



## Review of 2012

In spite of all the unhappy headlines - anxiety over America's finances, a highly-partisan presidential election, worries about the Eurozone, the fiscal cliff and the potential for recession - stocks quietly rewarded patient investors with double digit gains.

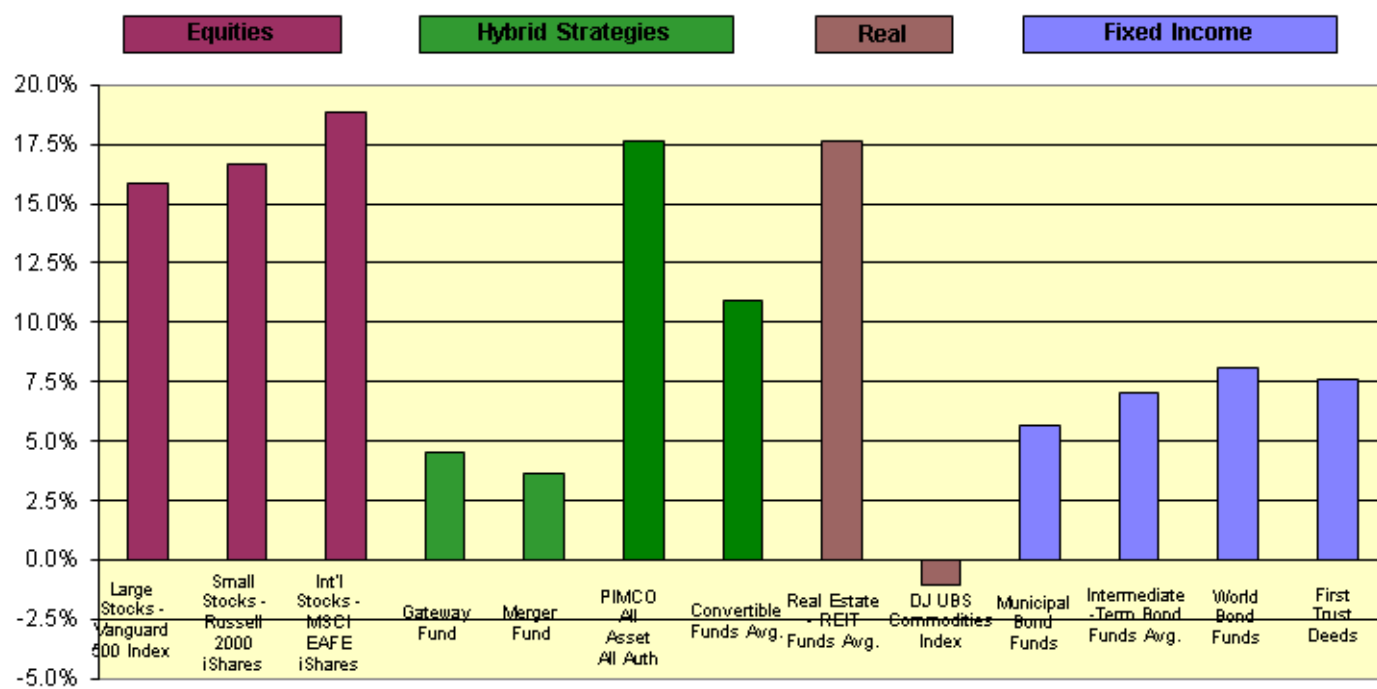
As you can see from the 2012 Short-term Returns graph below, asset class performance was positive across the board. Domestic and international stocks all provided very strong returns as did domestic and international REITs. Lower risk hybrid strategies earned more modest returns with the exception of the Pimco All Asset All Authority fund which had a stellar year. These hybrid investments take less risk than pure equity funds and we expect them to underperform equities in a bull market. It is during falling markets when they should outperform.

Bond investments provided lower positive returns and diversified commodity returns were muted in 2012. Higher yielding, multi-sector and international bond investments outperformed higher rated domestic bond investments in 2012 (these investments are not shown in the graph below but are included in client portfolios).

