

# Marshalla Asset Management, LLC

Registered Investment Advisor

## Year End 2011 Commentary

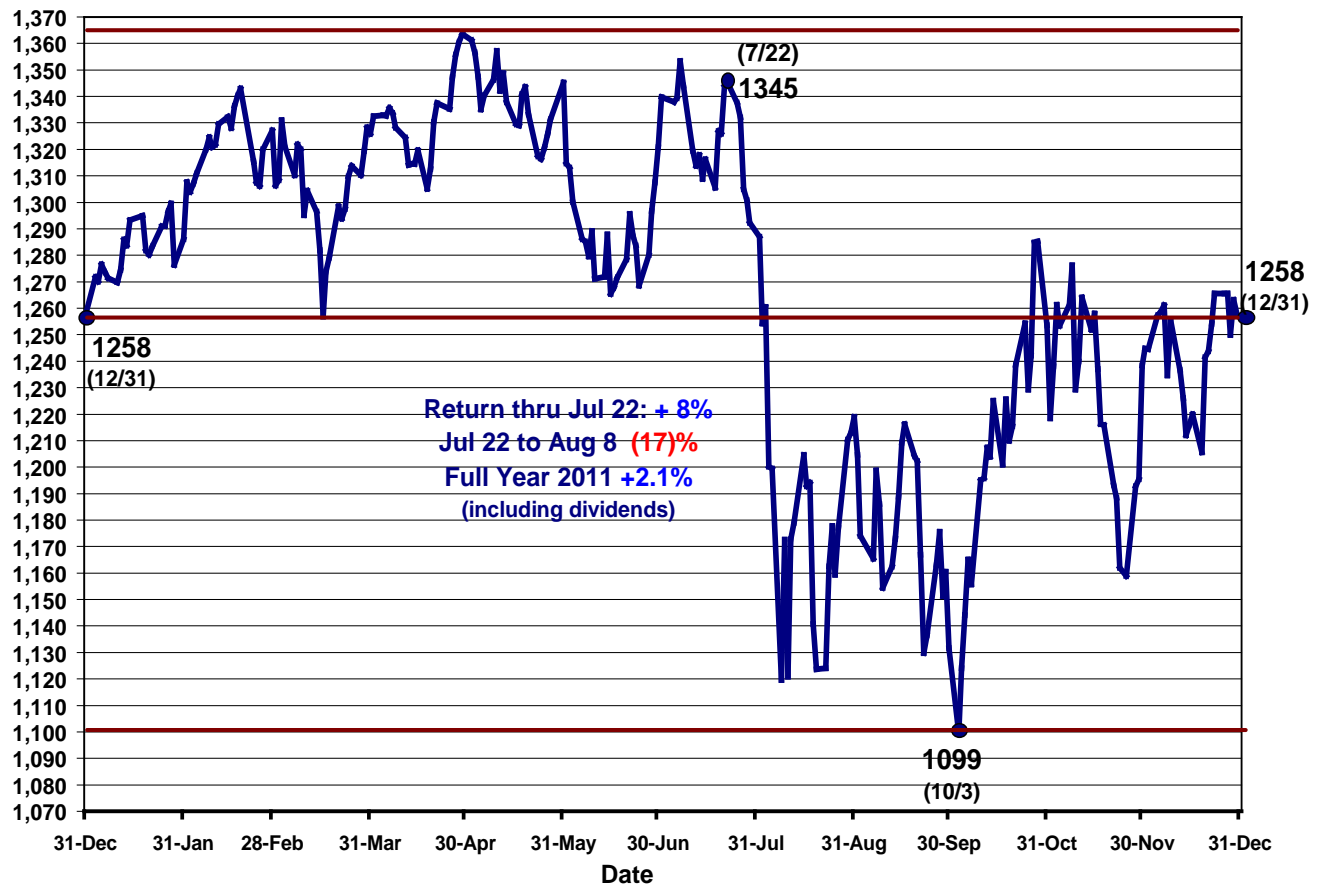
### A Roller Coaster Ride

By Bob Marshalla  
January 13, 2012

#### Markets and Investments

Up and Down Markets - 2011 was a strange year indeed for investors. There were three distinct periods. To begin with, the S&P 500 started out strongly, continuing an uptrend that had generated returns over 20% in the last four months of 2010. Although there was a sharp setback in late February and March when the Japanese tsunami and nuclear accident happened and when we faced a possible government shutdown, the market quickly recovered and we were still up by 8% for the year as of mid summer.

Figure 1 – S&P 500 Performance in Calendar Year 2011



The second period can be dated to July 22, when the market began to really tank. Initially this was in response to our self-induced debt ceiling fiasco, but it was reinforced soon thereafter by fears that European sovereign debt problems might induce a new recession or even a full blown global financial crisis. The S&P fell more than 18% in the two months plus between July 22 and October 3.

The third period ran from that date until the end of the year; roughly speaking this was the fourth quarter. This was such an outlandishly volatile period for stocks, that I suspect it will be shocking to some readers to report that the net result was extremely good. The S&P 500 was actually up by 15% from October 3 until the end of the year, and by 19% as of this writing (January 12).

Stitching together this whole roller coaster of ups and downs for the full calendar year 2011 resulted in the S&P 500 ending the year at the exact same level it started the year, 1258! The total return to the index was 2.1%, which was entirely due to dividends<sup>1</sup>.

Domestic Blue Chips Were the Best - This may sound like, “whew! It wasn’t such a bad year after all.” I wish it were so, but I have to say, “not so fast”. In many reports like this one I’ve told you that the headline market indexes like the S&P 500 and Dow Jones Industrials understated how well the portfolios of investors like us had performed because our investments are diversified over numerous other kinds of asset classes and investment categories, like small cap stocks, developed foreign and emerging markets stocks, value stocks, real estate and commodities. Usually some or even all of these have performed better than the headline indices. But this year was different. Blue chip U.S. stocks, which comprise the noted headline indexes, performed the best of any of those other asset classes or investment categories. So this was one of those inevitable years when a diversified portfolio performed worse than the headline indexes. This is not at all an indictment of a diversified portfolio strategy. It is an inevitable albeit occasional occurrence as different asset classes take turns being the best and the worst from year to year.

Why Did Other Asset Classes Underperform? - This year it is easy to explain why some of these other asset classes underperformed. The European debt crisis is by far the biggest worry and risk facing investors, so we would surely expect foreign stocks to have struggled, and they did. Making it worse for U.S. investors, a flight to quality by investors all over the world led to a relative strengthening of the U.S. dollar. This makes the returns to U. S. investors in overseas companies even worse than they were in local currencies<sup>2</sup>.

