Market Analysis / Fourth Quarter 2011

INDEPENDENT WEALTH MANAGEMENT

Key Takeaways

- 2011 was characterized by a risk-on/risk-off investor mentality that resulted in extreme volatility for global stock markets. During sharp flight-to-safety rallies, high-quality bonds (US Treasuries and similar US Gov't bonds) became a safe haven for capital spooked by Europe's debt crisis and fears of China's slowing growth.
- Our portfolios trailed their benchmarks for the year mostly as a result of our positioning away from core bonds in favor of flexible bond strategies. Collectively, we believe these strategies will provide a good source of diversification and have the potential to outperform lower-yielding core bonds over our five-year horizon.
- The huge amount of debt in the developed world continues to drive our expectations about the years ahead, as its inevitable unwinding will be a drag on economic growth and creates risks likely to drive periods of high volatility.
- Our portfolios are positioned somewhat defensively as a result, with an underweight to stocks that means we would not participate as fully if markets rally on positive shorter-term economic news.

Asset Class Returns

Through 12/31/2011 **Past performance may not be indicative of future returns.**

Asset Class	4th Qtr. 2011	12 Months	5 Years (Ann.)
Russell 1000 Value iShare (Domestic Large-Cap Value)	13.01%	0.21%	-2.73%
Russell 1000 Growth iShare (Domestic Larger-Cap Growth)	10.54%	2.47%	2.34%
Vanguard 500 Index (Domestic Larger-Cap Blend)	11.78%	1.98%	-0.32%
Russell 2000 Value iShare (Domestic Smaller-Cap Value)	15.88%	-5.64%	-1.94%
Russell 2000 Growth iShare (Domestic Smaller-Cap Growth)	15.02%	-2.86%	2.09%
Russell 2000 iShare (Domestic Smaller-Cap Blend)	15.45%	-4.19%	0.19%
Vanguard Total Intl Stock Index (Foreign Stocks)	4.22%	-14.56%	-3.48%
Vanguard REIT Index (Real Estate Investment Trust)	15.20%	8.45%	-1.05%
Merrill Lynch High Yield Master (High-Yield Bonds)	6.17%	4.50%	7.25%
Vanguard Total Bond Mrkt Index (Domestic Invest-Grade Bonds)	0.94%	7.55%	6.37%
Citigroup World Gov't Bond (Global Invest-Grade Bonds)	-0.13%	6.35%	7.13%
Dow Jones-AIGCI (Commodity Futures)	0.34%	-13.32%	-2.08%
JP Morgan Emg Local Mrkt+ (Short-term Local Currency Emg Markets Bonds)	0.48%	-1.74%	9.09%

Asset Class Index Descriptions

Investment Grade Bonds (Vanguard Total Bond Market Index): We are currently using the Vanguard Total Bond Market Index to represent an index of U.S. investment grade bonds and absolute return oriented bonds.

High Yield Bonds (Merrill Lynch High Yield Index): We are currently using the Merrill Lynch High Yield Index to represent an index of U.S. high yield bonds.

Emerging Markets Local Bonds (JP Morgan GBI-EM Global Diversified Index): We are currently using the JP Morgan GBI-EM Global Diversified Index to represent the Emerging Markets Local Bonds.

Large-Cap Stocks (Vanguard 500 Index): We are currently using the Vanguard 500 Index Fund to represent the S&P 500, an index of primarily U.S. large-cap equities.

Small-Cap Stocks (Russell 2000 Index): We are currently using the Russell 2000 Index iShares Exchange Traded Fund (ETF) to represent the Russell 2000, an index of primarily U.S. small-cap equities.

U.S. Equities (Vanguard 500 Index): We are currently using the Vanguard 500 Index Fund to represent the S&P 500, an index of primarily U.S. equities.

International Equities (Vanguard Total Int'l Index): We are currently using the Vanguard Total International Stock Index Fund to represent an index of primarily developed market non-U.S. stocks with some emerging market stocks.

