



## Review of 2011

The year was once again marked by large swings in stock markets around the globe. Early in the year many hoped that economic growth would accelerate thanks in part to aggressive measures by the Federal Reserve and the payroll tax cut (stimulus) that started in January.

Then we saw disruptions from a devastating tsunami in Japan, the “Arab spring”, and a continuing European debt crisis. By mid-year, double-dip recession worries were compounded by a surprising downgrade of US debt by Standard & Poor’s! There was certainly no shortage of negative headlines in 2011. But against this backdrop the US economy showed signs of resilience.

As you can see from the 2011 Short-term Returns graph below, asset class performance was mixed with flat performance from US stocks, and poor returns from international stocks. Except for world bond funds, fixed income generally provided the most meaningful returns. There were bright spots for the year - Muni bonds offered a 9.00% return, US REITs returned 7.51% and once again first trust deeds provided a healthy return of over 8%.

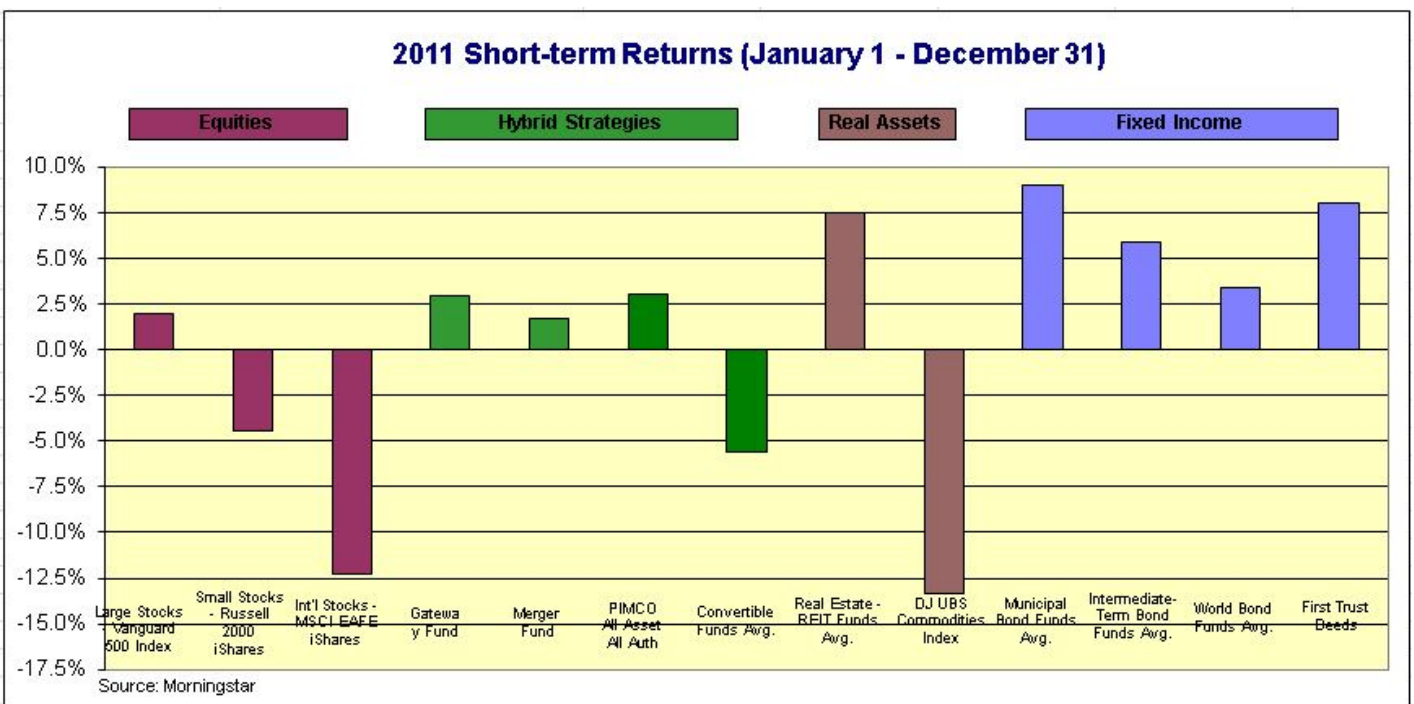
Today, many well known economic and geopolitical concerns remain, and we therefore believe a cautious approach is warranted. On the other hand, there are reasons for optimism. Multinational corporations have relatively strong balance sheets and earnings growth, global

