse triggering defaults in the trillions of euros, a 2008-type banking crisis, and possible European or even global depression. There are other outcomes in between these two extremes. Most economists now view recession in Europe in 2012 as almost certain. European authorities have so far been ineffective in containing the crisis through incremental steps. The worsening of the crisis actually increases the likelihood that the European Central Bank will finally step in more decisively and provide major support for the sovereign debt market and the banking system, e.g., by buying Italian and Spanish government debt via "quantitative easing" (much as the Federal Reserve has done with Treasuries) to bring down interest rates, restore confidence, and break the debt contagion adverse feedback loop. But, this is not certain and the question of whether they will do it in time to avoid a serious and potentially devastating economic downturn is one we can't confidently answer. The costs of a European Union break-up are high so there should be strong motivation to avoid it, but the political and practical realities are highly complex.

As we enter 2012, stress on the banking system is intensifying and banks are downsizing by aggressively reducing lending, selling assets, and pulling out of many markets as funding has dried up and assets on their balance sheets have become riskier and less valuable. Their actions are being felt around the world. In short, there is already a European banking crisis though not yet as severe as what we saw in 2008 in the United States.

The global ramifications of a disorderly EU breakup would likely be severe. The banking system would be a primary way to transmit the crisis globally and trade would be a secondary transmission mechanism. Though most of the direct exposure to default is with European banks (and they also operate in the U.S. and around the world), U.S. banks have exposure through derivatives (a financial instrument whose price is derived from the value of another asset or group of assets). Unfortunately, there is a lack of transparency that makes it impossible to fully understand the nature and amount of the derivatives risk to U.S. banks. (We have seen estimates that exposure through counterparty risk the risk that the other party to a derivatives contract does not live up to its obligations is as high as $4 trillion.) The likely result of this scenario would be at the very least a developed world recession, as credit could temporarily freeze and trade levels would drop. This would also result in a slowdown in some emerging economies and outright recession in others. Heightened risk triggered by concerns about sovereign risk could also trigger a funding crisis. According to the Organization for Economic Cooperation and Development, developed countries will need almost $11 trillion in funding in 2011 mostly maturing loans needing to be rolled over. Normally this would not be a problem. But a European meltdown could conceivably trigger market pressure on the heavily indebted U.S. and Japanese economies (though capital has to go somewhere and U.S. Treasuries remain the asset of choice in times of heightened risk aversion).

Policy tools would likely be more limited than in 2008 and 2009 because we've already used up some of our "bullets," contributing to government debt levels that are very high and that could reduce the political will to allow them to expand further. We view this overall scenario as improbable because the ramifications are so extremely negative that authorities will want to avoid it at all costs. However, we have learned not to dismiss the unthinkable and we are not able to have complete confidence in policymakers taking effective actions at the right time.

While Europe is the imminent risk there are other worries. The U.S. economy, though still weak, has performed somewhat better recently and appears to have moved back above stall speed. But, 2012 will be a year of fiscal contraction with the amount still uncertain as we write this. If a European meltdown can be avoided it is expected that the United States will continue its slow expansion, but our own maddening political dysfunction, severe debt problems, and continued housing weakness makes the United States susceptible to economic shocks and policy errors. (The Fed is conducting another round of stress tests on banks and their worst case assumptions are telling: 13% unemployment, a 21% decline in home prices, and a 52% peak to trough decline in the stock market.)

Japan is one of the most indebted developed countries and highly susceptible to rising interest rates. China's economy is slowing and the authorities are now moving to stimulate growth. But, the impact of its previously booming real estate sector, which according to some reports is now contracting at disturbing levels in some regions, and slowing export growth to the developed world, remain serious risk factors. We can't confidently predict whether China will be able to avoid a sizable slowdown in growth (a "hard landing"). But, we are concerned because of the importance of China's impact on global growth, which has been disproportionate to their portion of the global economy. (Based on World Bank data, in 2010 China accounted for almost 20% of global growth.) A hard landing for China would be a significant blow to the developed world economies. And, yet another risk to the global economy as we move into 2012 is the possibility of rising Middle East tensions (with Iran specifically) driving up the price of oil.