## Executive Summary

- In spite of all the unhappy headlines, stocks quietly rewarded patient investors with double digit gains.
- Emotional control, acting in a slightly contrarian manner and maintaining a balanced approach to portfolio construction are three keys to successful investing.
- The GMO forecast graph on page 3 predicts that stock returns will outpace 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.
- Higher future inflation remains a risk. We invest in a high quality first trust deed investment to help counteract this risk.
- The inclusion of lower risk hybrid investments serves to reduce portfolio risk and volatility should equity markets disappoint.

2012 Short-term Returns (January 1 - December 31)



Source: Morningstar

The high quality first trust deed investment we use continued its excellent performance and will likely outperform most high quality fixed income investments by an even greater margin in the coming years. This investment has a very favorable risk reward ratio and should perform well in an inflationary and rising interest rate environment unlike most other fixed income investments.

In this newsletter we'll discuss the importance of emotional control and cultivating a slightly contrarian mindset while maintaining a balanced approach to portfolio construction. We'll also look at market valuations and expected future returns compared with this time last year.

## Emotional Control

There is nothing more important in investing than maintaining control of your emotions - which is much easier said than done. When markets crash and account values decline, our fight or flight response takes hold and we feel the need to flee to safety. The emotions of those around us and the media only serve to heighten our response.

During such inevitable emotional periods it is essential to step back as quickly as possible and to rationally assess the risks one faces. If an investor has a broadly diversified portfolio there is little chance of losing all their money. In fact, during market corrections assets become cheaper than they were before the fall. Normally people would be thrilled to be able to buy a product at a lower price.

Panic selling of a well diversified and balanced portfolio is rarely the right course of action and in the majority of cases it leads to reduced long term returns. Proper portfolio construction and a proper investment mindset takes into account the knowledge that market corrections take place regularly and will continue to do so in the future.

## Act in a Slightly Contrarian Manner

Acting in a slightly contrarian manner simply means acting contrary to your fearful emotions and the fearful emotions of the crowd. In other words, when your emotions are telling you to sell an otherwise well diversified investment, you should either hold it or even add slightly to your position. Over the long run you are likely to be far better off acting in this manner rather than following your fearful emotions.

The same applies to the emotion of greed. But in this case, you have to resist the temptation to buy into investments that have experienced very strong recent performance.

Rebalancing our clients' portfolios during times of significant market corrections or significant bull markets is our way of acting in a slightly contrarian manner over a long period of time. This rebalancing often takes place on an ongoing basis as clients save in their investment accounts, or withdraw from their accounts for living expenses.

When clients add to their investment accounts, we typically invest in those areas of the portfolio that have underperformed; and when clients withdraw from their

portfolios, we typically withdraw from areas of the portfolio that have outperformed. This may sound counterintuitive (buying losers and selling winners) but when done incrementally, it is simply acting in a slightly contrarian manner as well as serving to keep our clients' portfolios balanced.

## Balanced Approach to Portfolio Construction

A balanced approach to portfolio construction is vital for the simple reason that it allows investors to better control their emotions and also makes it easier for them to act in a slightly contrarian manner. If an investor has an unbalanced approach with too high a percentage of assets in equities for example, they may not be able to control their emotions during market downturns and they will have a higher likelihood of selling at the wrong time. A balanced approach helps investors control the volatility in their portfolios and thus reduces the inevitable emotions that come from market corrections.

## Update on Equity Valuations and Future Expected Returns

As we have discussed in past newsletters the GMO 7-Year Asset Class Return Forecasts graph shows expected annual real returns over the next seven years for various asset classes. The term real return simply means the return after subtracting an assumed inflation rate. GMO uses an assumed inflation rate of 2.5%. So the returns shown in the graph are after subtracting 2.5% from the expected return.

As you can see in the graph on page 3, the expected rate of return after inflation for US Large and US Small stocks is essentially zero. The projected returns for US High Quality Stocks and various international stocks are substantially higher. Because of this, we hold a significant portion of our clients' equity positions in international stocks and we also continue to believe that lower risk hybrid investments have a place in client portfolios.

