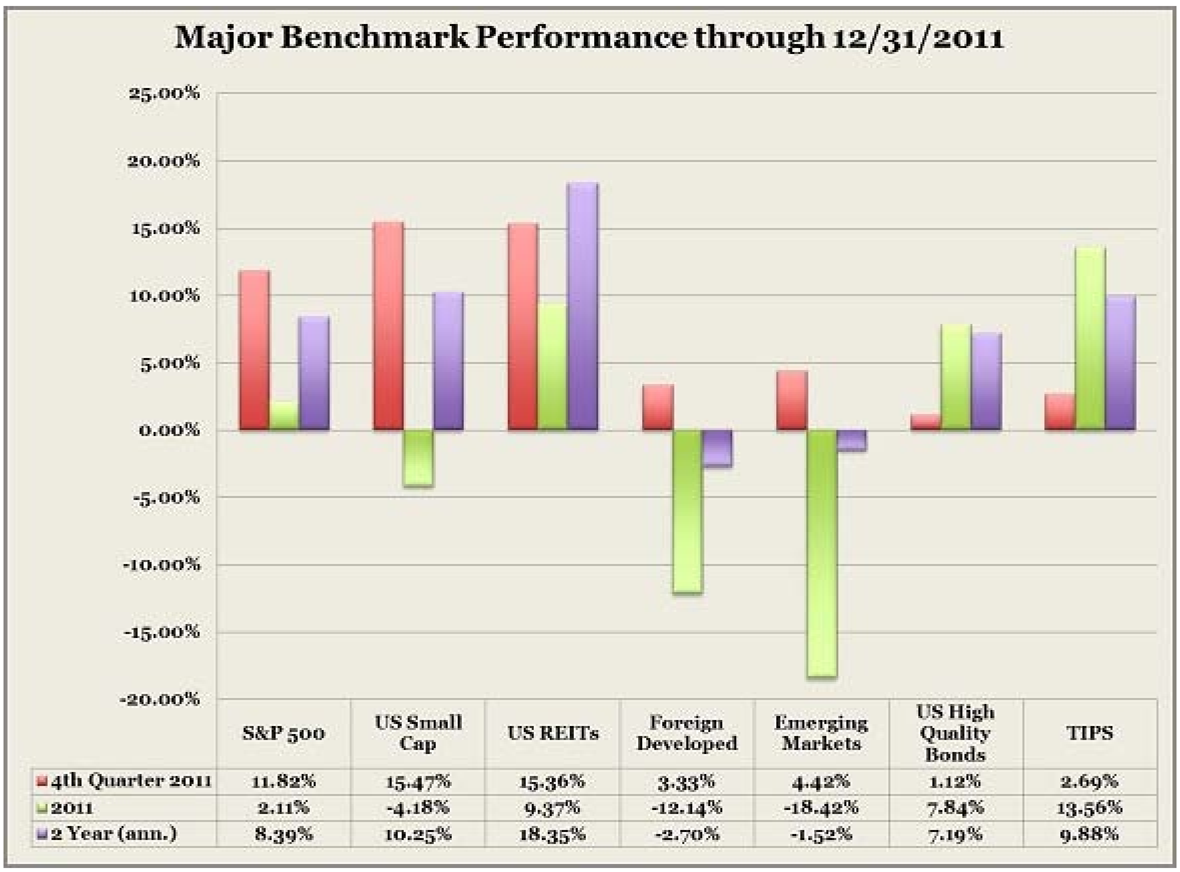
2011 Review and Market Outlook

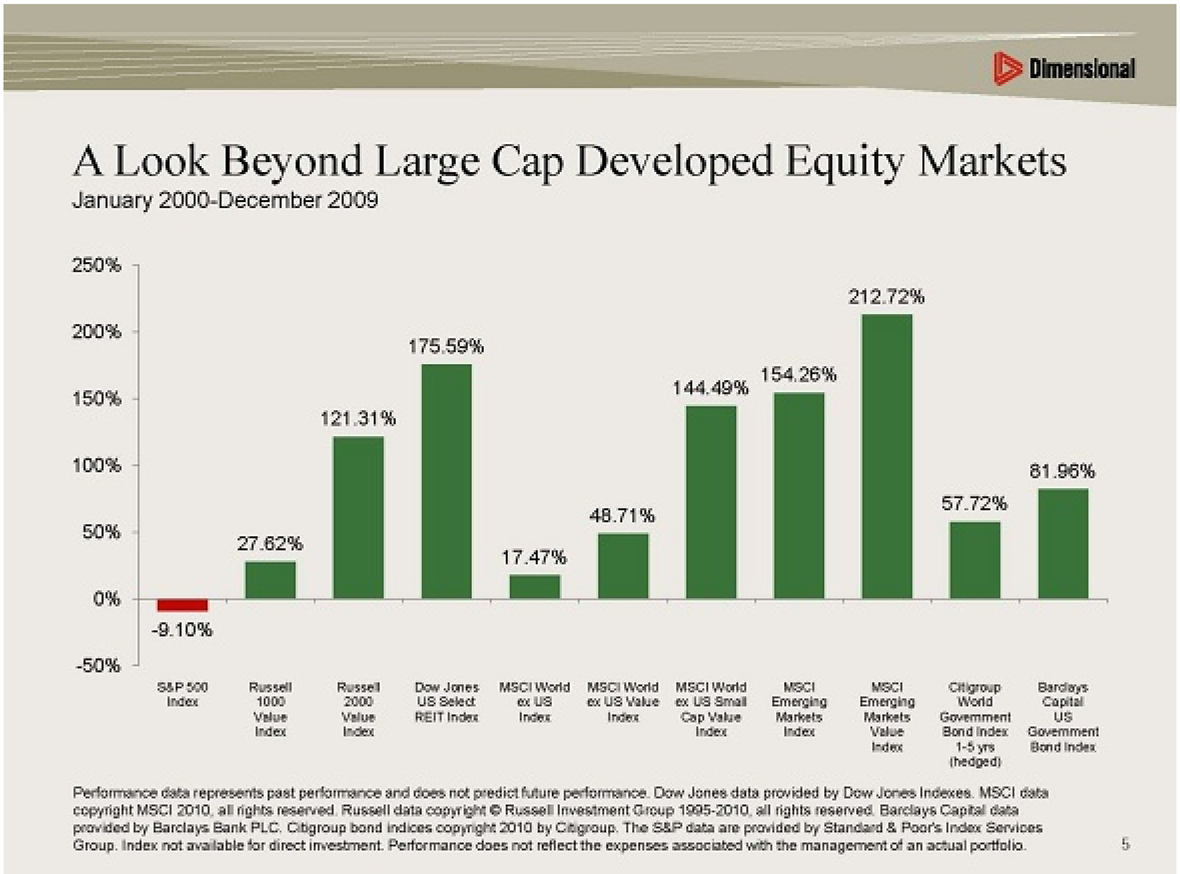
Major Benchmark Performance

After a year of tremendous volatility, the level of the S&P 500 ended the year at 1258, which is exactly where it started. As there was no increase in the S&P's price during 2011, the 2.11% return was entirely due to dividends. The US large cap market was the bright spot across all equity categories, but the US small cap and international equities underperformed in 2011 despite a strong comeback in the 4th quarter.



Source: DFA

Market performance in 2011 was in contrast to the 10-year period 1/1/2000 - 12/31/2009, sometimes referred to as the "Lost Decade." During that time, the S&P was negative (-0.95% per year or -9.10% cumulative) but all other equity categories (as well as fixed income) were positive. As always, our view is to stay focused on the long term with the right mix of stock and bond funds rather than to follow the risky and generally unsuccessful strategy of trying to time the markets.



Source: DFA

Forecasting

As you have heard us say many times before, we do not advocate market timing, forecasting, or technical analysis. Instead, we work with each client to develop a long term strategy in both stock and bond funds. Additionally, we help our clients focus on what they can control, such as spending and savings levels.

To highlight the importance of this strategy, we present an example from last year. A consensus of institutional investors in early 2011 predicted an increase in equities by 15%, a decline in bonds, and an increase in commodities. However, exactly the opposite occurred.

We expect continued market volatility in 2012. The US economy is showing promise (evident in better housing reports and a continued slow decline in the unemployment rate). However, the problems in Europe have not been adequately addressed to alleviate market concerns. Several European economies are struggling, and it is unknown whether the sovereign debt problems which are closely tied with European banks could affect the US market.

Our client portfolios currently do not hold bonds of peripheral European countries (Portugal, Italy, Ireland, Spain, and Greece). We do hold international equity funds that invest in these countries, albeit in small amounts and do not recommend eliminating European equity exposure.