Of less prominence in the news media than Europe, but nonetheless of substantial significance to investors, was a slowdown in emerging markets countries’ growth, especially in China. Export demand was curtailed by the slow growth in developed markets, but on top of that, the Chinese government implemented policies to purposely slow down their real estate and infrastructure sectors for fear of over-stimulated growth (that is, a bubble)<sup>3</sup>.

A glance at Table 1 shows that for the year as a whole, developed market stocks (EAFE) lost 12.1%, while emerging market stocks fell by 18.4%, with almost a third of that loss due to the appreciation of the U.S. dollar<sup>4</sup>.

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<sup>1</sup> Stock index values, be they the S&P 500, the Dow Jones Industrials or others are based on stock prices only, and do not include dividends. Whenever we quote total returns for any index, we must add dividends in.

<sup>2</sup> For U.S. residents investing in foreign securities a rising U.S. dollar hurts returns, because the investor receives less dollars when the foreign currencies in which the foreign securities are priced are translated back into U.S.\$.

<sup>3</sup> Chinese policy makers appear to be satisfied they have sufficiently cooled the over-expansive sectors and have now changed course back to stimulating growth.

<sup>4</sup> The MSCI emerging market equities index for 2011 was down only 12.7% in native currencies, versus the 18.4% decline in U.S. dollars.

**Table 1 - Market Returns thru Year End 2011**

(Returns are cumulative, NOT annualized)

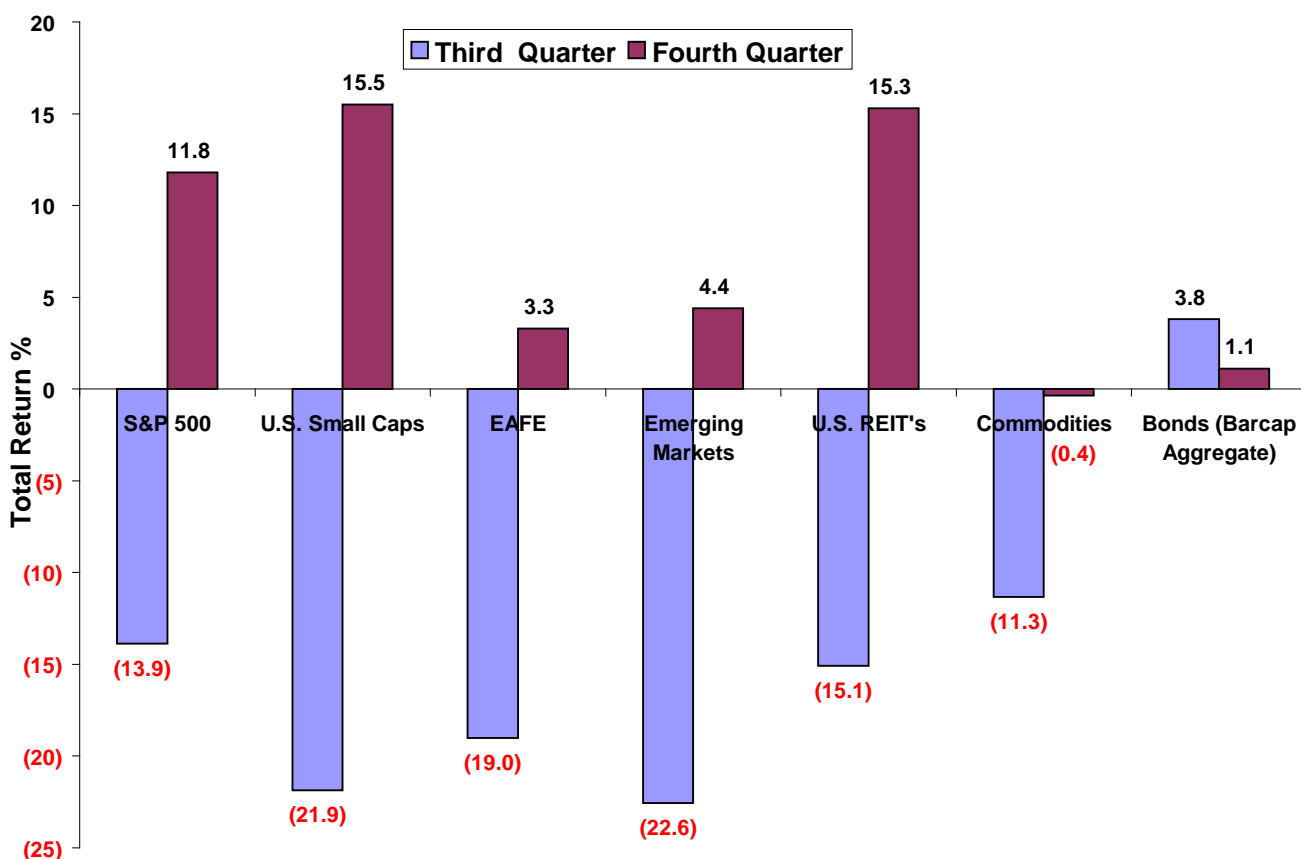
	Representative Index or Fund (blue font)	Full Year 2011	Last 3 Yrs Cumulative	Last 5 Yrs Cumulative
<b>Equities</b>				
Full U.S. Market (98% by MC)	Russell 3000	1.0	51.6	(0.1)
<b>U.S. Equities by Market Cap</b>				
Large Cap	S&P 500 (incl. dividends)	2.1	48.6	(1.3)
Mid Cap	Russell Mid Cap	(1.6)	73.5	7.3
Small Cap	Russell 2000	(4.2)	54.6	0.7
Micro Cap	Russell Micro Cap	(9.3)	49.1	(17.4)
<b>Value &amp; Growth</b>				
Growth Stocks	Russell 3000 Growth	2.2	64.7	12.9
Value Stocks	Russell 3000 Value	(0.1)	39.1	(12.2)
<b>Economic Sectors</b>				
Best This Year	Utilities	14.8		
2nd Best This Year	Consumer Staples	10.5		
Worst This Year	Financials	(18.4)		
<b>International Equities</b>				
Developed Large Cap	MSCI - EAFE Large Cap	(12.1)	24.8	(21.5)
Developed Small Cap	MSCI - EAFE Small Cap	(15.9)	50.6	(19.0)
Emerging Mkts Large Cap	MSCI - Emerging Markets (Std)	(18.4)	73.1	12.6
Emerging Mkts Small-Mid Cap	MSCI - Emerging Mkts SMID	(25.0)	89.3	16.8
<b>Real Estate</b>				
Equity REIT's - Domestic	NAREIT Equity Index	8.3	77.3	(6.9)
Equity REIT's - Foreign	EPRA Global ex US Index	(15.4)	42.0	(32.5)
<b>Commodities</b>				
Commodity Futures (Long Only)	Dow Jones UBS Commodity	(13.3)	20.4	(9.9)
	PIMCO Commodity Real Return*	(7.6)	60.5	18.9
<b>Alternative Investments</b>				
Merger Arbitrage	Arbitrage Fund*	4.7	17.4	25.5
<b>Fixed Income</b>				
Investment Grade Bonds	Barcap Aggregate Bond	7.8	20.6	35.7
	PIMCO Total Return Fund*	4.2	29.0	47.5
Inflation Protected (TIPS)	Barcap US TIPS	13.6	34.5	46.6
High Yield Bonds	JP Morgan High Yield	2.7	74.7	38.3
Floating Rate Bank Loans	Fidelity Floating Rate High Inc*	1.7	41.3	21.2
Int'l Bonds, Developed Mkts	PIMCO Foreign Bonds*	8.4	47.9	56.8
Int'l Bonds, Emerging Mkts	PIMCO Emerging Local Bonds*	(0.8)	48.1	48.6
Short Term Money	3 Month T- Bills	0.1	0.4	6.7