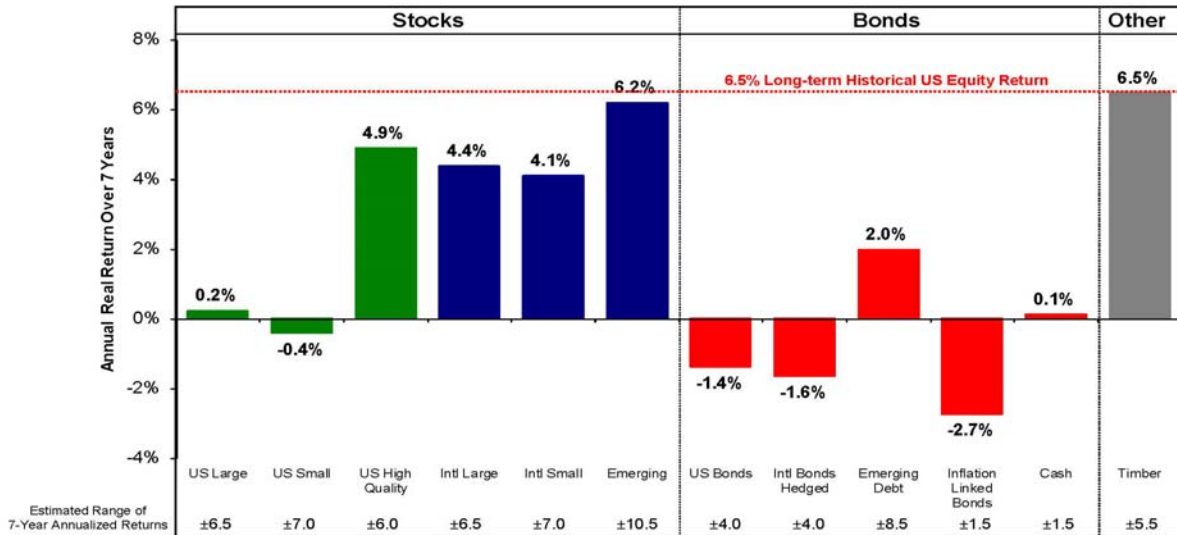
As you can also see, expected bond real returns are mostly negative. This is the main reason we prefer to hold a significant amount of our clients' fixed income allocation in a first trust deed investment that is currently yielding approximately 8%. After subtracting 2.5% for inflation from this 8%, you are left with a real return of 5.5% which is higher than the GMO seven year forecast for most assets - even for most of the equity asset classes.

It is also interesting to compare this November 2012 graph to the 2011 graph. This reveals that November's 7-Year return forecast for equities is lower than the prior year. This is to be expected since equities experienced strong performance over the past year. In Grantham's forecasts, strong current returns result in lower future expected returns and weak current returns result in stronger future returns.

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## GMO 7-Year Asset Class Return Forecasts\*

