

BLACKHAW WEALTH MANAGEMENT

INVESTOR NEWSLETTER: 4th QUARTER 2011

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2011 REVIEW

The U.S. stock market essentially ended the year where it began: with dividends included, investors in the U.S. stock market eked-out a small gain for the year and made a 2.1% return on their capital, based on the S&P 500 stock market index. The same cannot be said for global stock markets, however, most of which experienced significant declines for the year (see Table 1). You can also see that the United States is the only country whose stock market performance for the past year was approximately equal to the annualized historical return over the past 10 years. All other countries posted stock market returns that were far below their historical growth rates of the past 10 years.

<u>Country</u>	<u>2011 Return</u>	<u>10-Year Annualized</u>
United States	2.1%	2.8%
Australia	-10.8%	13.8%
South Korea	-11.8%	14.1%
Canada	-12.2%	11.8%
Japan	-14.2%	3.1%
France	-16.0%	3.5%
Hong Kong	-16.0%	8.6%
Germany	-17.5%	5.1%
China	-18.2%	15.2%
Russia	-19.3%	14.2%
Taiwan	-20.2%	4.8%
Brazil	-21.6%	21.6%
Italy	-22.3%	1.2%
India	-37.2%	16.3%
Greece	-62.7%	-10.3%

NOTE: The U.S. stock market return is the S&P 500 Index; all other index returns are provided by MSCI.

Emerging market stocks, the darlings of the past decade, took a drubbing in 2011. Brazil, Russia, India and China lost a market-weighted average of -23% during the year. Some of these markets, such as China, are nearing the extreme low levels seen during the financial crisis of late 2008 and early 2009. Markets seem to be discounting a near-certain “hard landing” for the Chinese economy.

As always, it’s important to look into the details of the market averages to understand the underlying composition. For example, when looking at the individual *sectors* of the U.S. stock market, it is obvious that the 2.1% return for 2011 was the result of a wide range of underlying sector performance. Depending on the sectors to which an investment portfolio was allocated, individual investors may have done considerably better, or worse, than the overall index (Table 2). It is not surprising that the “defensive” sectors of the economy – utilities, consumer staples, and healthcare, fared better than the cyclical, pro-growth sectors.

<u>Market Sector</u>	<u>2011 Return</u>
Utilities	14.8%
Consumer Staples	10.5%
Healthcare	10.2%
Consumer Discretionary	4.4%
Energy	2.8%
Information Technology	1.3%
Telecommunications	0.8%
Industrials	-2.9%
Materials	-11.6%
Financials	-18.4%

One final note: the entire return on the S&P 500 in 2011 was attributable to dividends – there was no capital appreciation in this broad stock market index whatsoever; the 2.1% return was due entirely to dividends. I have preached about the

importance of dividends for some time now, and this year we've seen once again that focusing on profitable companies, with shareholder-friendly dividend policies is a good investment strategy.

To complete our 2011 review of financial market returns, here are a few other noteworthy numbers:

- Domestic corporate bonds returned 4.3% on the year and high yield bonds returned 5.0%
- Municipal bond investors who panicked at the end of 2010 were proven wrong, as the municipal bond market returned about 10% for the year (almost 5x the return on U.S. stocks!)
- Emerging market bonds were flat for the year, the mediocre performance being due to strong dollar appreciation (in other words, U.S. investors in emerging market local bonds made money on the securities, but lost money on the currency translation, so the overall investment return was flat for 2011).
- Commodities declined more than 13% on the year, according to the Dow Jones-UBS Commodity Index
- Crude oil and gold both rose by roughly 10% during the year.

So...what was the best investment for 2011? Answer: 30-year U.S. Treasury bonds, which returned more than +30% during the year. Of course, most of this return was not due to yield, but was due to changes in long-term treasury interest rates, which declined from 4.4% at the end of 2010 to roughly 3.0% at the end of 2011 – the declining interest rates boosted Treasury bond prices dramatically. This demonstrates the high degree of interest rate risk inherent in long-dated bonds, as these price moves cut both ways. An equivalent *rise* in market interest rates would produce a similarly large *decline* in the value of these bonds.