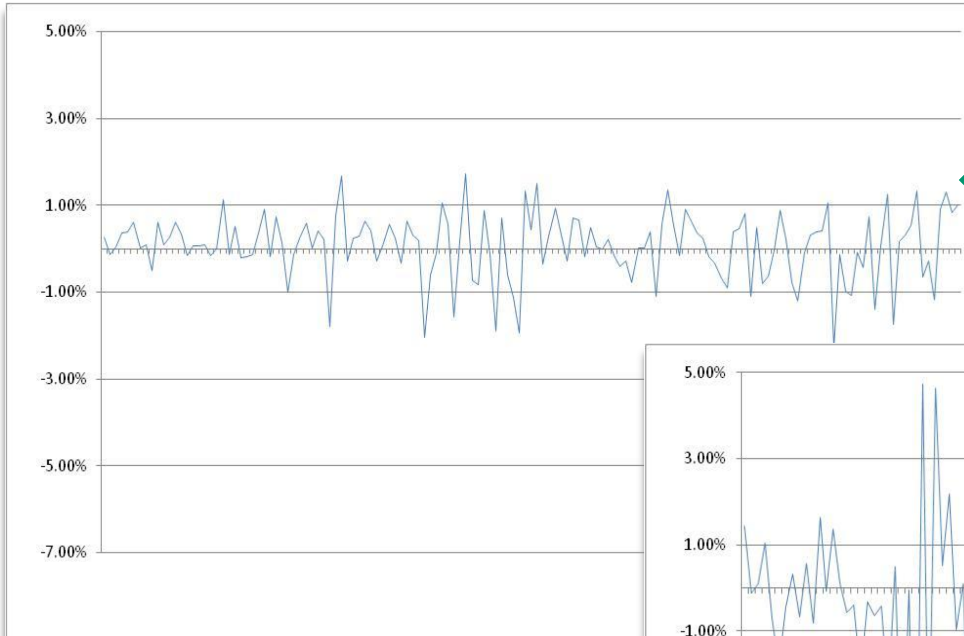
TIPS (Barclays TIPS Index): We are currently using the Barclays TIPS Index to represent and index of U.S. Treasury Inflation-Protected Securities.

REITS (Vanguard REIT Index): We are currently using the Vanguard REIT Index to represent an index of U.S. REITS.

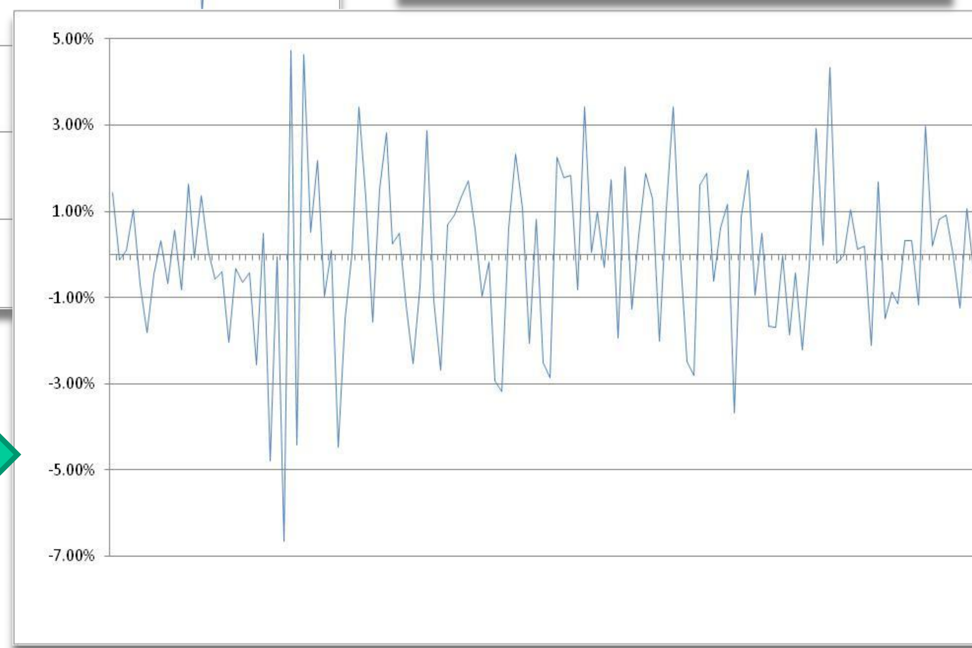
Commodity Futures (Dow Jones UBS Commodities (Total Return)): We are currently using the Dow Jones UBS Commodities Total Return Index to represent an index of U.S. total return commodities**.**