As of November 30, 2012



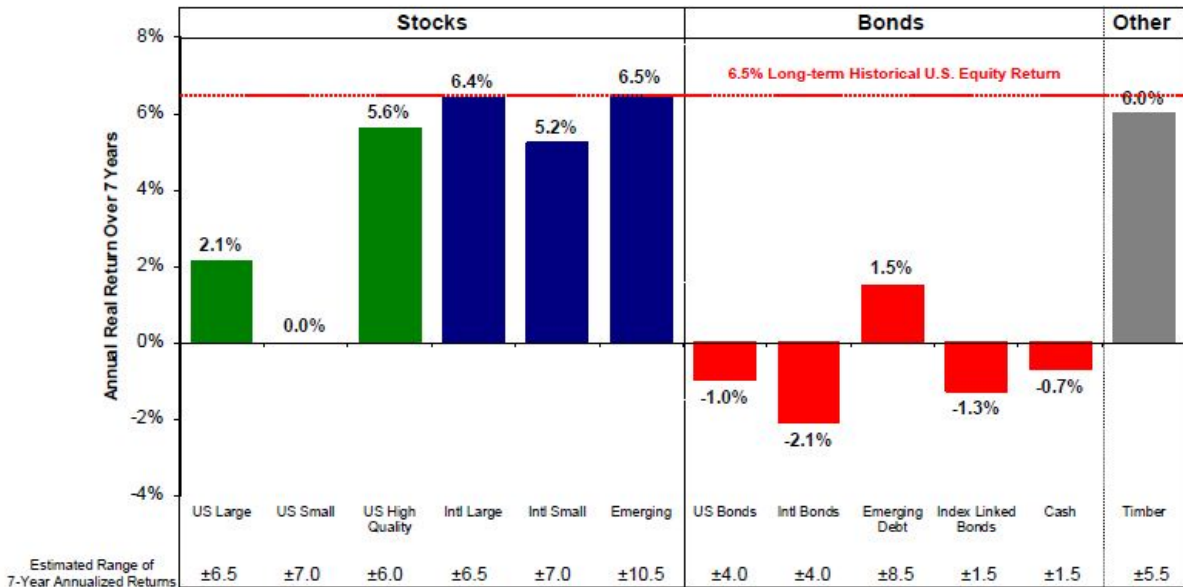
\*The chart represents real return forecasts for several asset classes and not for any GMO fund or strategy. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Forward-looking statements speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in forward-looking statements. US inflation is assumed to mean revert to long-term inflation of 2.2% over 15 years.

Source: GMO

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## GMO 7-Year Asset Class Return Forecasts\*