There are a couple of lessons here that we can all reflect upon. First lesson: beware the prognostications or warnings of the strategists and the media, which have bemoaned the risks of owning treasuries and municipal bonds for a long

time now. As history suggests, when all the experts seem to be in agreement on what is likely to happen, something *different* will probably happen – be wary of “groupthink.” Second lesson: intelligent diversification matters. Investors who were betting on a strong economic recovery in 2011 (which seemed to be most professional investment strategists) likely reduced their bond holdings and loaded-up on the stocks of financial and cyclical companies, and perhaps commodities. This proved to be a costly error. Of course, one might feel compelled to “cry foul” and argue that the Arab Spring or the tsunami in Japan were unforeseeable developments. One might further argue that the large degree of acrimony among our elected officials, as well as the dithering on the part of European officials, were not consensus viewpoints either. Well, too bad. That’s how these things go sometimes, and that’s why investment strategies that are predicated on seemingly rational expectations frequently produce disappointing results. As I’m fond of quoting, Jack Welch once said, “*Face reality as it is, not as it was or as you wish it to be.*”

As for our client accounts, I believe that our performance was acceptable, although far from pleasing. Two of the broadest measures of global financial markets, the MSCI All Country World Index and the Barclay’s Global Bond Index, produced returns of -6.9% and +5.4% for the full year. Thus, a globally-diversified investor with 60% stocks and 40% bonds would have seen a return of -2% before fees and expenses, and a realized return of -3%, or worse, after fees and expenses. Although there is a wide variation in the risk and return objectives of the accounts that I manage, most portfolios had returns in the range of -2% to +2%, so most client accounts outperformed the global market averages.

2012 OUTLOOK: RISKS & OPPORTUNITIES

In many ways, 2012 does not look much different from 2011, and this is not terribly encouraging. As investors, we still face an uncomfortably wide range of potential outcomes for economies and financial markets in 2012. Unfortunately, all of the myriad problems facing the global economy in 2011 still remain. In fact, I am not aware of one significant

financial or political problem that has been decisively *resolved* during this past year. The European Union is in disarray. The political process in the United States remains unproductive. Consumers are still deleveraging and home prices are still declining (albeit modestly at this point). Social Security and Medicare remain on a path toward insolvency, as do many state and local government pension plans.

In addition to the spillover from 2011, we have a whole host of comparatively *new* problems to deal with. The “Arab Spring” continues and it is possible that more governments will be toppled and that the Middle East will remain unstable. Iran is a wildcard and the risk it poses to global oil markets may be underappreciated. Emerging market economies – the world’s engine of growth for many years now – are experiencing a significant economic slowdown. Crude oil costs more than \$100 per barrel once again; 12% higher than where it was one year ago (Middle Eastern turmoil will only stoke higher prices). Suffice to say, the cumulative effect of all these factors will do nothing to improve the sentiment or risk appetite among investors or corporations.

Having said all that, I do believe that the U.S. economy is likely to grow more rapidly in 2012 than it did in 2011, and this is very good news. But, the risks still remain to the downside. Just as a patient with a weakened immune system is vulnerable to serious illness from a minor virus, the global economy exists in a state of fragility – highly vulnerable to external shocks. There are plenty of candidates for such external shocks in the coming year, the most consequential of which would be a disorderly default of a European nation, such as Italy.

We also need to keep in mind that our federal government can do little at this point – we have already been running massive budget deficits, monetizing trillions of dollars’ worth of mortgage and government debt, holding interest rates at zero percent, and cutting already-low tax rates. It is unlikely that we will see even *larger* deficits, *lower* interest rates, or *lower* taxes in 2012, so government policy in the next year will have a

contractionary effect on the U.S. economy. Politics aside, we need to remember that budget cuts and tax increases can only lead to a *reduction* in aggregate demand and reduced short-term economic growth. Contrary to what some politicians would have you believe, it is not possible to cut government spending by \$1 trillion AND simultaneously grow the economy. This is a nice story, but it is not economic reality.