\* Based on mutual fund returns. Others are costless market indices.

Amongst other asset classes, small cap stocks, value stocks, foreign real estate and commodities all had bad years as well. Still, all the major asset classes<sup>5</sup> performed way better in the fourth quarter than in the third quarter. Figure 2, which compares third and fourth quarter total returns for several major asset classes, makes this abundantly clear.

<sup>5</sup> Except for TIPS, in which we are no longer invested at MAM.

**Figure 2 – Comparison of Third and Fourth Quarter Returns by Asset Class**



It is worth taking a closer look at a few of the asset classes and investment approaches that underperformed in 2011.

Emerging Markets - Emerging markets investments are important to review since we have made such a substantial commitment to them. I began increasing our allocations to emerging market investments almost three years ago. In this fall's latest portfolio review cycle we maintained a target of 18% of equities in emerging markets stocks, and another 6% in emerging markets local bonds (i.e., bonds issued in their own currencies). I wrote a 14 page paper for clients two years ago explaining the case for investing in emerging markets<sup>6</sup>. To quickly recap, the rationale includes the following factors:

- (a) These are the only countries having good prospects for high economic growth rates in the next few years.
- (b) They are not plagued by the suffocating debt levels such as in Europe, Japan and the United States.
- (c) Most of them are running trade surpluses, so that the rest of the world is progressively owing them more money rather than the other way around.
- (d) If they can keep inflation under control their trade surpluses should, by the normal fundamentals of economics, cause their currencies to appreciate versus the U.S. dollar.

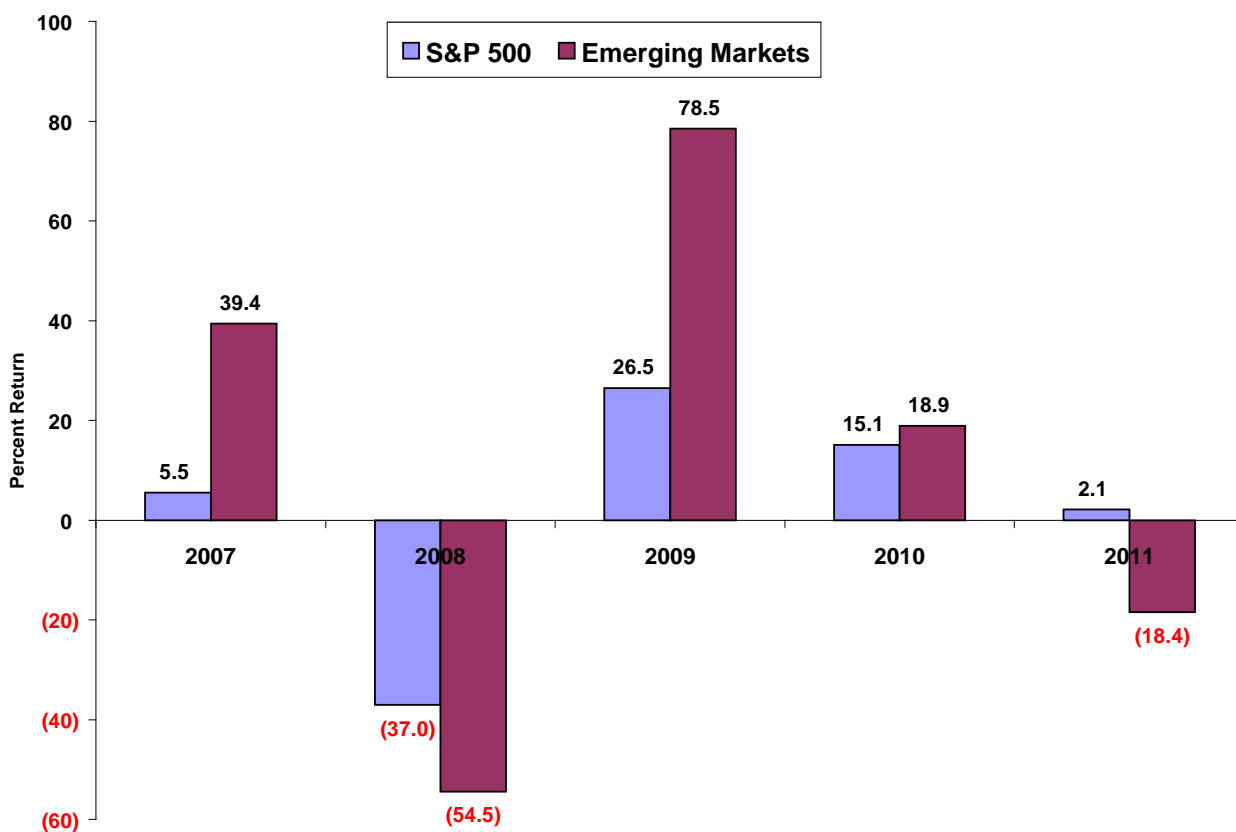
Finally, there is valuation, which is always as important a factor in selecting investments as any other. A couple of years ago I had noted that emerging markets valuation metrics (PE ratios, price-to-book,

<sup>6</sup> See "A Case for Investing in Emerging Markets", Bob Marshalla, January 15, 2010. It can be found on the MAM website, or I will send a copy to anyone so requesting.

dividend yields and more) were a little high by their own historical standards, but were about equal to those in the U.S. It seemed like a good deal to me to get their much higher growth potential for the same price as we were paying for developed market equities. But now that emerging markets have underperformed the U.S. by 20% in the past year, their valuation metrics have become an unqualified positive factor. According to JP Morgan, at year end the average forward PE for the emerging market countries as a group was only 9.4. This is 15% lower than it was a year ago, and is also nearly 15% lower than the comparable PE for U.S. stocks. So, if someone asked me now if I thought we should scale back emerging markets targets, I would answer absolutely not! If I were going to make a change I would be more likely to double down than to cut back.