Alternatives – Arbitrage Strategies (Citigroup 3-Month U.S. Treasury Bill Index): We are currently using the Citigroup 3-month Treasury Bill Index as the benchmark for absolute-return-oriented alternative strategies

Euro Fears Stoked Huge Volatility in the Second Half of 2011

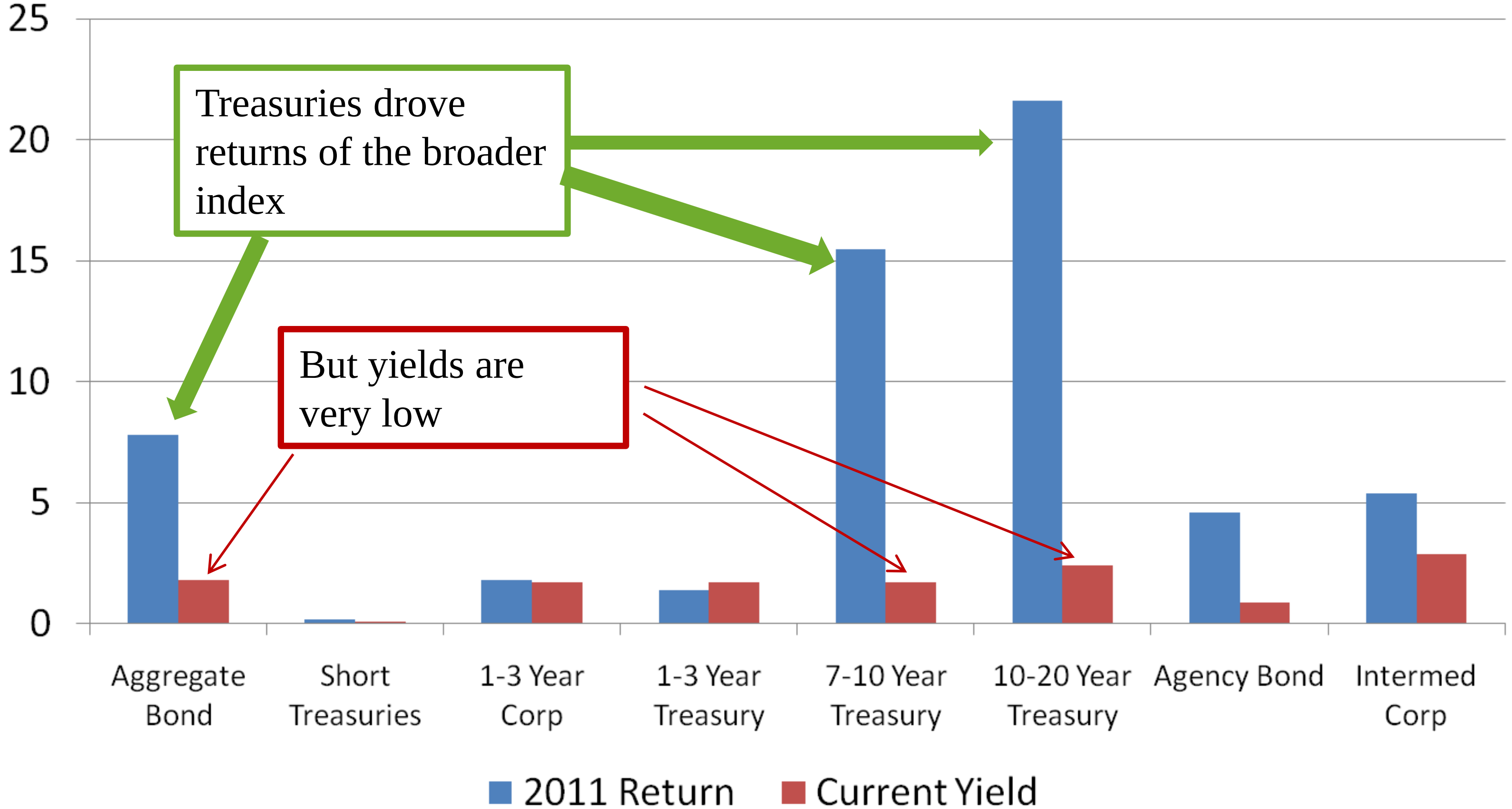


Daily S&P 500 price swings during the first half of 2011 were in line with historical averages…