Across the pond, with large and growing sovereign debt levels, the EU still lacks a long-term solution to its problems and this will continue to contribute to financial market volatility in 2012. Italy will be the primary subject of the EU conversation going into 2012, as she needs to refinance more than 300 billion euros worth of debt this year (more than 100 billion worth in the first quarter alone), and it is not possible for this refinancing to occur at current interest rates, with so little market demand. The key question for 2012 is the following: will the European Central Bank engage in large-scale asset purchases (i.e., “quantitative easing” or “printing money”) as we have done in the United States? If so, then Europe is likely to muddle through the year without much change. To a certain extent, the ECB has already done this and it signaling its intention to do more. In an indirect fashion, the ECB is working through the various commercial banks in Europe and extending unlimited lines of credit, thus providing the banks with unlimited capacity to finance their own governments’ debts. Ultimately, I can’t envision a solution for Europe that doesn’t include some large scale form of debt monetization & money printing. Beyond 2012, however, the question returns to the structural problems in Europe. Ultimately, Europe must either become more unified, or less unified, but it cannot remain in its present form, having a common monetary union but lacking a common fiscal union.

So, where does this leave us from an investment perspective as we head into 2012? As I said before, investors face an uncomfortably wide range of potential outcomes. I believe that the primary focus remains capital preservation and income, while selectively looking for areas of opportunity where there are positive secular fundamentals. As

always, income will matter, regardless of whether it comes from bonds, dividends or distributions.

With respect to those “areas of opportunity” there are a number of sectors or niche markets that may offer attractive investments in the coming year. Many of these are already significant areas of investment focus within client accounts, while others are merely areas of interest in which we may or may not make new investments in the coming year:

1. **Large-cap consumer staples:** The expanding middle class throughout the emerging world continues to benefit many consumer staples companies as global consumers are able to increase their discretionary spending and purchase the products that benefit their everyday lives. Additionally, many of these large-cap consumer companies have high margins, strong cash flows and investor-friendly policies of dividend growth and share repurchases.
2. **Energy Infrastructure:** The domestic energy industry continues to experience a resurgence of investment activity. New oil and gas pipelines will be built to accommodate new productive capacity and bring energy resources from their points of origin to the markets for their consumption. These are attractive long-term assets with large capital requirements, and having healthy returns on investment capital.
3. **Oil Producers:** Oil producers, particularly small and mid-cap companies, continue to benefit from the combined trends of increasing global oil consumption combined with continuous resource depletion. The world consumes about 88 million barrels of crude oil every day, but each year the industry loses about 5 million barrels per day of aggregate productive capacity, due to resource depletion. In other words, if the oil industry didn't drill

any new wells for a full year, the global oil market would quickly fall into a deficit and demand would outstrip the available supply. So, the industry needs to replace about 6% of its own capacity *every year*, just to break even from a supply/demand balance perspective (forget about actually adding *new* productive capacity). The end result is that small and mid-cap oil producers who have the ability to economically grow their production will continue to benefit disproportionately from high and rising oil prices.

4. **Multi-family housing:** Although regional in nature, multi-family housing assets have finally regained pricing power in many markets as the home ownership rate continues to decline and people appear to be exhibiting a paradigm shift in which housing is no longer viewed as an investment, but merely as a necessity. Low apartment vacancy rates and the relatively low volume of new multi-family development during the past 4 years support the value proposition for ownership of multi-family housing properties.
5. **Wireless Communications Infrastructure:** Although the wireless voice market has matured in the United States, consumption of wireless *data* continues to grow by more than 100% per year, requiring significant new capital expenditures in wireless equipment and communications infrastructure. With the termination of AT&T's attempt to acquire T-Mobile, it appears likely that we'll have a more competitive wireless market for some time, and this strengthens the need for new infrastructure. Wireless tower operators look attractive, particularly as they all convert to real estate investment trusts (and therefore begin paying dividends) in 2012 and beyond.

