



**Year-to-Date Performance (through 12/6/2011)**

Dow Jones Industrials	<b>7.62%</b>	S&P 500 Index	<b>2.02%</b>	NASDAQ	<b>-0.12%</b>
Bonds <sup>1</sup>	<b>6.66%</b>	International <sup>2</sup>	<b>-10.44%</b>	Gold <sup>3</sup>	<b>21.24%</b>

December 7, 2011

Dear Valued Client,

One of the unfortunate effects of the Federal Reserve's conventional and unconventional means of keeping interest rates low is that it has punished an entire class of savers and eliminated any meaningful means of growth through compound interest. This disincentive to save hurts some savers more than others, as subsets of these savers don't really mind what the interest rate is as long as their principal is safe. Others, however, are dependent on these savings for monthly income and are forced to make some tough decisions as their income continues to drop. What message is the Federal Reserve sending the public when there is no financial incentive to save? The primary incentive to save today is not based upon the anticipation of making more money, but instead on the anticipation of losing less money by paying off high interest credit card debt. Credit card debt has moved from 957 billion in 2008 to 789.6 billion dollars today <sup>5</sup>. Debt service payments as a percentage of disposable income are 11.09%, which is the lowest level seen since the 4<sup>th</sup> quarter of 1994 <sup>6</sup>. Hopefully this trend will continue. However, for retirees who have already paid off their high interest debt obligations, they don't receive any benefit from lower rates. This is an unfortunate reality that will hopefully reverse in time as interest rates return to normalized levels.

Unlike savers, however, investors in fixed income have benefited from the drop in interest rates because it has caused bond prices to move higher. Year-to-date, the Vanguard Total Market Bond Index is up about 6.66%, half of which is attributable to interest and half to positive movement in price. For the past 3 decades, interest rates have steadily moved lower, which has provided a positive tailwind for bond prices. This tailwind, however, is coming to an end, which means that a larger proportion of total returns from bonds will come from the interest paid and less from movements in price, assuming a stable interest rate environment. With the exception of high yield bonds, which have somewhat different price dynamics than traditional investment grade bonds, 2011 may be the last year we see in a long time where bonds return in excess of 5%. The current yield on the Vanguard Total Market Bond Index is now just 2.38%, which arguably isn't high enough to clear expected inflation.

From a financial planning and asset allocation standpoint, super low interest rates pose some challenges for both individual & institutional investors alike. Bonds represent a sizable component of most asset allocation models and are unlikely to produce a respectable real-return, let alone come close to matching their historical average annualized compounded return of around 6%. When a stable asset class' return potential is diminished, it puts greater pressure upon volatile asset classes like stocks to pick up the slack in order to meet the portfolio's overall expected rate of return. From



an individual perspective, this means that in order to guard against the risks of inflation and elongated life expectancy beyond retirement, investors should continue to have a portion of their portfolio allocated to stocks even after retirement. If you are in the fortunate group of retirees that receive a monthly pension from your previous employer and are not dependent upon your portfolio for living expense purposes, the amount allocated to stocks can be within a more flexible range, depending upon your risk tolerance and overall goals.

From an institutional perspective, the challenging effects of the current low interest rate environment can be clearly seen with pension plans, where lower interest rates increase defined benefit liabilities, taking them into “underfunded” status. In order to bring underfunded pensions back into balance, companies must either increase their equity allocations in the hope of earning a higher rate of return or they must take a charge against earnings and deposit funds back into the plan. Based upon the Milliman pension funding index, which tracks 100 of the nation’s largest pension funds, the funded status has decreased by 175 billion year-to-date, dropping the funded ratio from 84.1% to 75%. “So long as we have low discount rates we’ll have no choice but to hope for improved asset performance,” said John Ehrhardt, co-author of the Milliman Pension Funding Study. “As 2011 draws to a close it seems increasingly likely that this will be a lost year for pension funding”. Along with growing liabilities, another challenge many pension funds face is unrealistic expectations for asset returns. The Milliman pension funding index, for example, has an expected *median* asset return of 8%. 8% is taken from long-term historical returns of stocks (10.7%) and bonds (6%), which is historically accurate, but may not be attainable in today’s market environment.

Switching gears to recent economic & market events, nothing much has really changed. Our politicians continue in their partisan ways, the European Union continues to have summits in the hope of greater fiscal unity, the US economy continues to grow at a slow pace, and corporations continue to exhibit above average profitability. 2011 has been a unique year in terms of equity performance because there were almost no markets, domestic or overseas, that made any respectable gain for the year with the exception of the mega-cap stocks in the Dow Jones Industrial Average. Although short-term performance is never a good predictor of future returns, valuations are and as we look across the spectrum of global equity markets, most markets are trading at attractive levels. Equity valuations mean squat if the situation in Europe gets out of control in 2012, but assuming Europe navigates a mild recession and US businesses keep chugging along slowly, expectations embedded within equity valuations are low enough to allow stocks to perform better than some expect.

We hope you & your families have a safe & happy holiday season. Thank you for your continued trust and support.

Sincerely,

Scott Smith



- 1 *Bond performance measured from the Vanguard Total Bond Market Index (VBMFX)*
- 2 *International performance measured from the I Shares MSCI EAFE Index (EFA)*
- 3 *Gold performance measured from the Spider Gold Shares (GLD)*
- 4 *Source: National Association of Realtors [www.realtor.org](http://www.realtor.org)*
- 5 *Source: Federal Reserve <http://www.federalreserve.gov/releases/G19/Current/>*
- 6 *Source: Federal Reserve <http://www.federalreserve.gov/releases/housedebt/>*

*The S&P 500 consists of 500 stocks chosen for market size, liquidity and industry group representation. Each stocks weight in the index is proportionate to its market value. The S&P 500 is one of the most widely used benchmarks of US equity performance.*

*The opinions and forecasts expressed may not actually come to pass. This information is subject to change at any time, based on market and other conditions and should not be construed as a recommendation of any specific security or investment plan. The advisor does not guarantee the accuracy and completeness, nor assume liability for loss that may result from the reliance by any person upon such information or opinions. Past performance does not guarantee future results.*

*Diversification can be thought of as spreading your investment dollars into various asset classes to add balance to your portfolio. Although it doesn't guarantee a profit, it may be able to reduce the volatility of your portfolio.*