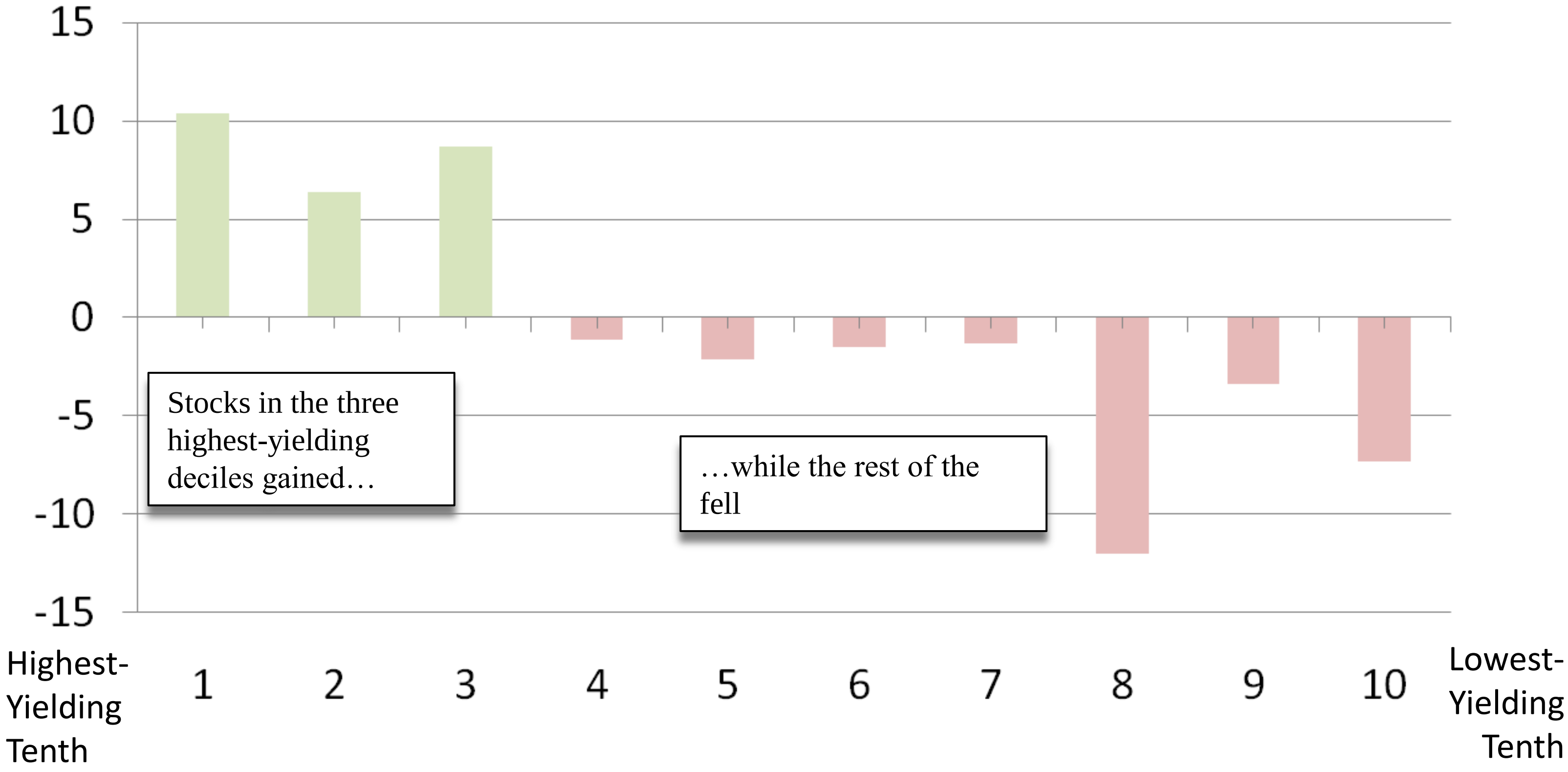


But fear and hope about Europe drove volatility through the roof in the second half.