The fact that emerging markets underperformed U.S. and other developed market equities last year should not come as a great surprise to anyone who follows the markets carefully. Emerging markets stocks and bonds have always been and will continue to be quite volatile and not all that strongly correlated to other region's stocks. A quick look at the bar graphs in Figure 3 demonstrates this observation nicely. The figure compares the returns of the MSCI emerging markets equities index to the S&P 500 for each of the past five years. We see that emerging markets significantly underperformed the S&P 500 in two of the years, drastically outperformed it in two other years, and in only one year did it have a similar outcome (a 19% return in 2010 versus 15% for the S&P).

**Figure 3 – S&P 500 vs. Emerging Markets Equities Returns, Year by Year**



In Table 2 below we pull this altogether over the past three and five year periods, and can see that the net results strongly favor emerging markets. Of course we don't know what will happen in the future, and past performance surely doesn't guarantee anything. But I continue to believe it is more likely we will again in the next five years get better returns in emerging markets equities than in developed markets equities. If I had to put numbers to it I would expect mid single digits for developed market equities and high single digits or even low double digits for emerging markets equities. But these are just expectations, and the range of possibilities around them is very wide. One thing I believe with more confidence is that the actual and relative returns will continue to be highly volatile. In fact, I would actually be surprised if emerging markets do not again underperform U.S. equities in two or more of the next five years.

**Table 2 – Annualized Total Returns for U.S. vs. Emerging Markets Equities**

	Past 3 Years	Past 5 Years
S&P 500	14.1	(0.3)
MSCI Emerging Markets	20.1	2.4
Difference, EM - S&P	6.0	2.7

Europe – The sovereign debt situation in Europe continues to be the biggest threat to economic growth and financial markets everywhere. If countries beyond Greece, notably Spain and Italy, see their sovereign debt interest rates skyrocket, the increased debt burdens could sink their economies, or even worse make it impossible for them to roll over their debt. Such occurrences would cause serious damage to all European economies. There would definitely be spillover to the U.S. and other worldwide economies and markets, although nobody really knows how strong the “contagion” would be.

The ECB and the healthier Eurozone countries are trying to contain the problems via small incremental steps and hopeful but less than enforceable policy statements. Can they muddle through this way indefinitely? Or will they face the music and do what has to be done to prevent a crisis? Or will a full blown financial crisis actually happen?

Although no one can be sure that things will not unravel, I think it is by far most likely they will continue to muddle through as long as they can by applying fairly tepid measures. They will do this indefinitely unless and until it becomes crystal clear that much stronger actions are necessary; actions like the ECB backing all sovereign euro debt or committing to sufficient bond purchases to keep interest rates manageable for the peripheral countries. A full blown financial crisis is preventable; what is in doubt is whether there is the political will and unity needed to do it.

Having said this, when it comes to investment strategy, isn't it a no brainer that we should avoid all investments in Europe? In a word, no! While I think it makes sense to keep our allocations to European equities, real estate and bonds on the light side, I don't think it is wise to avoid investing in anything with a European address on its headquarters. Perhaps it makes sense for our most conservative, safety conscious investors, but for the majority of us who are continuing to hold risk assets, we need to look realistically at the relative risks of differing investments. Some companies nominally based in Europe are less exposed to the effects of a sovereign debt meltdown than many companies nominally based in the U.S. or other countries. And some European companies have had their prices pushed down so far by indiscriminate fear of crisis that we may be leaving lots of money on the table by simply omitting them from consideration.

The MAM model portfolio that I used to set fund targets in our latest round of portfolio reviews contains two foreign equity funds in which the managers have full discretion about where to invest

fund assets<sup>7</sup>. Each of these funds has a target of 6% of equities in our portfolios. On last reports, they held an average 46% of their assets in continental Europe, and another 15% in Great Britain. Other MAM funds have only miniscule amounts invested in Europe if any. Adding it all up, at year end our model portfolio would hold about 5.7% of equities in continental Europe. And keep in mind this is 5.7% of our equities, not of total assets. If your portfolio has 50% of assets in equities, the European equities component would be less than 3% of assets.

I mentioned that not all European companies would be equally vulnerable to a European financial fiasco. We should consider the economic sector in which a company operates and the geographic markets where it sells its products. For example, two of the top 25 holdings in our two developed foreign funds are Nestle and Adidas. These companies, of course, sell consumer goods and are quite different from companies in the financial or cyclical economic sectors. Furthermore, they are global companies who sell their products all over the world.

To be fair, companies like Credit Suisse, BNP Paribas and Allianz are also in the top 25, and these are European banks and financial companies. In these cases I'm leaving it to our managers to determine if the combinations of financial strength and valuation make such holdings worthy components of their funds.

We do have to consider the valuations of European stocks. In aggregate they seem to be priced for very bad outcomes already, which leaves plenty of room for modest upside surprises to bring investor benefits. Table 3 below shows some common valuation metrics for companies based in Germany and France compared to those in the United States. It doesn't take much study to see that European stock prices are relatively very cheap.

**Table 3 – Equity Valuation Metrics,  
Germany & France vs. United States**

	<b>Germany &amp; France (average)</b>	<b>United States</b>
<b>Price / Earnings (forward)</b>	<b>9.0</b>	<b>11.8</b>
<b>Price / Book</b>	<b>1.15</b>	<b>2.0</b>
<b>Price / Cash Flow</b>	<b>3.75</b>	<b>7.4</b>
<b>Dividend Yield</b>	<b>4.2%</b>	<b>2.1%</b>

As of 12/31/11, from MSCI & JP Morgan, in Jan. 2012 Guide to the Markets

And finally here is one more surprising fact. European stocks have not actually been performing that badly relative to other foreign stocks. In 2011, the European component of the EAFE index lost 11.1%, while the Far East component lost 14.7% and the emerging markets index lost 18.4%.

To summarize, we only have about 6% of equities invested in Europe, all European stocks are not that terribly vulnerable to financial sector problems, their valuation metrics look excellent and even their investment performance over the past 12 months has not been as bad as one might think. If anything, I would consider investing more assets in Europe rather than less.

Interest Rates and Bond Returns – Last spring I moved lots of our fixed income holdings into less interest sensitive types of bonds. By interest sensitive I mean bonds whose values will increase when prevailing interest rates go down, or decrease when interest rates go up. With the Ten Year Treasury yield just a little over 3%, QE II scheduled to end in June and rising commodity prices threatening to kick start inflation, it seemed at the time that interest rates had nowhere to go but up.