## Executive Summary

- Stock markets experienced a high degree of volatility due in part to the European financial and banking crisis as well as lower than hoped for economic growth.
- The GMO forecast graph on page two predicts that stock returns will out pace bond returns over the next seven years. In general it also predicts that international stocks will out perform domestic stocks.
- The P/E 10 Ratio indicates that US stocks are currently at the higher end of their historical valuation range.
- For the above reasons we continue to feel good about including international stocks in our client portfolios.
- The inclusion of lower risk hybrid investments, first trust deeds and a diversified collection of bond investments will continue to smooth out portfolio volatility.
- A balanced, prudent approach can help keep investors on the right track. History shows that those with the discipline to stick with intelligently diversified portfolios are likely to achieve their goals with less effort and stress.

equity valuations in general are cheaper than a year ago and with the slack left in the economy it’s difficult to expect inflation in the near term.

In this newsletter we’ll discuss current stock market valuations and also briefly discuss the different asset



classes we hold in our client portfolios.

## Looking Ahead – Stock Market Valuations

We look at multiple valuation measurements in our effort to assess investment valuations, two of which are the GMO 7-year Asset Class Returns Forecast graph and the Shiller 10-year Normalized Price/Earnings ratio for the S&P 500 – commonly referred to as the “P/E 10”.

A quick look at the November 30<sup>th</sup> GMO graph reveals their 7-year forecast for stocks to be much higher than for bonds. This is not surprising since bond prices have continued to rise in the past year while their yields have declines. This trend of rising bond prices and declining bond yields cannot go on forever, and at some point this will begin to reverse itself - leading to the weaker bond returns this graph illustrates.

The graph also reveals that, in general, the forecast for international stocks is greater than for US stocks. Again this is not surprising given the significant decline in many international markets in 2011. This seems counterintuitive to some, but as markets decline (become cheaper) their expected longer term returns increase.

Due to this phenomenon, we are very comfortable maintaining our international allocations even through they

