

# MARKET REVIEW | DOMESTIC EQUITY INTERNATIONAL EQUITY FIXED INCOME

Fourth Quarter 2011

## DOMESTIC EQUITY MARKET

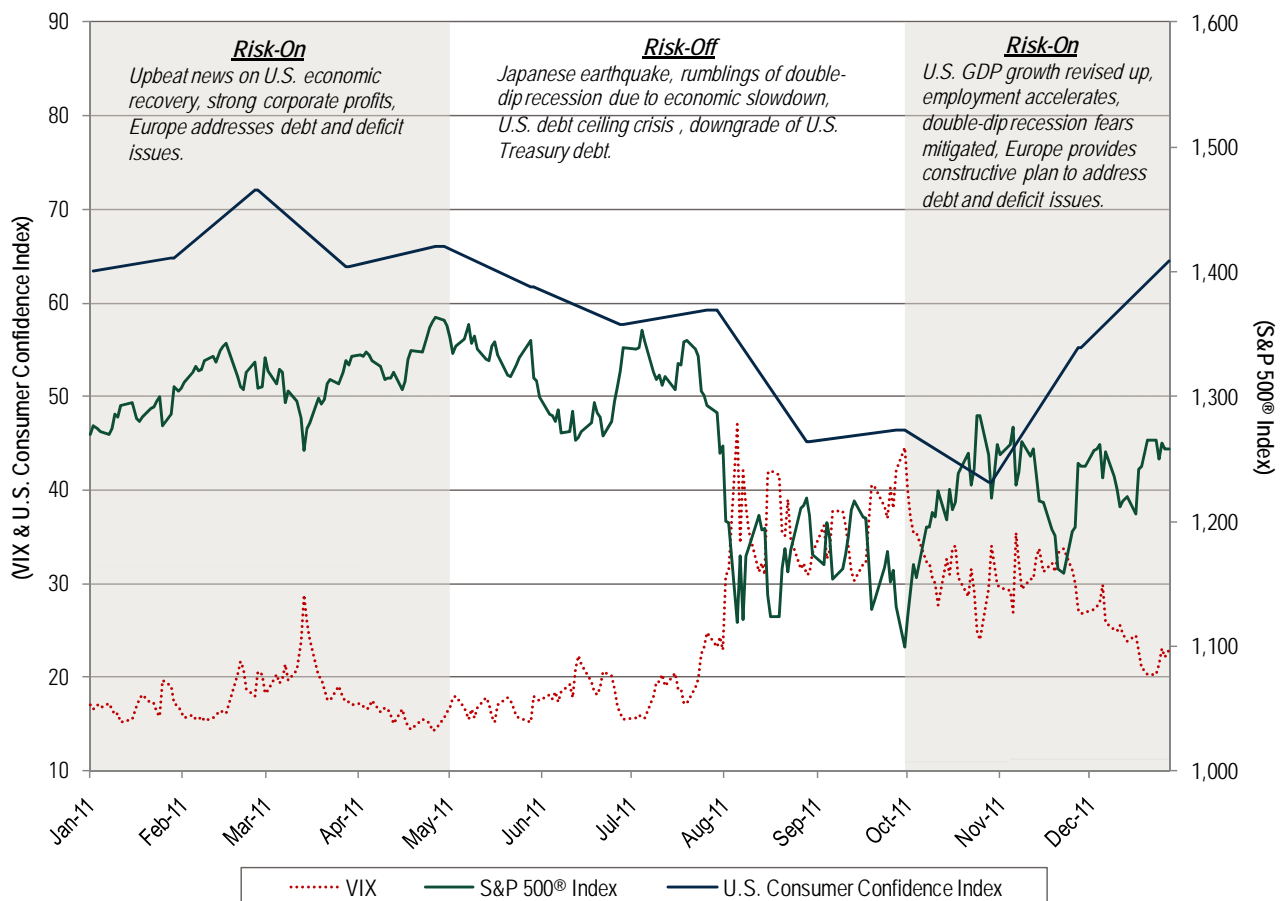
The fourth quarter of 2011 saw a strong recovery of returns relative to the dismal performance of the previous quarter. Throughout the quarter, stronger statistics on employment and gross domestic product (GDP) supported by a change in sentiment concerning the European debt crisis, encouraged investors to return to the equity markets. In addition, third-quarter earnings modestly beat expectations, increasing at a double-digit rate of 14%, continuing the strong financial performance from the corporate sector. The large-cap segment of the equity market, as measured by the S&P 500® Index, returned 11.82%. Mid-cap stocks (represented by the Russell Midcap® Index) beat large-caps with a 12.31% return, while small-cap stocks (Russell 2000® Index) beat both large- and mid-cap by posting a 15.47% return. This revealed a more aggressive posture on the part of investors. From a style perspective, the relatively strong outperformance of the financial sector (+10.82%) versus the technology sector (+8.71%) resulted in value stocks outperforming growth stocks, 12.97% vs. 10.80% respectively.