<sup>7</sup> These funds are Oakmark International (OAKIX) and Thornburg International Value (TGVIX). They are both Morningstar 5 star funds, and both carry Morningstar's highest forward looking rating, "Gold". You can look them up on Morningstar.com if you want to know more about them.

This expectation proved to be exactly wrong. Between March and September, interest rates went down, down, down. The Ten Year Treasury fell from 3.47% on April 8 until it had reached its all time low of only 1.72% on September 22. The Five Year Treasury fell all the way to 0.78%. Both figures are well below the inflation rate, whether you consider the core inflation rate, 2.2%, or the headline rate of 3.4%.

The result was that bonds that were the most interest sensitive performed the best and those that were the least interest sensitive performed the poorest. The types of bonds that are the most interest sensitive of all are Treasuries<sup>8</sup>. The most widely referenced benchmark of fixed income performance is the BarCap Aggregate, and more than half of it is composed of Treasuries and agency bonds that have similar interest rate sensitivity. The result is that the BarCap index performed exceptionally well in 2011. As shown in Table 1, its return for the year was 7.84%. Beating the benchmark in 2011 was impossible for domestic bond managers unless they had packed their portfolios with long duration Treasuries or agency bonds.

Our core investment grade domestic bond fund has long been Bill Gross's PIMCO Total Return. Even he had moved his holdings towards less interest sensitive holdings early in 2011. That fund returned only 4.16% last year, a rare year in which it did not beat the BarCap Aggregate benchmark. On top of that I moved some of our holdings into so-called flexible funds and floating rate funds that have even less interest rate sensitivity. So it was generally not a good year for our bond funds relative to the benchmark.

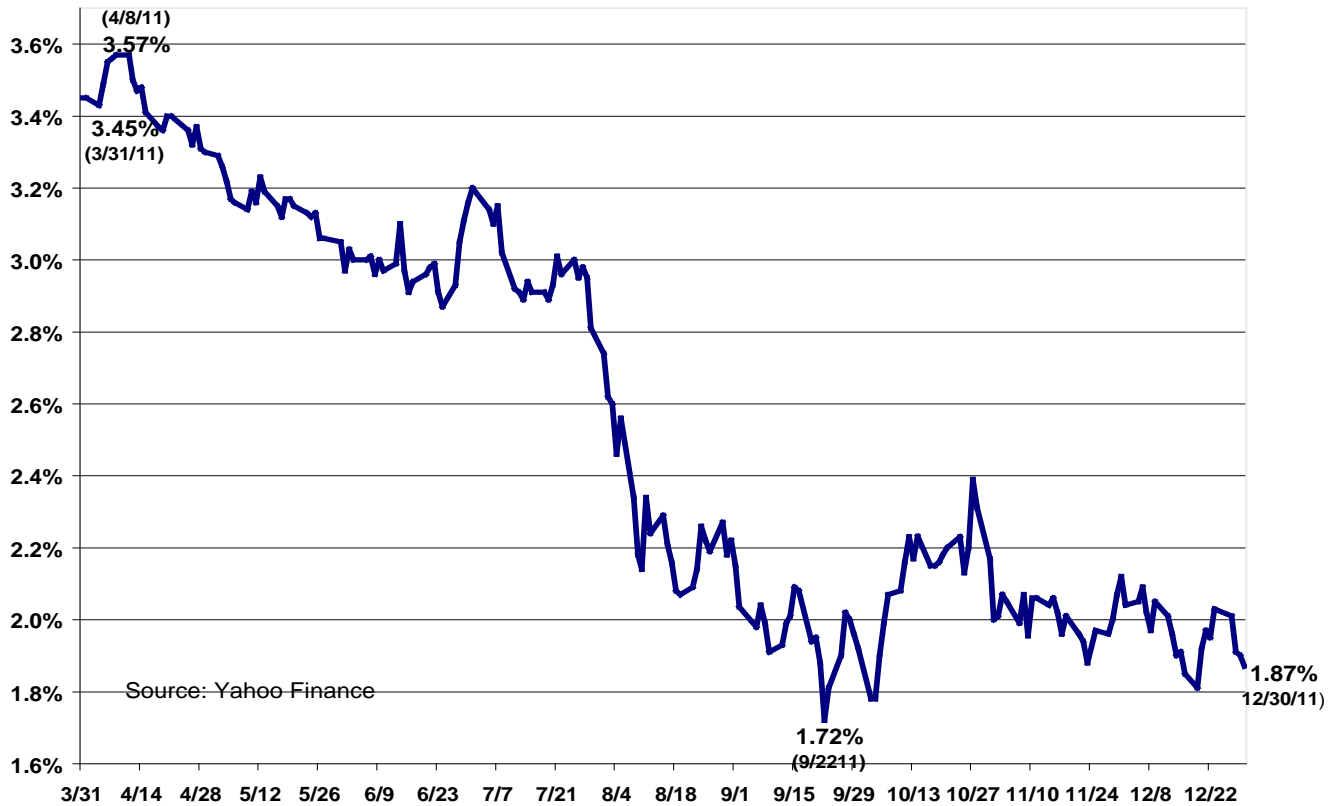
I, along with Bill Gross and many other respected bond managers, were clearly early in our moves to flee interest rate sensitivity. But now I would absolutely be doing this. The Ten Year Treasury closed the year at 1.87%. The thing about interest rates is there is a hard floor, and it is zero. It challenges credibility to think there is much left to be made in medium and longer duration Treasuries. It is not so much I expect interest rates to make a dramatic move upwards any time soon. It's more that I believe that future returns in Treasuries and similar bonds will be miniscule. What returns we may be able to get out of fixed income are likely to come from other types of bonds, and factors other than declining interest rates.

In fact, since I reported to you last quarter, interest rates have stopped declining and have been generally fluctuating in fairly narrow ranges. Figure 4 shows the Ten Year Treasury yield day by day from March 31 until the end of the year. It was at 1.92% on September 30 and ended the year at 1.87%. An upshot is that all of our bond funds have finally been doing better than the BarCap Aggregate benchmark over the last three months, although not enough so to make up for the lagging performance earlier in the year when yields were still plunging. Still, it is good to know that the trend is now positive.

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<sup>8</sup> This is because they have no credit risk, and interest rates are the only thing their values react to.