6. **IT Services:** Corporations are producing record levels of profitability and have high cash holdings – this is the direct result of their focus on efficiency and productivity improvements, rather than capital expenditures and payroll expansion. Small businesses still cite “lack of demand” as the number one problem they face and the result is that corporations, large and small, have continued to focus their efforts on operational efficiency, rather than adding to productive capacity. The easiest way to do “more with less” is through investments in technology and IT services. I’ve written about this subject recently as I believe that technology will continue to displace workers throughout the global economy, and companies that provide such profit-enhancing, technology-based products and services will be the beneficiaries of this structural trend.

7. **High Yield Bonds:** High yield bonds currently yield close to 8%, which suggests a higher-than-likely degree of corporate defaults in the next few years. In other words, an 8% yield is actually quite attractive from a risk/return perspective and presents a compelling investment opportunity in the current environment. We have focused on the high yield sector of the bond market for the past couple years and will continue to invest accordingly, as long as market yields remain attractive relative to the degree of risk.

8. **Municipal Bonds:** As noted previously, 2011 was a good year for municipal bonds due to the overblown fears of a meltdown. There have been, and will continue to be, defaults of certain municipalities in 2012 and beyond, but nothing approaching the degree of panic that was discounted into market prices at the end of 2010. At the time of this writing, 10-Year, AA-rated municipal bonds are yielding approximately 3.5% (tax exempt) which compares to the taxable yield of 1.9% for 10-year U.S.

Treasuries. For an investor in a 35% tax bracket, this implies a yield of 3.5% for municipals bonds versus an after-tax yield of 1.2% for treasuries. This is an attractive yield spread for municipal bond investors.

THE IMPORTANCE OF PORTFOLIO DESIGN & DIVERSIFICATION

“In most people’s vocabularies, ‘design’ means veneer. It’s interior decorating. It’s the fabric of the curtains and the sofa. But to me, nothing could be further from the meaning of design... Design is not just what it looks like and feels like. Design is how it works.” -Steve Jobs

Portfolio design is the foundation of the investment process at Blackhaw Wealth Management. This process begins with a global view and an eagerness to identify in, and invest across global markets and multiple asset classes. This global view is then married with the objectives of each individual client (risk, return, tax, liquidity, etc.). The final result is an investment portfolio that is both globally diversified and risk-managed, while being tailored to the unique considerations of each individual client. A well-designed investment strategy is not about colorful pie charts or graphs, nor is it about labeling an investor as “conservative” or “aggressive” – a well-designed portfolio is about how a portfolio of financial assets *works* in practice, under a wide variety of financial market conditions – growth or recession, deflation or inflation, falling interest rates or rising interest rates, as well as foreign exchange fluctuations, commodity price fluctuations, and a wide variety of unpredictable external shocks. In other words, a well-designed portfolio is about maximizing the likelihood of achieving an investor’s goals across the wide range of possible economic outcomes that lay ahead.

In addition to simply looking for attractive investment opportunities for the coming year (as described previously), it is imperative that investors have an understanding of the importance of a correctly *designed* investment strategy and portfolio. A core component of this strategy is diversification. This is a frequent conversational subject with my clients, but I’ve never written much

about it before and so I wanted to take a moment to illustrate the point.

Referring to the table on the following page, you'll see various asset class investment returns during each year of the preceding decade. There are 10 different asset classes represented and color-coded on this table, along with a "Diversified Portfolio" which is simply the arithmetic average of the 10 individual asset classes. This hypothetical diversified portfolio represents the performance that an investor would have realized had he or she simply selected 10 different index funds, one for each asset class, and rebalanced his or her portfolio each year.