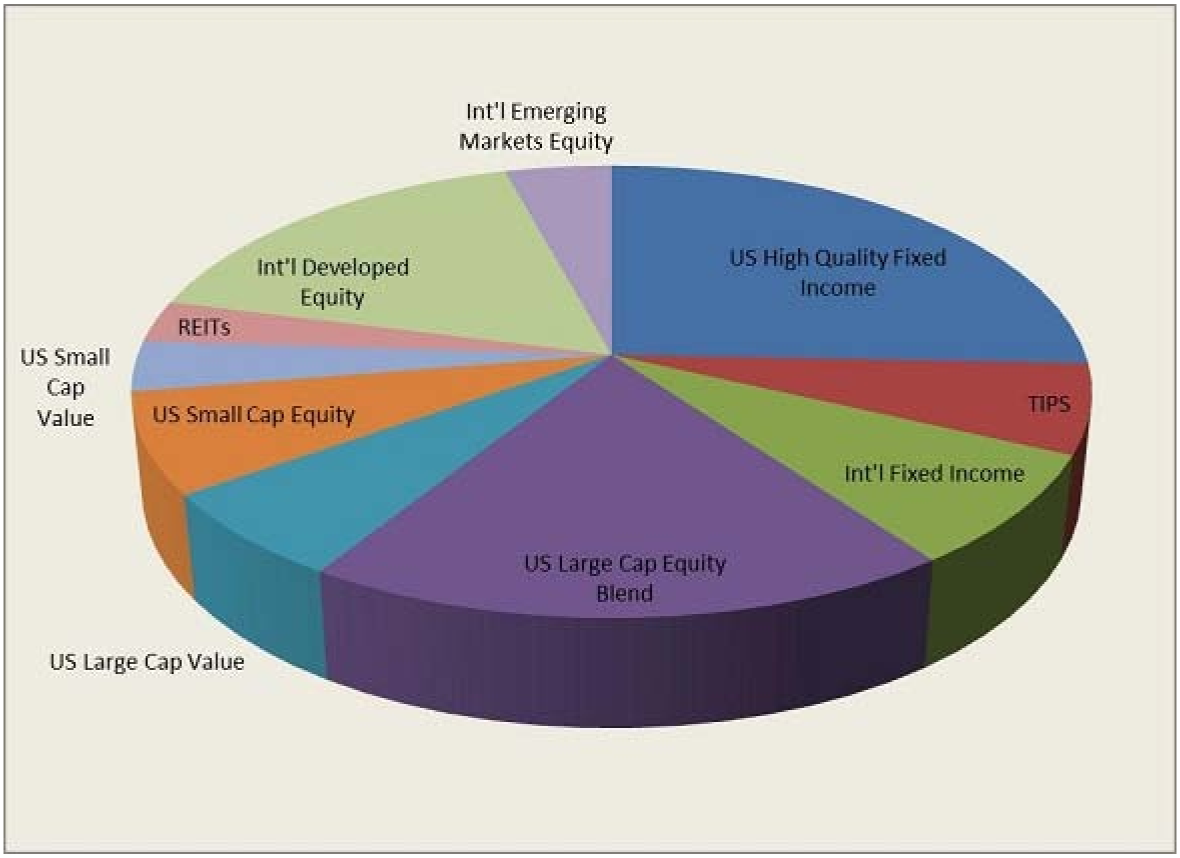
Our Strategy

We thought the beginning of 2012 would be a good time to review the types of asset classes and the role of each in our investment strategy.

- **Cash** - we generally do not prefer holding cash UNLESS it is earmarked for specific expenses in the next couple of years or as an emergency fund. As a long term investment, cash loses purchasing power, i.e. its return does not keep up with the rate of inflation.

The pie chart below shows the broad asset categories that we include in a diversified portfolio.

The broad stock/bond allocation is customized for each client.



- **Equity (stocks)** - we acknowledge that equities can be a volatile investment. However, the central rule in investing is that risk and return are closely related. To mitigate volatility and enhance returns, we continue to endorse diversifying across different equity categories. Over the long term, we expect equity investments to grow at a faster rate than inflation. We diversify across such equity categories as US Large Cap/Small Cap, REITs (commercial real estate), international developed markets and emerging markets.
- **Fixed Income (bonds)** - we rely on fixed income investments to help level out volatility that can adversely affect equities. High quality bonds are expected to have lower but steadier returns over time. As with all investment categories, there is risk; with bonds, we are most concerned by an increase in interest rates and inflation. Currently, interest rates are at historic lows. When interest rates rise, bond prices go down but are somewhat offset by the bond's yield (regular interest payments). To protect against an increase in interest rates, we keep the maturity of our bonds low and offset this risk with equities. We diversify across bond categories such as international, US high quality (taxable) government and corporate, municipal (tax-exempt) and TIPS (Treasury Inflation Protected Securities).
- **International Investments** - there are two components that affect performance of international investments: the underlying stock and bond investments and currency. Foreign currency movements in relation to the US dollar are difficult to predict, so we leave at least half of the international investments in a position whereby they gain in value if the dollar declines in value or depreciates against the foreign currency. We are concerned about a continued weakening of the dollar; however, currency movements can change direction quickly. If the world economy worsens, the US dollar would likely strengthen as it did in 2008 when there was a flight to the perceived safety of US Treasury bonds.
- **Alternative Investments** - our research with this widely reported investment category is ongoing. The goal of alternative investments is to provide an investment that performs in a different manner than both equities and fixed income thereby helping to reduce portfolio volatility. We continue to search for an alternative fund that is reasonably priced, does not generate a K1, have a load, liquidity limitations, and really does live up to its promise of providing strong returns that are driven by factors other than stocks and bonds.

Summary

Although we expect 2012 to continue to pose challenges for investors, we believe maintaining a long term outlook and focusing on what you can control are the most appropriate strategies. We thank you for your confidence in us.

-Janet & Barry

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