The year 2011 will likely be remembered for the macroeconomic uncertainties confronting investors on three particular fronts: financial, political, and Mother Nature. The Japanese earthquake and floods in Thailand had detrimental economic ramifications worldwide as production disruptions revealed the scope of the global supply chain. The political upheavals in several Middle East countries disrupted oil production and generally increased tension in an already volatile part of the world. Washington and several European capitals had their own political confrontations as the debt ceiling debates in the U.S. and the fall of the Italian and Greek governments demonstrated how ineffective policymakers have been in addressing the serious economic problems and consequent social issues in their respective countries. The year's financial news has been dominated by the developments surrounding the European sovereign debt crisis—overwhelming the generally strong financial performance of the U.S. corporate sector.

The news flow during 2011 created episodic crises and resulted in the “risk on/risk off” (to quote the vernacular) performance of the equity markets. Seth Klarman, a very successful value investor, has characterized investing as “the intersection of economics and psychology” and 2011 added credence to that assessment.\* Investors’ psyches have alternated between despair and euphoria in

## Risk On, Risk Off

The impact of investors' psychology, macroeconomic uncertainties, and volatility on the 2011 equity market



response to their perceived state of affairs. Investor optimism was reflected in the S&P 500® Index's 9.06% return over the first four months of the year in response to the upbeat news on the economic recovery, strong corporate profits, and the expectation that Europe's sovereign debt issues would be constructively addressed. Thus, *risk on*.

Then the news flow changed. The economic ramifications of the Japanese earthquake became evident. Domestically, economic momentum appeared to stall with negative consequences for employment and talk of a double-dip recession surfaced. Moreover, the debt ceiling crisis in Washington and the downgrade of U.S. Treasury debt further unnerved investors. As such, the equity market reacted with a -16.26% return over the next five months (May through September). Thus, *risk off*.

Again, the tone of the news changed as U.S. GDP growth was revised up, employment accelerated, and talk of a double-dip diminished. Internationally, rumblings out of Europe raised hope anew of constructive steps to address their debt and deficit problems and the risk to the banking system. *Risk on*. There was nearly a 12% return in the equity market during the fourth quarter; yet for the year, the equity market was essentially flat on a price basis with the total return of 2.11% due to the dividend. The market swings in 2011 led to domestic equity mutual funds experiencing their second-biggest redemption year on record (2008 was the number one year for withdrawals).