**Figure 4 – Daily Ten Year Treasury Yields**



An exception to the story of lagging bond fund performance has been our municipal bond funds. I had also increased our allocations to tax exempt<sup>9</sup> bond funds last spring, bringing their total targets up to 20% to 30% of fixed income for most clients. Higher quality muni bonds are actually also quite sensitive to interest rates. And as bad as state and municipal finances still are, they actually started to look a little better in the second half of the year as tax revenues started to tick up and local government budget cuts started to kick in. As a result, the two tax exempt bond funds that are used in most client portfolios<sup>10</sup> earned very healthy returns of 9.7% and 12.8% for the year. I don't expect total returns to be that high again looking forward, but I think munis are still pretty good values. They still have current yields higher than similar maturity Treasuries (despite Treasuries being taxable and munis not). I am not counting on those yields falling further, but I don't see any reason for them to go up in the near future either.

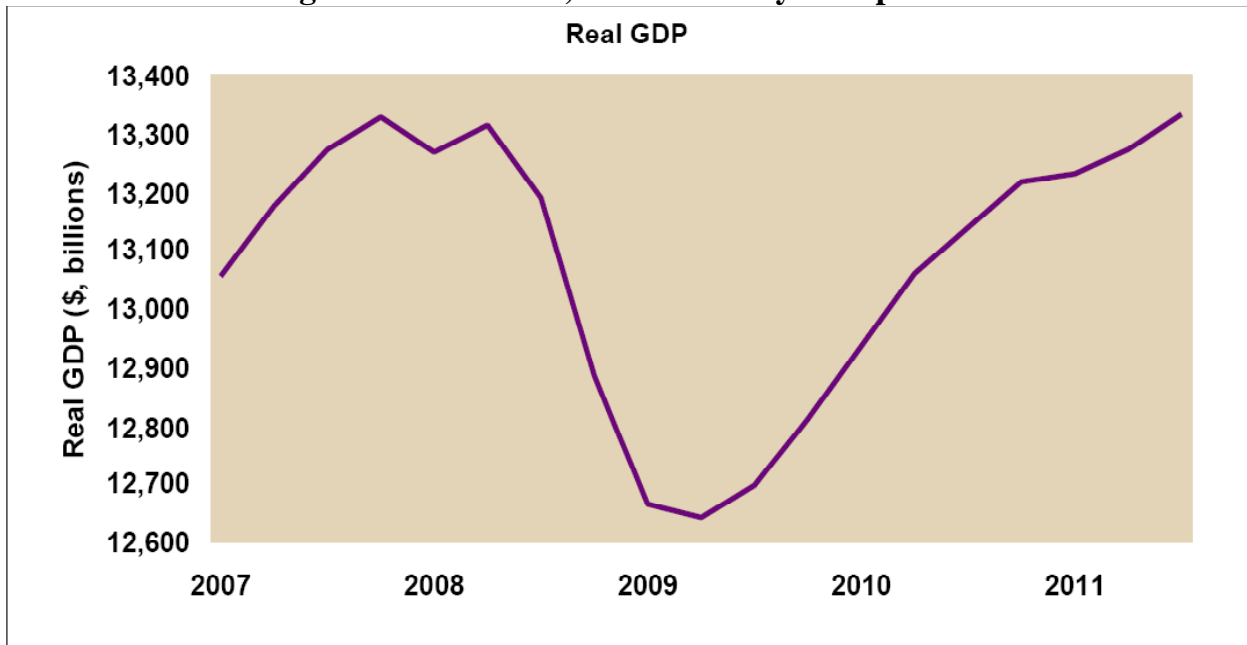
### ***The Economy***

The U.S. economy is still weak and is still moving along more like a tortoise than a cheetah. But it definitely has been performing better and better over the past year, and especially over the past several months. In fact, it is technically no longer accurate to say we are in an economic “recovery”. As Figure 5 shows, the absolute level of real GDP has now finally come to exceed its level prior to the recession, which technically makes our current economic phase an “expansion”.

<sup>9</sup> I use the terms “municipal” and “tax exempt” interchangeably to refer to the same kind of funds.

<sup>10</sup> These funds are Vanguard Intermediate Term Tax Exempt (VWITX or VWIUX) and Managers GW&K Municipal Bonds (GWMIX and GWSMX).

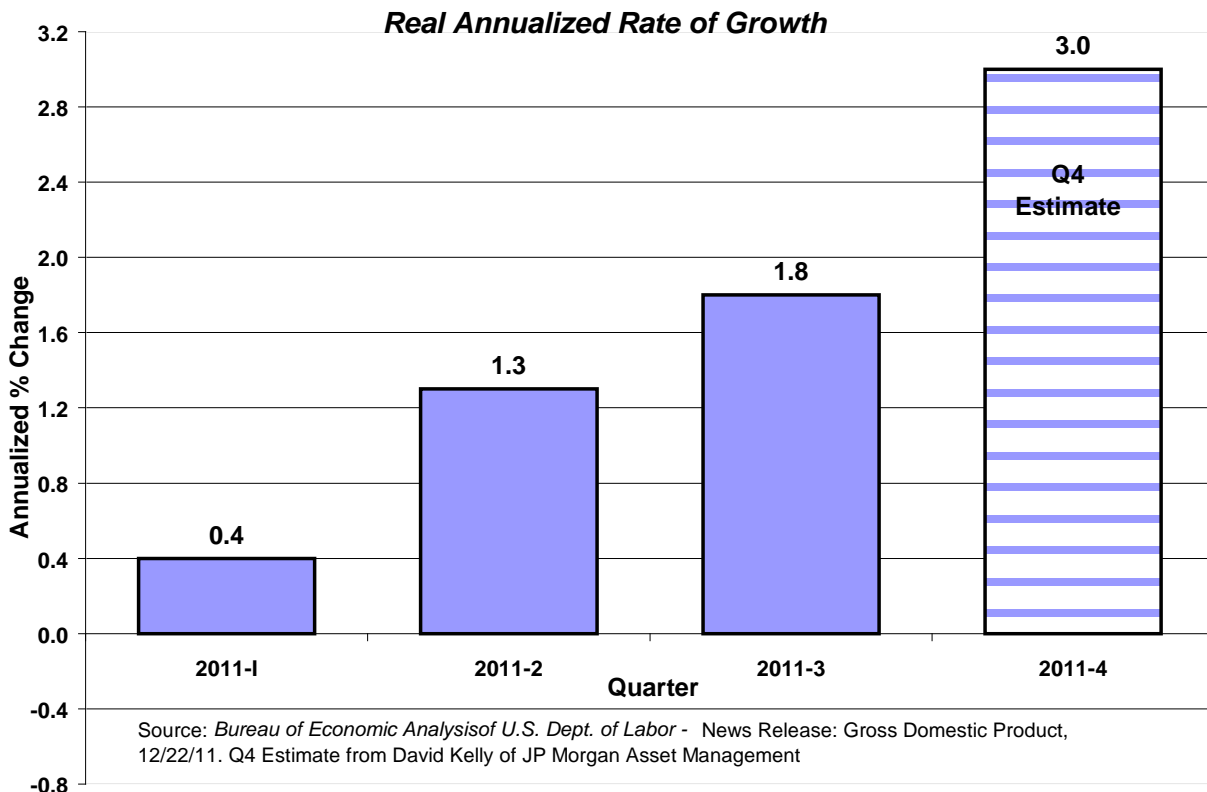
**Figure 5 – Real GDP, from Recovery to Expansion**