A Look Inside the Bond Index Shows What Happened in 2011 and What to Expect Going Forward



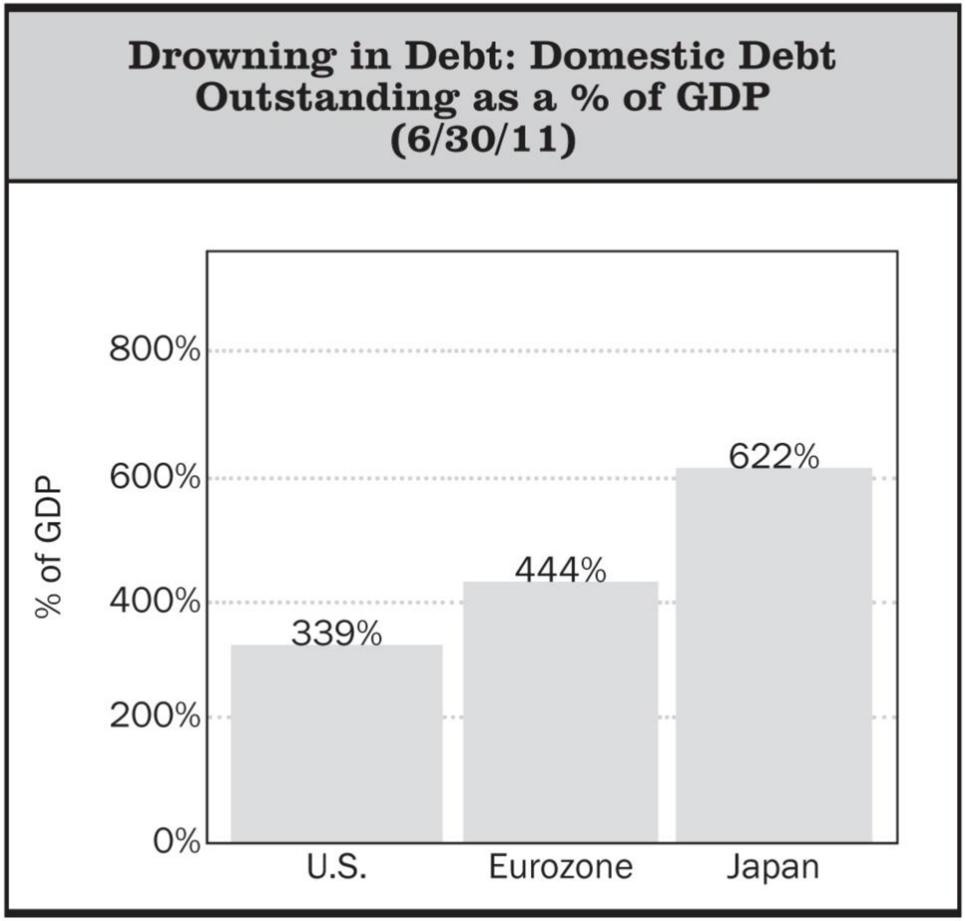
2011 Performance of S&P 500 Stocks Based on Yield



We Remain Confident in Our Current Positioning Despite Trailing Our Benchmarks in 2011