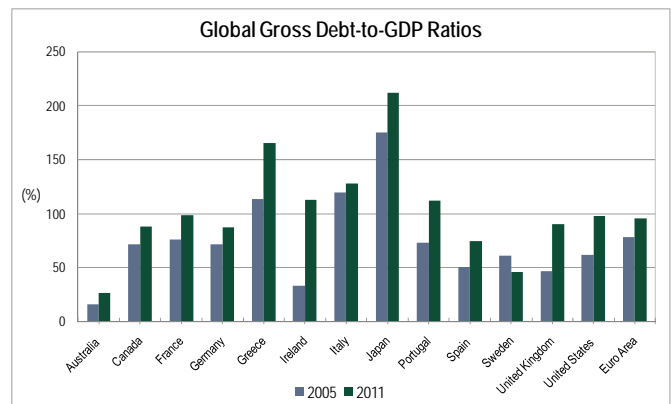
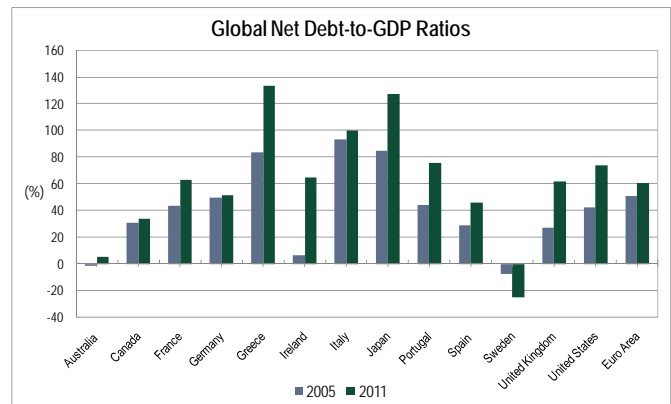
Are we in for more of the same in 2012? It is hard to believe we can avoid it. While it seems highly unlikely that a natural disaster as disruptive as the Japanese earthquake will occur, the financial and political issues that plagued 2011 are still with us. The trite phrase "kicking the can down the road" aptly describes the steps policymakers on both sides of the Atlantic have taken to address the debt and deficit issues. Moreover, being an election year in the U.S. certainly doesn't aid the possibility of any constructive solutions being deployed. Consequently, a domestic economic outlook of slow growth, continued historically high unemployment, low interest rates, and increasing economic and political angst is likely. Corporate financial news should be supportive of equity prices with mid-single digit earnings growth, attractive dividend yields and strong free cash flows funding dividend increases, and share buy backs. As in 2011, companies with superior business models and the ability to execute are likely to lead the performance derby.

The volatility of returns in 2011 was certainly due more to the changing psychology of investors rather than any significant changes in economics. There the story remains unchanged. Michael Lewis, in his new book *Boomerang* observed, "When you borrow a lot of money to create a false prosperity you import the future into the present". In this context, considerable austerity will be required to bring the two back in line, an adjustment process likely to produce more episodic crises and result in sub-potential economic growth in the developed countries for some time to come.

### INTERNATIONAL EQUITY MARKET

Global equity markets ended the year on a high note posting positive returns, but were down significantly for the year. The MSCI EAFE Index (Net Dividends) was up 3.33% for the quarter, but was down 12.14% for the year. The MSCI ACWI ex-U.S. Index (Net Dividends) was up 3.72% for the quarter, but was down 13.71% for the year. The MSCI Emerging Markets Index (Net Dividends) was up 4.42% for the quarter and down 18.42% for the year. The MSCI World ex-U.S. Small Cap Index (Net Dividends) was up 0.69% for the quarter and down 15.81% for the year. The realities of the global economy were likely a factor contributing to the poor 2011 equity performance. Despite the strong fourth quarter for equities, the underlying problems hampering the global economy remain largely unresolved.

Developed nations are not in very good shape as they have an enormous amount of debt that continues to grow relative to GDP. Rather than address the problems head-on, leaders have chosen to implement short-term solutions that are devoid of meaningful change and do little to solve the underlying problems. In fact, debt-to-GDP figures are consistently higher now than they were prior to the financial crisis in 2005, as illustrated in the charts to the right.



Source: NCPA

If unfunded liabilities such as governments' future pension and healthcare costs are included, debt-to-GDP ratios are simply unmanageable. For example, the average European nation debt-to-GDP ratio is a staggering 434% when unfunded liabilities are included.

Europe's own sovereign and bank debt issues have been in the forefront of the financial news. Its problems are further complicated by a complex political structure in which there is a monetary union, but no real fiscal or political union. The interconnectedness of the banks and sovereigns is also of concern. Many serious questions remain unanswered: How will Greece and Italy get out of their current financial situation? Will they default? How will other countries be affected? How will the euro zone and the euro be affected? However, European leaders have met regularly throughout the year in an attempt to solve their problems and alleviate the fears of market participants.