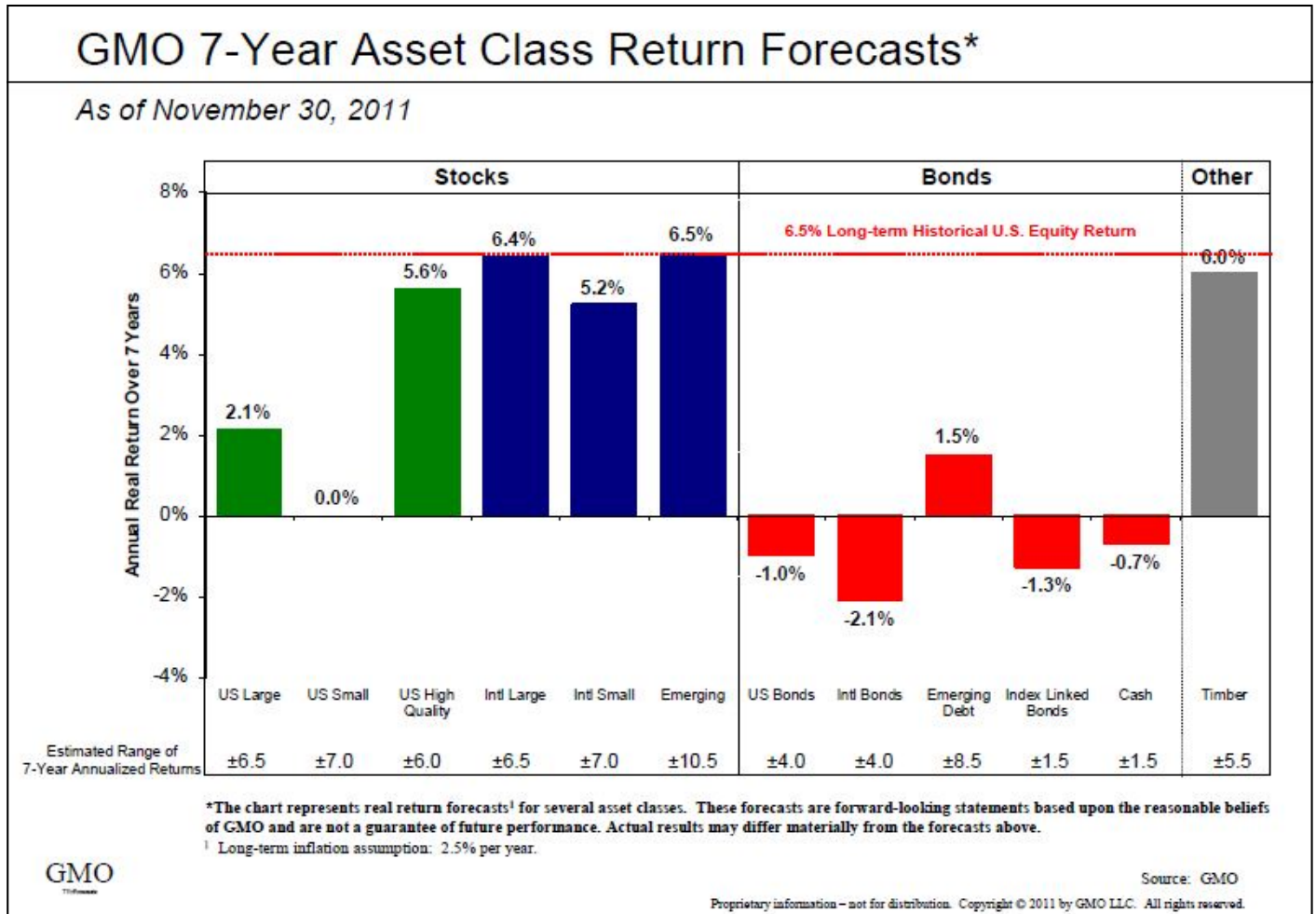
underperformed in 2011.

Now let’s look at the P/E 10 valuation model. We covered this ratio extensively in our July 2009 newsletter – but here is a quick explanation: The P/E10 is the current level of the S&P 500 Index divided by the average earnings of the prior 10 years. Lower ratios have historically led to higher subsequent returns, and vice versa. We must be careful when using data such as this because often there are exceptions to a rule or trend.

The current P/E 10 ratio is 20.60 which is certainly not cheap by historical standards. Remember this is only a measurement for the S&P 500 (US large cap stocks). This measure is consistent with the GMO 7-year forecasted return of only 2.1% for US large cap stocks over the next 7 years.

Again, with a P/E 10 ratio over 20, and a significant downturn in international markets, we believe in maintaining a healthy allocation to international markets as well as lower risk investments such as those held in our Hybrid Strategies.

A strategic combination of disparate investments reduces overall portfolio risk, and helps strike the proper balance between capital growth and capital preservation. This type of portfolio design also gives us the option to



make tactical changes where it makes sense to do so – particularly when assets are persistently and significantly over or undervalued.

In the following sections we will review the role, performance, and adjustments being made for each of the four asset classes we utilize.

## Review of The Four Broad Asset Classes

### I. Equities

Role: to provide long-term capital appreciation and currency diversification with international equity holdings. Volatility/Risk: High over short periods, moderate over long periods.

Stock investments represent ownership in companies. Shareholders earn their return through dividends and price appreciation. Stocks have historically kept pace with inflation and outperformed bonds over long periods of time. Stock gains and losses however are very unpredictable in the short term and often come in rapid bursts and sudden declines – for example, the S&P 500 was up over 10% in October 2011 alone!

It was a relatively disappointing year for stock markets around the world. Broad US markets were relatively flat, and international/emerging markets were hard hit. The S&P 500 Large Stock Index was up 2.11%, while the MSCI Emerging Markets Stock Index was down -18.42% and the Russell 2000 Small Stock ETF lost -4.18%.

In the previous section we took a brief look at stock market valuations. Here is a short list of statements that reflect the main points of the bearish and bullish outlooks on the global economy and financial markets.