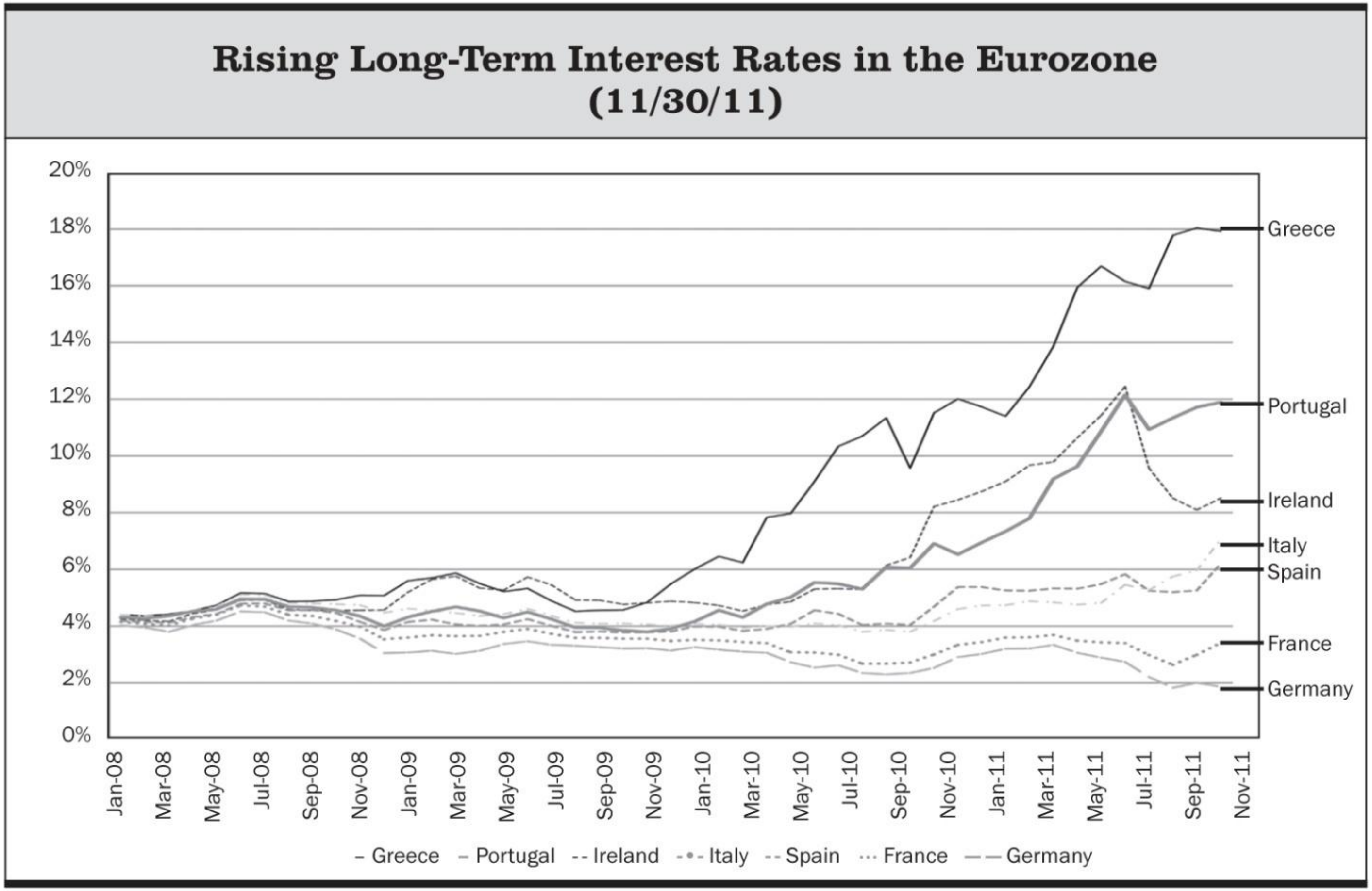
- Our portfolios are underweighted to core bonds in favor of flexible bond and alternative strategies, which didn't gain as much as core bonds in 2011
- Our core bond fund, PIMCO Total Return, was also underweighted to Treasuries
- We are always disappointed to underperform but we are focused on long-term returns and managing shorter-term risk