Of the announcements out of European Council's December 2011 meeting, the most meaningful were "a new fiscal compact and strengthened economic policy coordination" and "the development of our stabilization tools to face short-term challenges." The new fiscal agreement isn't materially different than the Stability and Growth Pact adopted in 1997, which stipulates that annual deficits be less than three percent of GDP and that gross government debt-to-GDP ratios not exceed 60%. Only Estonia, Finland, Luxembourg, and Sweden have not violated this agreement. To note, the new agreement is different in that it is to be binding at a constitutional or equivalent level. Most notably, the United Kingdom vetoed the measure. It remains to be seen if the countries that agreed to it will ultimately ratify the agreement internally. Even if they all successfully ratify the agreement, it is unclear if compliance would be more universal this time.

The language associated with the stronger policy coordination and governance statement is essentially meaningless. They will "make more active use of enhanced cooperation", they are "committed to working towards a common economic policy", and they have agreed to regular Euro Summits that will be held at least twice a year. Some might suggest faith is better placed in an agreement between two six-year olds that involves enhanced cooperation, a commitment to work toward attempting to get along, and regular timeouts than in an agreement among leaders that have so far demonstrated a complete lack of political will to do anything of importance.

Annex Table 33. **General government net financial liabilities**  
Per cent of nominal GDP