Bearish investors cite the following:

- An economic slowdown in China (world's second largest economy).
- European Union muddling a solution to the crisis, with a possible break up.
- Deleveraging that is far from over.
- European Union austerity that dries up consumption.
- US State and local governments austerity.
- Paralysis in Congress leading to no policy direction.

Bullish investors take the other side, and cite the following:

- Companies have strong balance sheets and plenty of cash.
- Consumer demand in the US is still holding up despite relatively poor sentiment.
- Companies have healthy earnings.
- Unemployment is trending down.
- Low inflation is expected to continue through 2012.
- Some US housing indicators are showing a possible turn around.

As you know we do not normally make significant bets on either the bullish or the bearish scenario. Instead we will

continue to take a measured, balanced approach for our clients. As mentioned in the valuation section above, we will maintain our allocation to international markets due to their potentially higher long-term return forecast. If markets experience a significant drop, we will consider adding to stocks; and if they continue to rise, as we discussed in our last newsletter, we will consider trimming stock positions. Above all we will continue to remain disciplined and balanced in our approach.

In last years' newsletter we pointed out that although US Large companies lagged other stocks, we planned to hold on to our positions because they typically hold up better to external shocks. To our credit, this is just what we saw happen in 2011.

Through periodic rebalancing, we act in a somewhat contrarian manner – adding to positions that have fallen in value, and taking profits in those that have increased in value.

At the end of 2011 we also proactively harvested tax losses where appropriate. Taxes can be a significant drag on performance, and these harvested losses help boost after-tax returns by offsetting current and future taxable gains.

### II. Hybrid Strategies

Role: non-traditional investment strategies intended to mitigate losses in down markets, while providing income and growth potential. Volatility/Risk: Moderate

This is a very broad asset class encompassing many strategies. The investments in this class use non-traditional approaches to reduce losses in down markets.

The managers in this category employ a variety of strategies including merger-arbitrage, covered call option writing, short sales and convertible security investment strategies. This combination of investments has less upside potential than traditional stock funds in a bull market, and more downside protection in a bear market. Compared to bonds, most of these investments have more growth potential and are more resistant to the interest rate risk – the risk that rates will rise, causing bonds to lose value.

In 2011, the Gateway Fund was up 3.2%, the Merger Fund 1.7%, and the Pimco All Asset All Authority Fund gained 3.0%. These funds employ complimentary strategies in pursuit of superior risk-adjusted returns. As a group, these funds play a significant role in mitigating losses during a crisis.

The Gateway Fund provided downside protection for the year and ended up providing a return slightly higher than the S&P 500. We are still watching this holding more closely due to its lackluster 2010 performance; we expect that it will perform better as interest rates rise – particularly when compared to the bond market.

The Merger fund continues to provide much better than CD and money market returns with very low risk. The funds' steady returns, even though modest over the past few years have been a welcome respite from volatile stock returns.

We saw very strong returns from the utility stock posi-

tion we held for many clients; and we may tactically rebalance this area later in 2012.

We will continue to hold the Calamos Growth & Income fund which is the most aggressive fund in this category. It has historically provided excellent risk adjusted returns relative to pure stock funds due to its allocation to convertible securities.

### III. Real Assets

Role: to provide capital appreciation and complimentary diversification over the long term relative to financial assets while also offering inflation protection. Volatility/Risk: High.

Historically, over long periods of time, when real assets such as commodities and real estate are added to a diversified portfolio of stocks and bonds, they have been shown to reduce the overall long-term volatility of a portfolio. This beneficial effect is primarily due to the dissimilarity in patterns of returns of real assets compared to financial assets like stocks and bonds.

Commodity returns often fluctuate differently from stock and bond returns. The same events that hurt stocks, like higher energy costs, may benefit many real assets. Furthermore, commodities provide some protection against inflationary shocks, which have the capacity to harm both stocks and bonds.

However, during shorter time periods, as witnessed during the recent 2008 financial crisis, stocks (both US and international), commodities, and REITs can and sometimes do fall swiftly and simultaneously.