There are a handful of critical takeaways from this chart:

- **Stocks Are Not Enough:** An investor who held nothing other than U.S. stocks would have lost about 9% of his/her money during the past decade (even with the dividends!). After factoring inflation into the mix, such a non-diversified investment portfolio would have lost about 35%! Simply by adding foreign stocks didn't help either.
- **Diversification Matters:** During the 2000-2002 collapse of the technology bubble and subsequent credit crisis caused by the Enron/WorldCom scandals, the diversified portfolio had positive returns every year.
- **Diversification Matters, Again!:** During the financial market meltdown and Great Recession of 2008-2009, the diversified portfolio made money as well; gains in 2009 made-up for the losses of 2008, and the total 2-year return was +5%. This may not seem terribly exciting, but almost anybody would have been happy to have simply avoided losing money during this time.
- **Rebalancing Matters:** It is apparent from looking at the table below that reversion-to-the-mean does exist in financial markets. Asset classes that do well during certain periods of time tend to do poorly during subsequent periods, and vice versa. This makes intuitive sense to most people and

this is why periodic rebalancing of investment portfolios is important; we harvest gains from asset classes that have performed well and re-invest in asset classes that have recently done poorly.

This specific analysis clearly only represents one decade, but if we take a longer-term view, the conclusions are still valid. Here are some highlights from the past century to keep in mind:

- During the past century, there were 3 different periods of time in which the U.S. stock market had no net positive price appreciation for periods of 15-20 years in length – the only investment returns during these periods of time came from income (i.e., dividends). In other words, for approximately half of the entire last century, there was no stock price appreciation at all. Fifteen to twenty years is a long time to wait for your stock portfolio to go up in value – for some it may represent the majority of their income-saving years of life.
- Also during the past century, most stock price appreciation occurred during 3 distinct bull markets, two of which ended in subsequent market crashes. The first bull market was in the 1920's, which subsequently ended in the Great Depression. The second bull market occurred in the 1950's, and the third bull market occurred from the early 80's to the late 90's, and ended with a 50% stock market decline at the beginning of this century. Each true bull market was separated by at least 2 full decades of stock market stagnation.

None of this should be interpreted to mean that stocks are a bad investment. On the contrary, stocks are one of the best long-term investments available and should be a core holding of almost all investment portfolios. Nonetheless, investors should recognize that the "long-term" might be a very, very long time, perhaps an entire generation (2 decades, or more). The bottom line is this: if we