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Australia	25.7	26.3	20.9	21.1	16.0	14.9	8.8	6.4	4.5	2.4	0.3	-1.3	-4.6	-7.2	-7.5	-3.7	1.8	4.9	6.1	6.1
Austria	35.2	38.6	40.2	36.4	36.5	35.7	34.7	35.6	37.1	36.1	38.1	37.9	34.0	31.4	34.7	40.6	44.0	45.2	47.4	48.9
Belgium <sup>1</sup>	114.4	114.5	115.3	110.8	107.7	103.0	97.5	94.9	93.1	90.2	83.7	82.0	77.2	73.2	73.6	79.7	80.3	80.4	81.5	81.1
Canada	67.9	70.7	70.0	64.7	60.8	55.8	46.2	44.3	42.6	38.7	35.2	31.0	26.3	22.9	22.6	28.3	30.4	33.6	36.6	38.3
Czech Republic	..	..	..	..	..	..	..	..	-15.6	-7.2	-9.3	-10.9	-11.2	-15.7	-6.7	-2.7	2.3	6.0	9.2	12.2
Denmark	32.9	33.4	33.3	32.3	35.1	28.4	22.5	20.1	19.1	18.0	14.8	10.5	1.9	-3.8	-5.3	-3.7	-1.3	2.4	7.4	10.2
Estonia	..	-39.2	-28.6	-23.5	-40.4	-39.8	-30.4	-28.5	-28.6	-29.1	-32.1	-31.9	-31.4	-28.9	-26.3	-29.6	-36.5	-32.7	-28.9	-26.9
Finland <sup>2</sup>	-16.3	-7.3	-6.7	-7.5	-14.5	-50.3	-31.1	-31.7	-31.3	-38.5	-46.7	-58.6	-69.5	-72.6	-52.2	-62.5	-64.5	-60.9	-56.6	-53.6
France	29.6	37.4	41.9	42.4	40.6	33.6	35.2	36.7	41.9	44.4	45.4	43.4	37.4	35.7	45.9	52.3	58.9	62.7	66.2	67.7
Germany <sup>3</sup>	19.1	29.7	32.7	32.5	36.3	34.4	33.7	36.1	40.3	43.3	47.3	49.6	47.7	42.5	44.6	49.1	52.2	51.5	51.6	50.5
Greece	..	81.7	82.2	77.5	73.3	71.2	89.8	94.1	95.9	88.4	88.5	83.7	87.1	82.0	90.4	102.0	115.5	133.1	144.6	147.8
Hungary	3.4	24.5	25.5	25.2	32.1	34.4	33.0	32.5	36.9	37.8	41.8	46.2	51.7	53.5	51.9	59.9	61.0	55.0	56.6	58.0
Iceland	..	..	..	..	42.6	35.9	37.5	29.2	28.5	30.7	27.6	13.6	7.9	-1.0	26.0	39.9	48.2	50.5	50.6	49.4
Ireland	..	..	..	..	42.2	27.4	15.9	12.5	14.0	11.9	8.7	6.4	2.0	-0.1	12.6	26.3	54.9	65.0	72.5	77.6
Italy	104.0	98.6	103.9	104.1	106.3	100.3	95.0	95.7	95.2	92.3	92.0	93.4	90.3	86.6	89.5	99.7	98.6	100.2	100.6	99.1
Japan <sup>4</sup>	19.6	23.8	29.2	34.8	46.2	53.8	60.4	66.3	72.6	76.5	82.7	84.6	84.3	81.5	85.6	110.0	116.0	127.6	134.8	142.5
Korea <sup>5</sup>	..	..	..	..	..	..	..	..	-32.3	-31.1	-31.6	-35.9	-36.8	-40.3	-37.7	-39.0	-37.4	-38.3	-39.4	-40.7
Luxembourg	..	..	..	..	-53.2	-52.4	-54.5	-60.6	-59.2	-56.9	-54.1	-51.4	-51.0	-54.8	-50.8	-55.6	-49.9	-46.2	-43.5	-39.8
Netherlands	44.6	54.0	52.7	49.7	48.2	36.7	34.9	33.0	34.8	36.2	37.6	35.0	31.6	27.8	27.0	29.7	34.4	37.7	40.2	41.8
New Zealand	43.9	37.6	32.4	29.8	27.8	25.4	23.4	21.1	17.6	13.1	8.3	3.7	-1.2	-5.5	-5.0	-1.0	2.9	10.8	14.3	16.8
Norway	-30.6	-36.1	-41.0	-48.5	-51.9	-57.3	-67.2	-84.4	-80.7	-95.1	-104.2	-121.4	-135.1	-141.3	-126.3	-158.8	-165.9	-162.5	-167.7	-170.4
Poland	..	-15.0	-5.7	0.3	6.4	13.5	15.5	18.5	22.1	22.7	20.8	23.5	22.4	17.0	17.2	22.5	28.7	32.2	33.7	34.0
Portugal	..	24.3	26.5	31.2	32.5	30.4	28.0	29.8	34.0	36.2	41.1	44.1	50.1	49.6	54.1	64.5	69.6	75.8	82.2	83.9
Slovak Republic	..	-30.7	-18.2	-12.1	-3.7	1.2	12.5	10.9	1.7	1.8	7.6	4.9	6.5	7.3	8.9	17.2	21.6	26.4	29.8	31.6
Slovenia	..	..	..	..	..	..	..	-15.6	-14.2	-9.5	-9.7	-8.5	-9.9	-16.9	-5.0	0.1	0.8	6.1	10.5	13.5
Spain	46.4	51.6	55.5	54.2	53.7	47.7	44.2	41.6	40.3	36.8	34.6	29.1	22.4	17.8	22.6	34.4	40.3	45.6	49.6	51.7
Sweden	20.7	25.6	26.6	24.6	22.0	12.4	5.5	-2.5	3.9	0.0	-2.7	-7.9	-18.9	-22.5	-16.6	-24.4	-26.1	-24.9	-24.2	-24.0
Switzerland	..	..	..	..	..	6.0	3.3	2.8	7.3	7.4	9.3	8.4	5.5	1.0	2.8	1.9	1.3	0.4	0.0	-0.6
United Kingdom	19.7	26.3	27.9	30.6	32.6	29.0	26.8	23.2	23.7	23.9	25.9	27.1	27.5	28.4	33.3	44.1	53.9	61.7	68.9	74.0
United States	54.4	53.8	51.9	48.8	44.9	40.2	35.3	34.6	37.2	40.5	42.1	42.5	41.8	42.7	48.5	60.5	68.4	73.8	80.3	85.6
Euro area	44.2	49.2	53.6	53.6	53.9	48.3	47.5	48.0	50.4	50.6	51.4	50.5	46.6	42.6	47.4	54.5	58.5	60.8	62.8	63.1
Total OECD	41.8	43.4	44.3	43.6	44.0	40.5	38.2	37.8	40.0	41.4	42.5	42.1	40.0	38.3	43.9	52.5	58.1	62.5	66.7	69.7

Note: Net debt measures are not always comparable across countries due to different definitions or treatment of debt (and asset) components, see also *OECD Economic Outlook* Sources and Methods (<http://www.oecd.org/eco/sources-and-methods>).