Although residential US real estate had another flat year; US REIT stocks had another outstanding year, providing a return of 7.51%. These domestic gains were offset by a poor showing in the international area however, with a downturn of -19.57%. Many of the issues that affected international stocks also came into play with international REITs such as

the flight to the dollar and global recession fears.

For most clients we will continue to split their REIT allocation 50/50 between US and international REITs.

Despite expectations of a continued surge in commodities for 2011, there were sharp downturns (gold and oil were particularly hard hit the past few months). We typically use diversified commodities funds: the DJ-UBS Commodity ETF and the Pimco Commodity Real Return fund which skid -14.01% and -7.56%, respectively. Much of this reversal was due to global growth worries, and we plan to maintain these funds for the diversification and inflation hedging benefits they offer.

### IV. Fixed Income

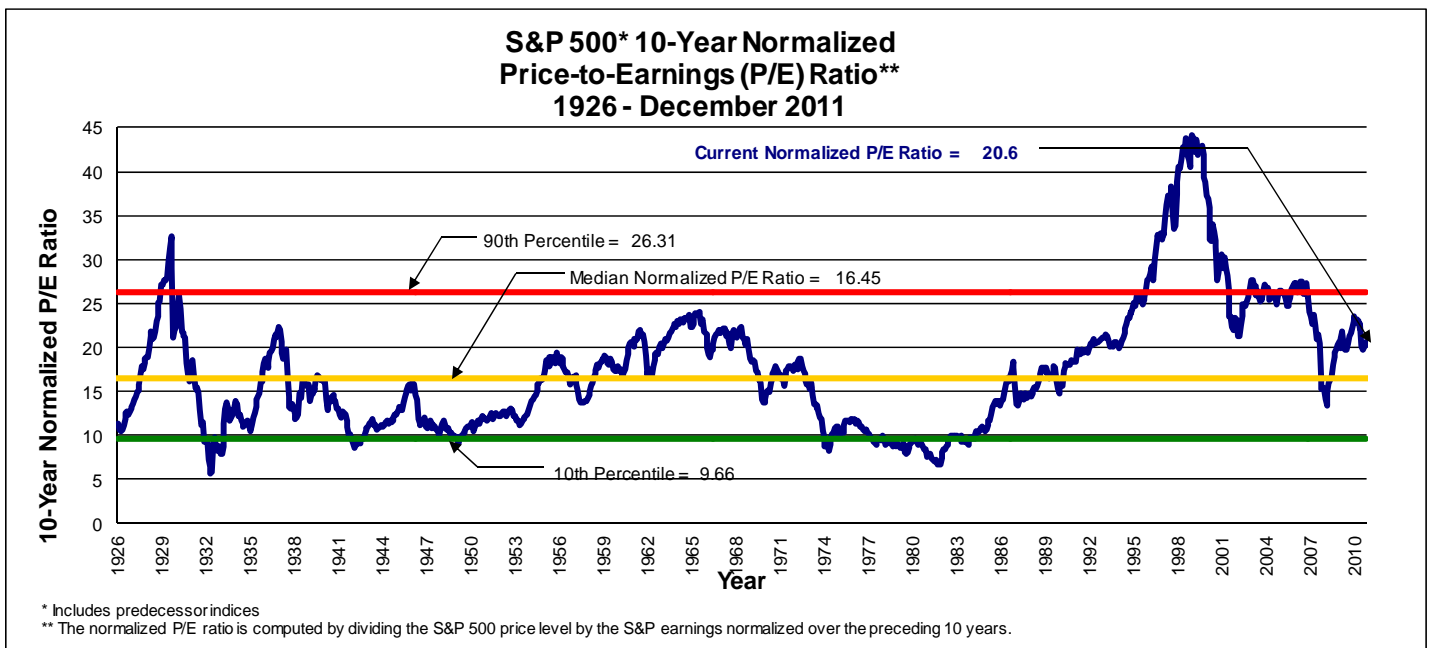
Role: to provide an income stream and a cushion to reduce overall portfolio risk. Volatility/Risk: Low to Moderate.

Fixed income investments again provided a stabilizing force in client portfolios. We continue to hold bonds and trust deeds in client portfolios to provide income and to mitigate economic and geopolitical risk.