Source: “Economic and Market Update”, by Liz Ann Sonders, Charles Schwab, Jan 12, 2012, p12

GDP growth had fallen back to stall speed a year ago. Some external shocks like the Japanese tsunami and nuclear accident, exceptionally bad weather, commodity price surges and the Arab uprisings were contributors to the slowdown. Political dysfunction highlighted by a near government shutdown in March also diminished already very low levels of consumer and business confidence. But as the year progressed, economic growth got progressively better. This undeniable trend can be seen in Figure 6, which shows the annualized rate of GDP growth for each quarter of the year.

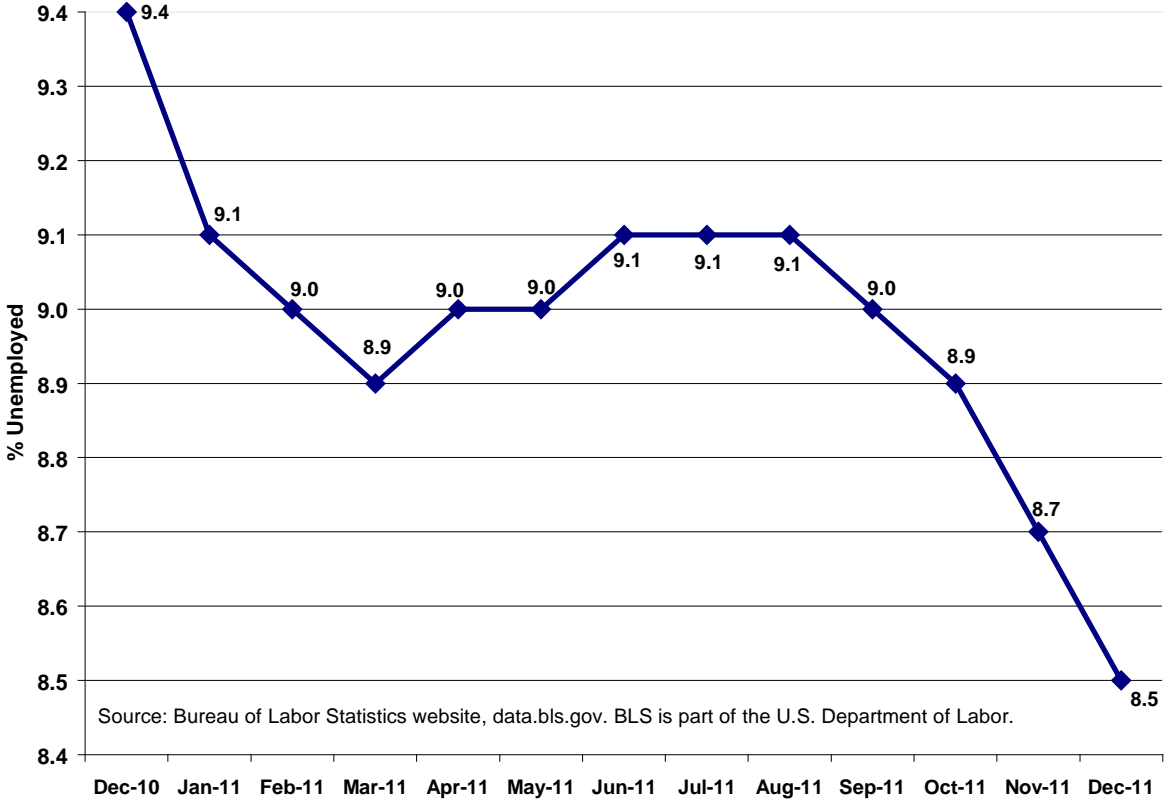
**Figure 6 – Real GDP Growth Rate by Quarter, 2011**



The national unemployment rate has also been dropping at a surprisingly fast rate. It has now fallen four months in a row, from 9.1% in August to 8.5% in December. Figure 7 shows the month by month changes in the unemployment rate throughout the past year.

This metric can be annoyingly volatile because its denominator, which is the number of people counted in the labor force, changes from month to month in unpredictable ways. The labor force is defined as people working plus unemployed people who are actively looking for work, and its value can change significantly through an economic cycle. In bad times, people drop out of the labor force due to discouragement, decisions to go back to school or retire early and other reasons, and this decreases the denominator. In good times, additional people join or re-join the search for labor, having the opposite effect. Luckily the last two month's declines in the unemployment rate were caused more by people actually landing jobs (thereby decreasing the numerator) than by the size of the labor force (the denominator) increasing due to people entering or re-entering the labor force. Nonetheless, I will offer a warning that the unemployment rate may tick back upwards a few times in the coming months as more and more people who had given up search or gone back to school gain enough enthusiasm to go out and look for jobs (thereby increasing the denominator of the unemployment rate metric).