1. Includes the debt of the Belgium National Railways Company (SNCB) from 2005 onwards. 2. From 1995 onwards housing corporation shares are no longer classified as financial assets.

3. Includes the debt of the Inherited Debt Fund from 1995 onwards. 4. Includes the debt of the Japan Railway Settlement Corporation and the National Forest Special Account from 1998 onwards.

5. Data are on a non-consolidated basis (SNA93). Source: OECD Economic Outlook 90 database. This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

The European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) are the two primary stabilization tools. European leaders have proposed issuing loans to the International Monetary Fund (IMF) to ensure it has adequate resources to deal with the crisis. The EFSF and the ESM are something like collateralized debt obligations (CDOs). The essential difference is that, unlike CDOs, they have no tranche structure. The EFSF and the ESM are guaranteed by the euro area countries. Europe cannot meet its debt obligations as it stands. Europe expects institutional investors to buy shares (i.e., loan money to Europe) of the EFSF and ESM so that the EFSF and the ESM can loan that money to struggling economies of Europe if and when they begin to struggle even more. In order to achieve a AAA rating and alleviate investor fears, these same European nations will guarantee the EFSF and ESM payments. To put things into perspective, it sounds a lot like trying to buy another house on credit after having lost your job and having spent your entire savings. At this time, the EFSF isn't pre-funded and the ESM is supposed to be 16% pre-funded, but that funding comes in the form of five annual 3.2% commitments. In addition, the most troubled nations in Europe are not excluded from these commitments.

All of this is important in that the global market seems to be reacting dramatically to any type of news out of Europe given that market fluctuations in excess of  $\pm 3\%$  have been relatively common this year. It is unlikely these types of market moves are over. How the crisis ultimately plays out is anyone's guess, and the solution will likely take years. However, the countries of the euro zone will survive. In addition, a large amount of uncertainty is, and has been, built into equity prices and the practices of public corporations. Large- and small-cap equities continue to play an important part of a long-term portfolio of investments.

### **FIXED INCOME MARKET**

As discussed, political unrest in the Middle East, natural disasters in Japan and Thailand, sovereign debt downgrades in the U.S. and Europe, and the ongoing sovereign debt crisis in Europe were some of the more significant events contributing to the elevated levels of volatility faced by investors throughout the past year. While investors may be happy to see 2011 come to a close, some of these issues that plagued the financial markets over the past 12 months are likely to continue to create significant amounts of volatility in the coming year. A presidential election year in the U.S., the Federal Reserve maintaining an accommodative monetary policy beyond 2012, and a slow and uneven economic recovery are all reasons why investors could maintain a cautious view toward risk as we embark on the new year.

The fourth quarter was dominated by developments in Europe as political leaders across the 17-member countries of the euro zone struggled to convince the global financial markets that their efforts to support weaker member countries would be enough to contain the crisis from spreading to the larger countries of Spain and Italy. Additionally, concerns surrounding the health of Europe's largest financial institutions came into focus due to their exposures to the sovereign debt of many of the weaker countries and their growing unwillingness to lend to each other in the inter-bank lending market. While the European Central Bank (ECB) took several steps to alleviate some of these mounting pressures, financial markets were disappointed on several occasions with the ECB's unwillingness to employ the full power of its balance sheet and buy unlimited quantities of sovereign debt to reduce the funding pressures facing many of the highly indebted nations. Investor confidence that a comprehensive solution could be agreed upon and implemented to contain the crisis appeared to diminish in the fourth quarter, as yields on the sovereign debt in some of these countries remained unsustainably high, in our opinion. On the other side of the Atlantic, political tensions continued in the U.S. as the "Super Committee" failed to reach an agreement on a deficit reduction plan, which will result in the automatic spending cuts to become effective as agreed upon back in August. Furthermore, Democrats and Republicans were only able to reach a last-minute agreement in December to extend the payroll tax cuts for an additional two months, leaving further negotiations on a year-long extension for early 2012.