The Developed World Is Struggling under a Mountain of Debt



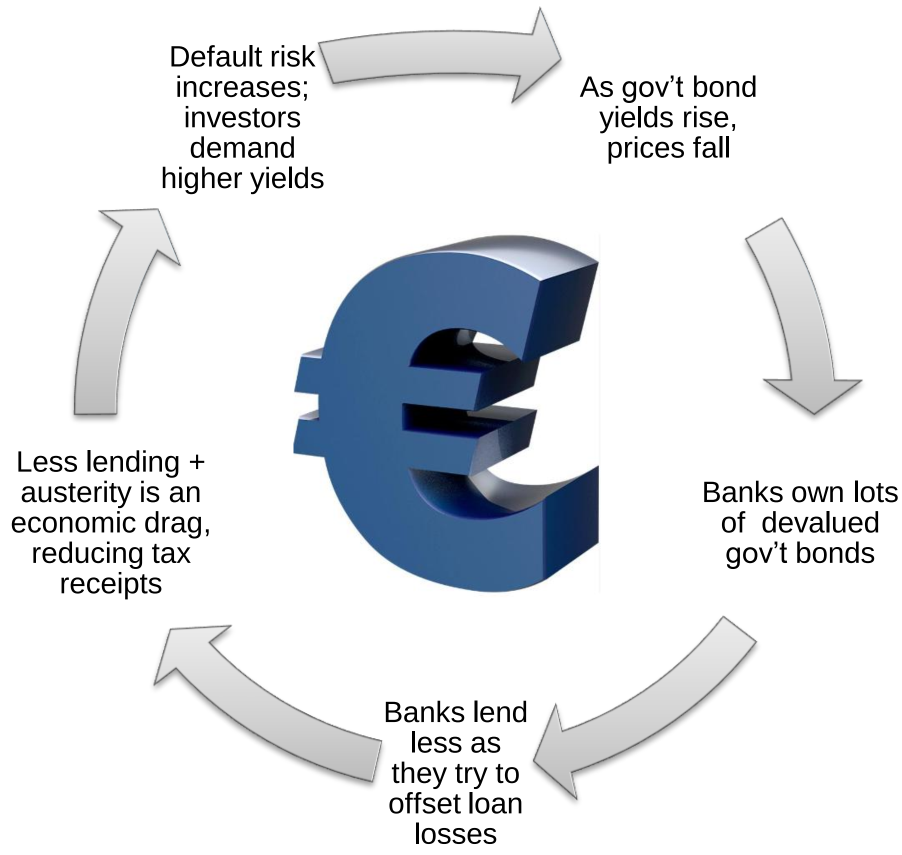
Sources: U.S. Federal Reserve, Bank of Japan, and Eurostat.

Rising Rates in Europe Are Both a Cause and Effect of Major Stress



Source: Eurostat.

An Adverse Feedback Loop Threatens Europe's Financial System



Why Debt Matters

- High debt levels create economic headwinds
  - It will take many years to reduce debt to acceptable levels
  - While debt is paid down there is less money available to spend
  - This slows the economy and is why we expect slower growth than in past recoveries
- High debt levels increase risk
  - After the debt crisis began in 2008, policymakers used up most of their tools and now have fewer tools available to combat a future crisis
  - The global economy and financial system is highly interconnected and debt-induced damage in one area, such as Europe, can affect the rest of the globe
- There is no solution that does not involve economic pain
  - Governments must spend less and/or tax more to fix their fiscal problems
  - The failure to address fiscal problems could cause interest rates to spike, making servicing debt more costly and compounding the fiscal problems

There Are Several Ways Things Could Play Out from Here

- **Pessimistic**
  - Another financial crisis with deflation and possible global depression
  - Big downside for stocks and other risky assets
- **Optimistic**
  - Policymakers hit the bulls eye
  - Emerging markets lift all boats
  - Growth is higher than we expect
  - Stocks and risky assets see strong gains
- **Base Case**
  - No major financial crisis but growth remains slow
  - Returns for balanced portfolios in the mid-single-digit range
  - Volatility remains high

Our Portfolio Positioning

Scenario Analysis: Asset Class Return Estimates

	⇦ *More Pessimistic*		*More Optimistic* ⇨	
Economic Scenario	***Recession Recur/Deflation***	***Stagflation***	***Subpar Recovery***	***Average Recovery***
As of 1/3/12 S&P 500 at 1258, Barclays Aggregate yield at 2.2%, MSCI EM Index at 916, Merrill Lynch High-Yield Cash Pay Index at 8.2%.				
Equity Asset Classes	**Estimated Average Annual Returns over Next Five Years**			
U.S. Equities	-3.1%	-0.5%	4.3%	12.7%
Developed International	*Similar to U.S. Equities*			
Emerging Markets	2.8%	n/a	11.6%	20.7%
REITs	-1.5%	0.8%	-0.8%	1.3%
Fixed Income Asset Classes				
Investment-Grade Bonds	1.2%	0.2%	0.3%	0.2%
High-Yield Bonds	3.8%	4.1%	4.9%	5.6%
Floating-Rate Loans	4.1%	4.5%	4.9%	4.6%
TIPS	1.1%	-0.1%	-0.6%	-0.6%
Emerging-Markets Local-Currency Bonds	*Low single-digit returns*	*Low/Mid single-digit returns*	*Mid/High single-digit returns*	*Mid/High single-digit returns*
Alternative Asset Classes				
Arbitrage Strategies	*Mid single-digit returns in most scenarios*			