**Figure 7 – National Unemployment Rate**

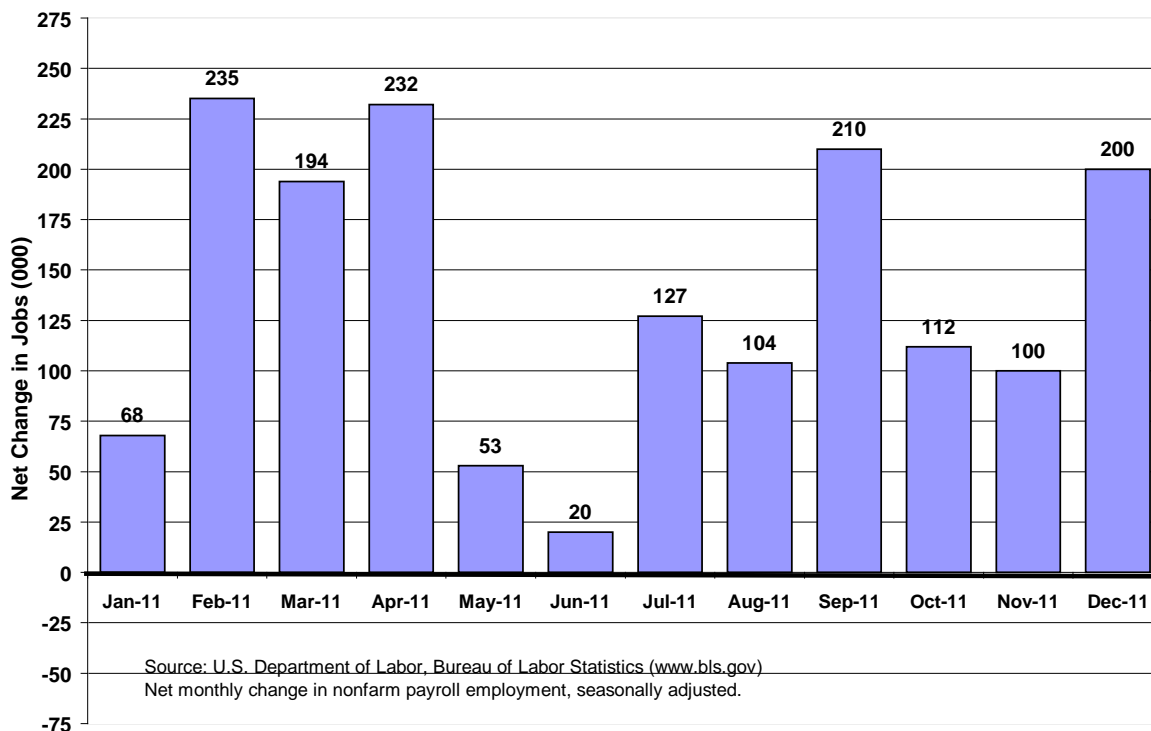


A frequent criticism of the standard national unemployment rate as computed by the U.S. Bureau of Labor Statistics (BLS) is that it understates the full nature of unemployment woes by leaving out people who would like to have a job but who have temporarily or permanently given up the search for work, or who are under-employed or only part-time employed when they would like to be full-time employed. Well it turns out the BLS does compute a measure of unemployment that includes this more expansive definition of the unemployed (and it compiles numerous other measures as well). It is called the U-6 measure of unemployment and is updated on the BLS website every month. The reason I'm mentioning this is to note that this measure has been

declining in similar fashion, in fact even faster, than the standard unemployment rate. The U-6 rate stood at 15.2% as of December, 2011, down from 16.6% in December of 2010.

Next, in Figure 8 we look at the month-by-month changes in the number of jobs. This measure is also computed by the BLS, but it comes from a completely different set of data. It is based on payroll data from companies, whereas the unemployment rate is based on a survey of residential households. The number of jobs metric is therefore more objective<sup>11</sup> but it will not fully capture changes in self employment.

**Figure 8 – Monthly Changes in U.S. Jobs in 2011**



Nonetheless as Figure 8 makes clear we see a similar pattern in this measure as in the unemployment rate of mildly revived employment activity in the past four months. In fact, similar to the stock market discussion, we can divide the performance of this metric into three phases. The average number of new jobs added per month in the first four months of the year was 182,000, then only 76,000 in the middle four months, but followed by a nice rebound to an average of 156,000 jobs per month in the last four months of the year.

How good, mediocre or bad is this? It can be frustrating to gauge since numerous estimates have been bandied about the media about how many job additions are needed to decrease the unemployment rate, or just to keep up with the natural growth of the labor force. The main source of ambiguity is that we do not know if or how much the labor participation rate may change in the future. This labor participation rate is the fraction of the able bodied working age population that chooses to seek employment. Based on recent analysis by the Congressional Budget Office (CBO)<sup>12</sup>, it would take only 97,000 net new jobs per month to keep the

<sup>11</sup> In the unemployment survey, answers to questions about whether one has been searching for work during a certain time window may be subject to interpretation or inaccuracies. The jobs figure come right out of companies' payroll databases.

<sup>12</sup> An article on the website [www.calculatedriskblog.com](http://www.calculatedriskblog.com) nicely summarizes the recent CBO studies.

unemployment rate steady if the labor participation rate holds steady. In an alternate scenario, the CBO assumes the participation rate increases by 0.5%. In that case, it would take 187,000 jobs per month to keep up with the size of the labor force. As for actually decreasing the unemployment rate by a full percentage point in one year, we would need 224,000 jobs per month if the participation rate remains unchanged, or 316,000 jobs per month in the scenario where it increases by half a percentage point.

I think the upshot of all this is that the past four months average gain of 156,000 jobs per month is likely enough to keep the unemployment rate steady, or even declining slightly over the next few months. But to make healthy progress – and I believe that chopping a percentage point per year off the unemployment rate is the most anyone can hope for – we are going to need considerably more activity. We should hope for something in the range of 220,000 to 320,000 jobs per month. We did get 200,000 new jobs in December, but that was only one month. Time will tell if this was an anomaly or the start of a healthier trend.

### ***Wrap Up***

It was a roller coaster year for the U.S. stock market, and despite all the political dysfunctions, natural disasters and continued economic woes, the market ended up slightly better than breaking even for the year. We get used to complaining about the United States, but it was tougher by far for investors to be anywhere else last year. From stocks to real estate to bonds it was a tough year to avoid losing money unless you held only U.S. blue chip stocks and/or U.S. Treasuries.

Europe continues to be the biggest imminent threat to financial peace and stability. We cannot ignore the possibility that it will create another worldwide financial crisis, but it looks increasingly likely that the situation will continue to simmer rather than boil for quite some time (more than a year at least). The institutions and countries in Europe, most notably the ECB, EMU and Germany plus France will likely continue to minimally contain the sovereign debt problems of the periphery without embracing the stronger but more painful actions needed to avoid a financial crisis for sure. The hope is that by the time the simmer begins transforming to a boil, they will have been at it long enough to know what they have to do -- and do it -- to avoid a disaster for all. Meanwhile, we should not be surprised as each new twist and turn in that saga causes our investment markets to lurch upwards and downwards.

Assuming the European situation continues in its muddle through scenario, I don't think the outlook is all that bad for our economy and our investments. By almost all traditional metrics, the U.S. economy is continuing to move forward. The pace is still very slow, but signs that it is speeding up at least a little are undeniable. Combining this with increasing corporate profits and cash reserves, pent up consumer demand for housing and capital goods and very reasonable equity valuations makes a good case for investor optimism. Any number of unforeseen political, natural or economic occurrences could invalidate this case, but there has never really been a time when this was not true. So as usual, a strategy of keeping with a diversified portfolio, going neither all in nor all out, is what I believe to be the most prudent approach.

As always, I look forward to discussions with any of you who may have questions about this commentary, or who would like to review your own balance between pursuit of returns and preservation of capital.

***Sincerely,***

***Bob Marshalla***

***Your Financial Advisor***