While the economic recovery in the U.S. continued to progress at a slow and uneven pace, economic data in the fourth quarter showed some positive signs. Most notable were readings regarding the labor market, as the unemployment rate declined to 8.5% in December from 9.0% at the end of the third quarter. Furthermore, initial weekly jobless claims reached their lowest level in mid-December since the middle of 2008, while non-farm payrolls have expanded by an average of 137,000 over the past three months. Auto sales reached their highest level in more than two years in November and activity in both the manufacturing and services sectors continued to expand at a moderate pace, as measured by respective Institute for Supply Management surveys. Finally, the Conference Board's measure of consumer confidence reached its highest level since April, ending 2011 at 64.5, up from 46.4 at the end of the third quarter. The Federal Reserve met twice during the fourth quarter with no material changes to their current policies providing a high level of accommodation to the financial markets. Importantly though, as noted in the minutes from their December meeting, members agreed to begin publishing their projections for the target federal funds rate as part of the Summary Economic Projections (SEP), which are currently released on a quarterly basis. In addition, the SEP will include members' projections regarding the timing of the first increase in the target federal funds rate based upon their views of future economic trends. Their goal is to increase the transparency of monetary policy as well as enhance their ability to influence long-term interest rates through more open communication with the financial markets.

In spite of the uncertainties emanating from the sovereign debt crisis in Europe, returns in the investment grade fixed income markets for the fourth quarter were led by non-government sectors, namely, commercial mortgage-backed securities (CMBS) and corporate bonds issued by industrial, financial, and utility companies. While all investment grade sectors posted positive absolute returns, these sectors outperformed Treasury securities by a wide margin for the quarter; only corporate bonds issued by industrial and utility companies outperformed Treasuries for the full year. For 2011, Treasuries posted a total return of 9.81%, while utility companies returned 13.23% and industrial issuers returned 10.47%. Standard & Poor's downgrade of the U.S.' AAA credit rating in August did not sway investors from increasing exposure to Treasuries as uncertainty escalated in Europe. Yields on 10-year maturity Treasury notes declined by 142 basis points during 2011, reaching a low of 1.72% in September. Interestingly, nearly 50 percent of this decline in yield occurred after the S&P downgrade and the 10-year Treasury posted a total return of 17.18% for 2011. Additionally, the 30-year Treasury returned 35.6% for the year as its yield declined by 144 basis points over the course of 2011, more than 60% of which followed the U.S. downgrade. The combination of the Fed's near-zero interest rate policy and the heightened demand for Treasuries resulted in a much flatter yield curve at the end of 2011. The yield spread between the 2-year Treasury and 10-year Treasury declined by 106 basis points to end 2011 at 164 basis points, after having been as steep as 289 basis points in the first quarter of the year.

As we enter 2012, our expectation is for the sovereign debt crisis in Europe to remain at center stage and likely be the primary source of volatility over the near term. Slowing global growth and prospects for sustained momentum in the U.S. economic recovery will also be focal points for investors in 2012. Election year gridlock in Washington will likely limit any progress on the fiscal policy front, yet the markets will become increasingly focused on the presidential election as we move through the new year. In a volatile environment, we believe investors who are able to maintain their focus on fundamentals, diversification, and a willingness to remain patient will be rewarded as the year unfolds.



### **Past performance is no guarantee of future results.**

All data is as of 12.31.11 unless otherwise noted.

*\*The Guru Investor, Friday, December 2, 2011, "In Rare Interview, Klarman Talks Value Investing"*

Index performance information was furnished by sources deemed reliable and is believed to be accurate, however, no warranty or representation is made as to the accuracy thereof and the information is subject to correction. Although reinvestment of dividend and interest payments is assumed, no expenses are netted against an index's returns. The indexes referenced are unmanaged market indexes. It is not possible to directly invest in an index.

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