

QUARTERLY COMMENTARY

December 31, 2011

Each December many articles tout forecasts for the direction of stock and bond prices in the year ahead. While we regularly give our ten-year outlook for the markets, as we have done below, we mostly avoid attempts to predict returns over shorter periods such as a calendar year. The reason for this is simple: it is an endeavor at which *no one* has shown consistent success.

This past year has again demonstrated just how difficult it can be to make accurate short-term predictions. Going into 2011, the view toward U.S. stocks was generally optimistic. As measured by the price-to-earnings ratio of the Standard & Poor's 500 Index[®] (S&P 500), valuations entered the year just below the historic average, while earnings were forecast to grow at an above-average rate. Investors would normally consider these conditions favorable. Yet, for the year, the S&P 500 ended virtually unchanged in price and provided a total return of just 2%, all of it coming from dividends. This low return occurred despite both earnings and dividends having increased at double-digit rates. (Note: while the 2011 total return for U.S. stocks was well below the historic average, it ranked best among of the world's major countries.)

Numerous negative events and macroeconomic factors limited progress in stock prices. Early in the year a spike in gasoline prices slowed the world economy. Global supply disruptions caused by the earthquake in Japan and flooding in Thailand also weighed-in negatively. Most important was the stress on the European financial system caused by the threat of default of sovereign debt issued by several Euro zone countries. These and other negative news events spooked investors into withdrawing money from stocks, as shown by the \$115 billion that flowed out of U.S. equity mutual funds through November.

Also surprising in 2011 was the course of U.S. Treasury bond prices. With the Federal Reserve having already suppressed interest rates for a relatively lengthy period of two years, and with its second round of "Quantitative Easing" (the purchasing of bonds in order to increase the supply of money in the economy) set to end at mid-year, the general consensus at the outset was for a *rise* in yields, and, therefore, a *decline* in bond prices, during the year. Yet, to the surprise of many, the yield on a 10-year bond, for example, actually declined from 3.3% to just 1.7% by year-end.

| Equity Indices | 4 th Qtr. | 2011 |
|---------------------|----------------------|---------|
| S & P 500 | 11.82% | 2.11% |
| S & P 600 | 17.17% | 1.02% |
| Russell 1000 Growth | 10.61% | 2.64% |
| Russell 1000 Value | 13.11% | .39% |
| EAFE (US\$)* | 3.38% | -11.68% |

Total Returns for the period. *an index of foreign stocks.

| Interest Rates | 9/30/11 | 12/31/11 |
|--------------------|---------|----------|
| 90 Day US T-Bill | .02% | .01% |
| 10-Year US T-Bonds | 1.92% | 1.89% |

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This caused its price to soar by more than 14%, and its total return, including interest payments, to reach 17%. Treasury bond prices rose due to a combination of (1) massive buying from certain Euro zone financial institutions as these looked for safer alternatives to their own countries' sovereign debt (2) a new round of long-term bond buying from our own Federal Reserve under "Operation Twist" (3) net bond purchases by U.S. banks as their deposit growth outstripped the demand for new loans, and (4) positive flows into bond mutual funds.

Comparing the results of U.S. stocks with those of U.S. Treasury bonds, we see first that stock returns were limited by a constant stream of negative news and pessimism, despite otherwise strong fundamentals. U.S. Treasury bonds, on the other hand, benefited from the large inflows of money described above, this despite providing unattractive yields. It has been this confluence of news and events that has caused stocks and Treasury bonds to be priced as they are now. So, while we cannot predict what returns will be for the New Year, it is our firm belief that a continued stream of negative news will be required in 2012 to keep stock prices from rising. Further, for Treasury bonds to rise in price (decline in yield), increased buying will be required by European institutions, the Federal Reserve, U.S. banks, and others, in order to absorb the ever-increasing supply of bonds created by Washington's deficit spending.

Unlike short-term market forecasts, which are dependent upon quick-to-change current news and investor emotions, longer-term forecasts, as we calculate them, are mathematical. By looking at current valuations, long-term trends in earnings, dividend levels, interest rates, and other factors, we can build reasonable (albeit not exact) expectations for returns over a period of ten years or so.

An update of our ten-year return expectations for U.S. large company stocks puts the average annual return in a range of 7% to 9%. This range is slightly higher than our expectation of 6.5% to 8.5% one year ago. The slight increase is caused by a combination of the average dividend yield climbing from 1.85% to 2.12%, an increase in trend earnings, and flat stock prices over the past year.

Our outlook for bond returns is as varied as the bond market itself, but overall it calls for returns to be at the lower-end of historical ranges. This is especially true for U.S. Treasuries, as their yields are currently near historical lows. It will take a significant increase in those yields within the next few years for U.S. Treasuries to provide an attractive ten-year return. Municipal bonds, mortgages, and corporate bonds are all positioned to provide much higher returns than U.S. Treasuries over the next decade. However, their returns are unlikely to approach those that investors have enjoyed over the past thirty years.

Our non-traditional assets portfolio is currently affected by the Federal Reserve's decision to keep short-term interest rates at near-zero levels. This policy generally helps the portfolio's holdings in gold and real estate investment trusts, while hampering the returns for floating rate loans, merger arbitrage, and managed futures. Overall, we have

not changed our ten-year expectation of 6% to 8% average annual returns for this portfolio.

As always, the New Year starts with much uncertainty. Markets in the short-term can be expected to gyrate in response to the latest news regarding the European sovereign debt issue, slowing economic growth in emerging markets, and the upcoming presidential election in the U.S. You can rest assured that we will be looking for opportunities in the volatility that these uncertainties create, while always keeping our focus on providing attractive long-term returns.

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