Our Four Broad Economic Scenarios*

SCENARIO	DEFINITION
Recession Recurs/Deflation	• Recession recurs; deflation appears in 2011 • Difficulty reflating the economy • Anemic consumer/weak recovery • Finally getting traction in later years • Assumes CPI is 2% and the 10-year Treasury yield is 4% at end of year 5
Stagflation	• Recovery that began late in 2009/early 2010 continues, but is subpar • Strong inflation spike at the end of our forecasting period • Assumes CPI is 5% and the 10-year Treasury yield is 6% at end of year
Subpar Recovery	• Recovery that began late in 2009/early 2010 continues, but is subpar • Assumes CPI is 3% and the 10-year Treasury yield is 6% at end of year 5
Average Recovery	• Policy is effective resulting in an average recovery • Reflation works, but Fed avoids monetary inflation • Assumes CPI is 3% and the 10-year Treasury yield is 6% at end of year 5

We Remain Underweighted to Core Bonds

- We expect low returns from core bonds in all our five-year scenarios
- Treasuries are especially poor long-term values
- We favor flexible bond managers
  - We accept less short-term protection in a major downturn
  - In our most likely scenario, we believe flexible bond funds should generate better long-term returns
- We aren't concerned about near-term inflation, but it is a concern a few years out
  - Our bond funds should do much better than the core bond index if inflation heats up

Our Fixed-Income Positions Are Likely to Outperform Core Bonds in Most Long Term Environments

Short-Term "Flight to Quality" Period (e.g. 3rd Quarter 2011)	5-Year Scenario Analysis			
	Recession/ Deflation	Stagflation	Subpar Recovery	Average Recovery
Barclays Capital Aggregate Bond Index	Floating-Rate Loan Funds	Floating-Rate Loan Funds	Emerging-Markets Local-Currency Bond Funds	Emerging-Markets Local-Currency Bond Funds
Investment-Grade Bond Funds	Multi-Sector Bond Funds	Emerging-Markets Local-Currency Bond Funds	Multi-Sector Bond Funds	Multi-Sector Bond Funds
Absolute-Return-Oriented Bond Funds	Investment-Grade Bond Funds	Multi-Sector Bond Funds	Floating-Rate Loan Funds	Floating-Rate Loan Funds
Floating-Rate Loan Funds	Barclays Capital Aggregate Bond Index	Absolute-Return-Oriented Bond Funds	Absolute-Return-Oriented Bond Funds	Absolute-Return-Oriented Bond Funds
Multi-Sector Bond Funds	Absolute-Return-Oriented Bond Funds	Investment-Grade Bond Funds	Investment-Grade Bond Funds	Investment-Grade Bond Funds
Emerging-Markets Local-Currency Bond Funds	Emerging-Markets Local-Currency Bond Funds	Barclays Capital Aggregate Bond Index	Barclays Capital Aggregate Bond Index	Barclays Capital Aggregate Bond Index

Best Returns

Worst Returns

We Are Underweighted to Stocks and Continue to Believe in Emerging-Markets Exposure

- We continue to believe in global diversification in both developed and emerging markets
- In developed markets we continue to favor larger-cap over smaller-cap stocks
- We continue to own managers we believe can outperform over the long term even as fundamentals may get ignored over short periods

Understanding Risk-Return Tradeoffs is Important In an Environment of High Risk and Uncertainty

- We make decisions by considering both probabilities of outcomes and their impact on portfolios (how likely and how positive or negative)
- In accounting for lower likelihood but highly damaging outcomes, we raise the chance that we could be positioned for an outcome that doesn't occur
- If things play out more positively than we believe prudent to expect, conservative strategies won't fare as well
- Each client needs to weigh the possible lost opportunity of favoring a more conservative strategy against their <u>financial</u> and <u>psychological</u> ability to withstand possibly damaging shorter-term losses
- Long-term returns are likely to be decent even if our most negative scenario happens, but capturing them requires staying put through a highly fearful period