High quality bonds and First Trust Deeds are the most defensive investment in most portfolios, serving a prudent risk-reduction role. The geopolitical issues of the past few years have had a minimal impact on these assets.

We hold Pimco Total Return for many clients. Although the fund provided a positive return of 4.17% for the year, it underperformed its benchmark by 3.67%. This underperformance was due to manager Bill Gross's decision to significantly underweight US Treasuries. When Treasuries rallied, due in part to the fear coming out of Europe, the fund's returns lagged. So far this year they are already off to a better start.

Despite the mistimed decision by Gross and his team at Pimco, we still have confidence in them. With bond





yields so low at this point in the interest rate cycle, we want bond managers who have the flexibility to navigate what may be a tricky road ahead – particularly as investors rely on them to provide principal preservation and income. Bill Gross and his team have successfully managed bonds in this manner for over 20 years, and for the time being we will stick with them.

As previously discussed, bonds (especially high quality bonds) will at some point face significant obstacles – simply put, when interest rates eventually rise, existing bond values will fall. The benefit of principal conservation provided by fixed income assets must be weighed against expected returns given the coming headwind of rising interest rates.

Although it is not possible to predict when rates will rise, we know that the current low rate environment is not sustainable. As we show above, the GMO 7-year asset returns forecast illustrates the structural performance challenges that lie ahead for bonds.

Because of the future challenges that bonds will face at some point, we continue to recommend the First Trust Deed pool for many client portfolios in lieu of high quality bond holdings. This pool has continued to provide an excellent yield of approximately 8% and can still be redeemed at 100 cents on the dollar.

We expect the trust deed investment yield to decline in the coming year as cash builds up in the fund – a result of loan payoffs running ahead of loan originations. Also, to stay competitive in this lower interest rate environment, they have to reduce the interest rates they charge.

The European debt crisis as well as other negative international geopolitical news prompted a flight to the safety of US Treasury bonds and the US Dollar. These issues conspired to weaken non-dollar denominated bonds. Although we do not see much dollar weakness in the short term, we continue to believe it makes sense to keep a small allocation to non-dollar denominated bonds. The longer term trend of the US dollar is still likely to be down given our current fiscal problems, and Congress' inability to act decisively to deal with them.

We are re-evaluating the Pimco Emerging Markets Currency fund currently used, and may replace this holding with a longer maturity emerging market bond fund.

Note that several variables influence clients' bond portfolio composition, including income needs, tax brackets, risk tolerance and the relative size of one's taxable and tax-deferred (IRA and other retirement) investment accounts.

## Summary Perspective

In 2011 a portfolio consisting solely of US large cap stocks and high quality US bonds outperformed more diversified portfolios. This is not unusual and occurred on a regular basis during the bull market of the late 1990s. We believe however, that over the long term a more diversified portfolio still makes the most sense.

With high quality bond yields as well as CD and money

market yields at historic lows, safe investment returns are difficult to come by. Stock returns will likely outperform high quality bonds over the longer term but could be very unpredictable and subject to negative surprises in the short term

To deal with low bond yields and volatile stock markets, in addition to using both US and international stock investments, we will continue to construct client portfolios using high quality first trust deeds, higher yielding (lower quality) bond funds like Loomis Sayles Bond, emerging market bonds, hybrid strategy investments, as well as commodities and REITs in an effort to strike the right balance between income, capital growth, and principal protection.

Experienced investors know that even a well diversified portfolio will not provide seamless year-over-year returns. This is why maintaining a long term perspective, and not making emotional decisions based on short term market movements is so critical.

A balanced, prudent approach can help keep investors on the right track. History shows time and again, that those with the discipline to stick with intelligently diversified portfolios are likely to achieve their goals with less effort and stress.

As always, we encourage you to call anytime with questions or to apprise us of changes that may affect your financial objectives. Once again all of us here at Financial Alternatives, Inc. wish you and your family the very best in 2012.

*Past performance is no guarantee of future results. All content in this newsletter is intended as general information, not specific advice. Performance data listed is for illustrative purposes only. Portfolios are personalized and often consider many variables, including investment objectives, age, time horizon, risk tolerance, and tax variables. Information contained herein has been obtained from sources believed reliable, but not guaranteed.*

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