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Commodities 49.7%	MLPs 43.7%	Commodities 32.1%	MLPs 44.5%	Foreign Stocks 20.7%	Commodities 25.6%	Gold 35.9%	Commodities 32.7%	Gold 25.0%	MLPs 76.4%
MLPs 45.7%	Domestic Bonds 10.3%	Foreign Bonds 17.1%	Foreign Stocks 39.2%	Commodities 17.3%	Foreign Stocks 14.0%	Foreign Stocks 26.9%	Gold 15.4%	U.S. Treasuries 13.3%	High Yield 58.2%
U.S. Treasuries 14.6%	U.S. Treasuries 7.6%	Gold 14.4%	High Yield 29.0%	MLPs 16.7%	Gold 8.7%	MLPs 26.1%	MLPs 12.7%	Cash 4.4%	Foreign Stocks 32.5%
DIVERSIFIED PORTFOLIO 10.0%	Cash 5.8%	U.S. Treasuries 14.2%	US Stocks 28.7%	Foreign Bonds 13.9%	DIVERSIFIED PORTFOLIO 6.7%	US Stocks 15.8%	Foreign Stocks 11.6%	Domestic Bonds -4.9%	US Stocks 26.5%
Domestic Bonds 9.1%	High Yield 5.3%	Domestic Bonds 10.1%	Foreign Bonds 24.0%	Gold 12.5%	MLPs 6.3%	DIVERSIFIED PORTFOLIO 12.1%	DIVERSIFIED PORTFOLIO 10.7%	Foreign Bonds -8.2%	DIVERSIFIED PORTFOLIO 25.4%
Foreign Bonds 5.6%	Foreign Bonds 0.8%	DIVERSIFIED PORTFOLIO 4.9%	DIVERSIFIED PORTFOLIO 21.6%	DIVERSIFIED PORTFOLIO 11.3%	US Stocks 4.9%	High Yield 11.8%	U.S. Treasuries 10.1%	DIVERSIFIED PORTFOLIO -16.0%	Domestic Bonds 18.7%
Cash 4.6%	DIVERSIFIED PORTFOLIO 0.6%	Cash 3.4%	Commodities 20.7%	High Yield 11.1%	High Yield 2.7%	Foreign Bonds 8.6%	Foreign Bonds 8.2%	High Yield -26.2%	Foreign Bonds 16.8%
Gold 0.1%	Gold -2.3%	High Yield -1.4%	Gold 17.2%	US Stocks 10.9%	U.S. Treasuries 2.4%	Domestic Bonds 4.3%	US Stocks 5.5%	MLPs -36.9%	Commodities 13.5%
High Yield -5.9%	US Stocks -11.9%	MLPs -3.4%	Domestic Bonds 8.2%	Domestic Bonds 5.4%	Domestic Bonds 1.7%	Cash 3.2%	Cash 4.7%	US Stocks -37.0%	Gold 11.6%
US Stocks -9.1%	Foreign Stocks -21.2%	Foreign Stocks -15.7%	U.S. Treasuries 2.4%	U.S. Treasuries 3.4%	Cash 1.4%	U.S. Treasuries 3.2%	Domestic Bonds 4.6%	Foreign Stocks -43.1%	Cash 1.4%
Foreign Stocks -14.0%	Commodities -31.9%	US Stocks -22.1%	Cash 1.6%	Cash 1.0%	Foreign Bonds -1.2%	Commodities -15.1%	High Yield 1.9%	Commodities -46.5%	U.S. Treasuries -1.6%

want to design an investment strategy that seeks to consistently and steadily grow the value of a clients' wealth over their lifetimes, it requires us to incorporate sound diversification across multiple asset classes, wherein individual investment results are driven by fundamentally different factors. This pursuit of intelligent diversification is one of the foundational design principles within the portfolio management process at Blackhaw Wealth Management.

Turning back to the previous table, I would be remiss if I didn't say that the performance of many asset classes over the past decade is probably unachievable during the *current* decade. For example, master limited partnerships were the

single best performing asset class during the past decade, returning about 17% per year, but this is not a reasonable expectation for MLP investment returns for the next 10 years. Gold returned 12% per year during the previous decade. At this same rate of return, the price of gold will reach about \$5,000 per ounce by 2020. This may prove to be a lofty expectation. Cash, treasuries, and corporate bonds returned 2.8%, 6.2%, and 6.0% per year during the past decade, and in each case these numbers may be mathematical impossibilities for the current decade. With interest rates so low, it simply becomes highly unlikely that these fixed income asset classes can produce another decade of such returns.

On a positive note, however, I believe that the outlook for stocks is almost certainly better for the current decade, but we must temper our enthusiasm due to all of the structural and macroeconomic problems discussed already. Global economic growth will be slow and inflation is likely to remain low, perhaps for many more years. With the stock market dividend yield barely above 2%, it only seems reasonable to expect a total equity market return of about 6-7% per year for the foreseeable future, although this may ultimately prove to be good enough to make stocks among the *best* investments for the remainder of this decade. Overall, the hypothetical “diversified portfolio” shown in the table above produced a compound annual growth rate of about 7.4% during the last decade. Going forward, such a diversified portfolio is likely to produce a return in the 4-6% range, and this is how we should calibrate our investment expectations for the years to come. Of course, as a professional investor, it is my objective and purpose to seek returns that are better this, by virtue of fund manager selection, individual stock and bond selection, risk management, as well as the continual pursuit of those areas of investment opportunity that I described previously.

As always, clients are encouraged to call or write with any questions they may have about my letter or their investments at Blackhaw Wealth Management. I wish everyone a happy and healthy 2012.

Sincerely,

Ian McAbeer, CFA

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