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2011 Fourth Quarter Review

For all the drama of 2011, with earthquakes, tsunamis, government shutdowns, sovereign defaults, insider trading scandals, the "Arab Spring" revolutions, U.S. Bond ratings downgrades, and assorted European crises, stocks went essentially nowhere. If you had closed your eyes on New Year's Eve in 2010 and opened them a year later, you might have thought that nothing much had happened. Unfortunately, those of us who were awake went on a roller coaster ride with the increased volatility that seems to have become part of "the new normal." For all of the back and forth, the S&P 500 finished the year essentially flat. (This was after falling over 14% in the third quarter and rising over 11% in the fourth.) The Nasdaq index finished down 1.8%, while the Russell 2000, which represents small company stocks, did the poorest by falling 5 ½%. This pattern continued the disparity we noted earlier in the year with the large, multinational, dividend paying stocks being the better place to invest. That was borne out by the fact that the Dow Jones 30 Industrial Index gained over 5% for the year (mostly due to the price rises of McDonalds and IBM), while most other domestic stock indices were either flat or down.

Even though the S&P 500 index held its own in 2011, that was not the case for markets abroad and in some particular sectors that had recently been "hot." Mutual funds holding international stocks fell on average by 12% for the year. Eurozone stocks fell 18% and the Japanese market fell 17%. The previously popular "BRIC" countries (Brazil, Russia, India, and China) had their own bear markets with their stocks falling by 18%, 20%, 25%, and 22% respectively. By comparison, the U.S. equity market ended up being "the best house in a bad neighborhood" in 2011. Most commodities reversed their recent trend and fell by double digits as well. Silver fell 10.5%, copper 23%, and platinum 22%, while wheat, sugar, and cotton fell by double digits as well. Crude oil gained 8% while natural gas prices plunged 32%. Even an upward move in gold was pretty bumpy as it fell almost 16% from its peak of $1,900 an ounce, but still posted a gain of 10% for the year. Still, mutual funds with precious metal stocks fell by 20% on average while those in the financial and natural resources sectors fell over 13% and 14%, respectively. It was a tough year around the globe, but less bad for us here in the U.S., particularly in the large, multinational, dividend paying equities that we have emphasized.

The financial news has had an understandable effect in unsettling the confidence of investors. The "new normal" that we have entered now has investors sitting uncomfortably on the horns of a dilemma. The first is that returns on cash investments are so low as to require investors to move into riskier assets than they might otherwise prefer in order to get any return at all. The second is that, once invested in those riskier assets, investors have to consider not only the normal disruptions effecting their particular investments but also the very real possibility of disruptions in the entire financial system. This "systemic risk" is the new beast that showed up in 2008 and refuses to go quietly away. Consequently, most investors have ventured timidly into the markets as they have risen, then scurried out on bad news as they have fallen. This makes for frustration and has taken its toll on investors for much of the last decade. It has caused investors to give up and look elsewhere for returns. It has also created an underinvested class of investors. It's what some on Wall Street call "being offside."

Hedge funds are the dominant investors of our time and recent statistics show that they now have, in aggregate, their lowest percentage of assets exposed to stocks since the darkest days of March 2009 (which turned out to be the market's low). Individual investors have taken out approximately $100 billion (net of deposits) from domestic stock mutual funds in the last year, with net outflows persisting for 32 of the past 34 weeks. Since 2007, individual investors have removed over $425 billion from domestic equity mutual funds and have put almost $850 billion into low or minimal yielding fixed income. That represents a swing of over $1.27 *trillion* in asset allocations away from equities and is unprecedented in its scope. Some of the major reasons for this shift are obvious and include investor frustration and fatigue, the increased volatility, and the greater "systemic risk" that might follow from the bad news in Europe getting worse.

What is interesting to us is that this provides the possibility for a positive market without a miraculous cure for the economic woes we all see. Along with all the possible scenarios for disaster, we should entertain the possibility that we just "muddle through." If that is the case, then the data show that individual investors as well as hedge funds are, in aggregate, poorly positioned for an equities market advance. They are way "offside" and may come piling in should things simply get less bad. This extreme "offside" position by so many can provide the buying power for a much more powerful advance than would otherwise be the case, given the level of economic activity. We mentioned this in our last letter and the market surprised many by turning up for the fourth quarter. Although the headlines may again shout that "the end is near," we should be aware that simply "muddling through" may produce an oversized "offside" reaction. It is certainly one of the possibilities that we want to be aware of (among the more obvious negative ones) as we begin a new year.

Enclosed you will find your 2011 fourth quarter and year-end statements and reports. We have included capital gains reports for taxable accounts to help with your preparation for tax season. Please feel free to ask us to provide these to your tax preparer directly if it is more convenient for you. Once you have reviewed them at your leisure, please give us a call with any questions or suggestions you might have.

We also want to take the opportunity to satisfy our regulatory duty (and dispense with the common boilerplate qualifications) by stating explicitly that we never share any of your personal or financial information without your express consent.

I am once again grateful for the opportunity to work with you on your investments, and we will strive to provide you with the best service and management we are capable of in the coming year.

Sincerely,

Claude Carmichael CFA