So Where Are We? Our Portfolio Strategy

The recent financial crisis and the aftermath that continues has been the most challenging investment environment we have seen. The weight of the evidence suggests to us that it is right to be cautious, but there are bullish arguments worth examining. By far the strongest bullish argument, in the short run, is that authorities will do whatever it takes to avoid financial catastrophe, and therefore there will be much stronger steps taken in Europe. For example, if the ECB undertakes major quantitative easing as discussed above, global stock markets could experience a massive rally. If this coincides with continued improvement in the U.S. economy, 2012 could turn out to be a very good year for the stock market. That could happen because a second bullish factor is that companies have piles of cash and are ready to spend it if uncertainty declines or demand increases. So, if policies are pushed forward that reduce some of the scariest risks, we could see companies loosening up their purse strings. This could be a positive double play for the economy and market as we'd have both policies that reduce uncertainty and a business sector that is poised to expand.

Our Outlook January 2012

We believe a broadly diversified portfolio gives our clients the best chance to achieve their goals while taking as little risk as possible to meet their goals. However, we do believe there are fundamental economic realities that warrant our consideration as we construct portfolios.

We are basing our current portfolio recommendations on the following assumptions:

1. The economic recovery remains fragile. Until unemployment decreases materially, this will continue to be the case. In addition, the impact of the withdrawal of government stimulus spending and the cessation of the Federal Reserve's intervention in the bond markets may impact growth and place additional upward pressure on bond yields and downward pressure on the U.S. dollar.

2. The U.S. federal, state and local governments will struggle with large structural deficits, a burdensome public debt and massive unfunded future liabilities (i.e. Social Security, Medicare, retiree pensions, etc.). Until there are concrete signs of dealing with these issues, the U.S. dollar will continue to decline compared to the currencies of more fiscally sound countries.

3. Inflation will be a concern in the medium and long term (3+ years) and there are increasing signs of near term (1-2 years) inflation.

4. Economic growth in developing economies will overtake that of most developed economies, including the United States, Europe and Japan.

5. Current stock market valuation metrics continue to suggest the U.S. stock market is overvalued based on historical data. Our Circuit Breaker technical indicator moved to an "Under-

weight Stocks" signal September 1, 2011.

6. The European Debt Crisis, if it worsens, has the potential to push the global economy into a recession.

7. The interest rates of US Treasury bonds dropped dramatically in 2011 in a "flight to quality", due primarily to the European debt crisis. We think this will continue until there is substantive progress made in Europe.

8. The Federal Reserve plans to keep short term itnterest rates near zero until at least the middle of 2013. This is intended to help stimulate the economy but will also have the effect of encouraging investors holding cash to seek higher returns through riskier assets.

Synthesizing these assumptions with our continued belief in the core tenants of Modern Portfolio Theory has resulted in the following primary themes for our portfolio construction recommendations:

1. This is a particularly difficult investment environment as stocks appear overvalued, bonds are facing the prospect of rising interest rates (this is bad for current bond holders) and the current interest rates on most cash and cash equivalent holdings are near zero.

2. We continue to invest globally, in both stocks and bonds.

3. We have increased our allocation to alternative investments (i.e. commodities, currencies, precious metals, hedging strategies, etc.).

4. Inflation protected bonds (primarily U.S. Treasury Inflation Securities, referred to as TIPS) continue to be a core component of our bond portfolios.

5. We have lowered our target stock allocations for most clients.

6. We believe an increased emphasis on dividends has merit in the low return environment we envision.

7. We continue to review, and stress test, our bond portfolios for sensitivity to rising interest rates, global diversity, potential "flight to quality" performance and devaluing dollar implications.

8. The impact of a worsening European debt crisis on US money market funds is still uncertain and cause for concern. Clients with large balances in Prime Money Markets should consider alternatives such as CD's or Treasury Money Market funds.

9. For clients willing to accept near zero returns, cash and cash equivalents have appeal for future deployment when stocks and/or bonds have a more attractive risk/return profile.

As always, thank you for your continued trust and confidence.

Disclosure:
1. This presentation may include forward-looking statements. All statements other than statements of historical fact are forward-looking statements (including words such as "believe," "estimate," "anticipate," "may," "will," "should," and "expect"). Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct. Various factors could cause actual results or performance to differ materially from those discussed in such forward-looking statements. 2. Historical performance is not indicative of any specifi c investment or future results. Views regarding the economy, securities markets or other specialized areas, like all predictors of future events, cannot be guaranteed to be accurate and may result in economic loss to the investor. 3. Investment in securities involves the risk of loss of interest and/or initial investment capital. 4. Nothing in this letter is intended to be or should be construed as individualized investment advice. All content is of a general nature. Individual investors should consult their investment adviser, accountant, and/or attorney for specifi cally tailored advice.