As of November 30, 2011

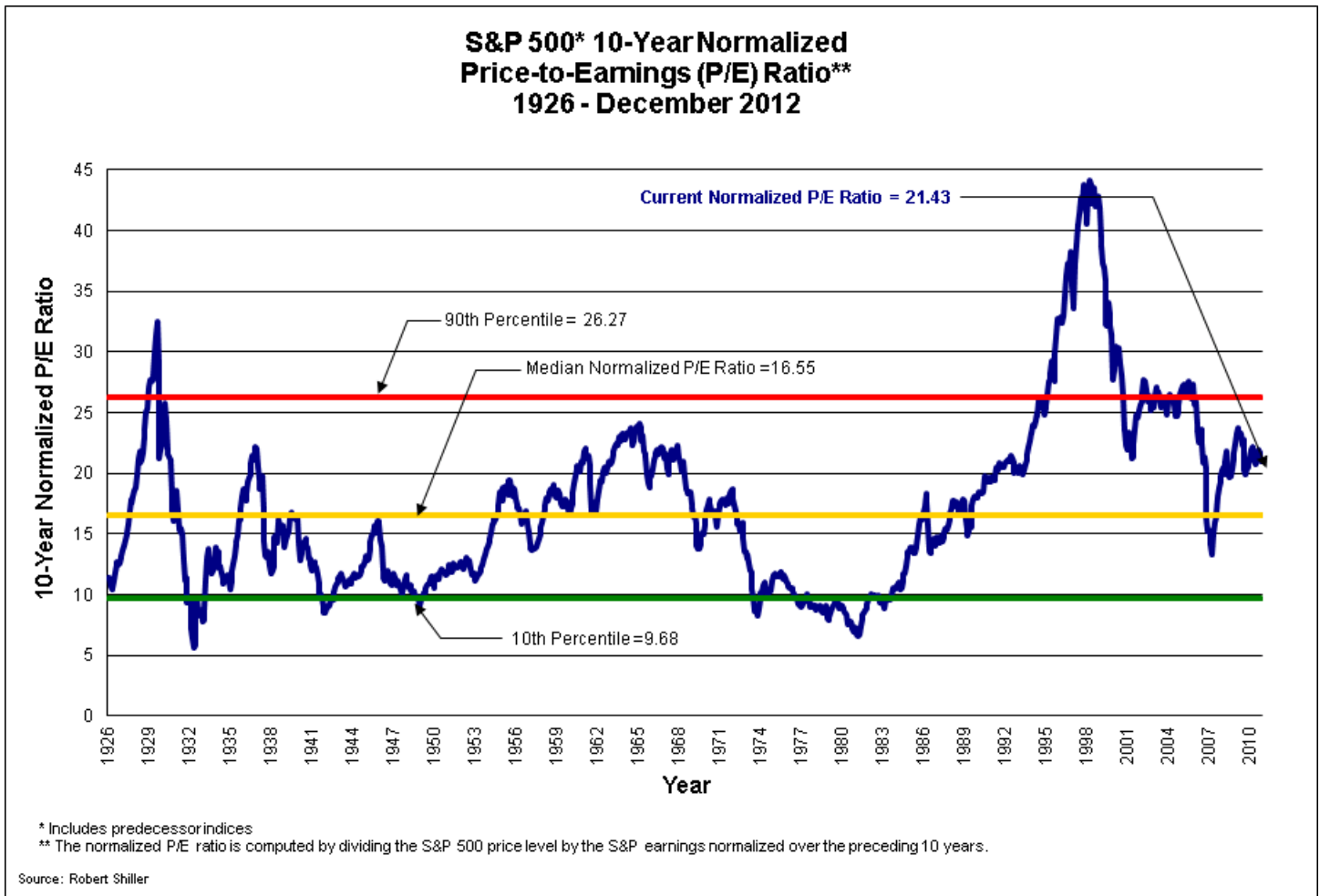


\*The chart represents real return forecasts<sup>1</sup> for several asset classes. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Actual results may differ materially from the forecasts above.

<sup>1</sup> Long-term inflation assumption: 2.5% per year.

Source: GMO

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It should be noted that other well known investors feel GMO's 7-Year forecast for US equities is too conservative.

## Shiller PE (Price/Earnings) Graph

We discussed Shiller's P/E 10 ratio extensively in our July 2009 newsletter – but here is a quick explanation: The P/E 10 is the current level of the S&P 500 Index (price) divided by the average earnings of the prior 10 years (earnings). The data shows that buying at lower ratios has historically led to higher subsequent returns, and vice versa. We must be careful when using data such as this because there are often exceptions to a rule or trend. Please refer to our July 2009 issue posted on our website for further interesting details.

The Shiller P/E 10 ratio currently is 21.43 which is certainly not cheap by historical standards. Remember this is only a measurement for the S&P 500 (US Large Cap stocks). But just as we said last year this measure is consistent with the GMO 7-year forecasted return of essentially flat real returns for US Large Cap stocks over the next 7 years.

With a P/E 10 ratio of over 20 for US Large Cap stocks we believe maintaining a healthy allocation to international markets as well as lower risk investments such as those held in our Hybrid Strategies is still a prudent approach.

## International Shiller PE 10 Valuations

A quick look at the Shiller P/E 10 valuation model for most foreign countries also shows that the US currently has a higher PE ratio than most foreign markets (see graph on page 5). This would argue for keeping equity allocations broadly diversified across foreign markets. We continue to maintain international investments in both developed and emerging markets for most clients.

On the other hand, it should also be said that numerous US companies are of a higher quality and probably deserve to have a higher PE ratio than some foreign companies. The US economy is also arguably further along the road to recovery than many other foreign countries.

## Summary

As the GMO 7-Year return forecasts show, US stock and bond investment returns could be significantly lower than long term historical returns of the past. Higher than expected future inflation might also be one of the results of current monetary policy. In order to counteract both of these issues, we hold a significant portion of our clients' fixed income assets in a high quality, high yielding, first trust deed investment that should perform well in an inflationary environment.



We will also maintain a healthy allocation to international investments which on average may currently be less expensive and therefore have higher expected future returns. In addition, we will continue to hold a small allocation in REITs and commodities for diversification purposes. And lastly because of the risks and uncertainty that still exist in the global economy, we will continue to keep an allocation to lower risk hybrid investments that will serve to reduce portfolio risk and volatility should equity markets disappoint.

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 2013.

*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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