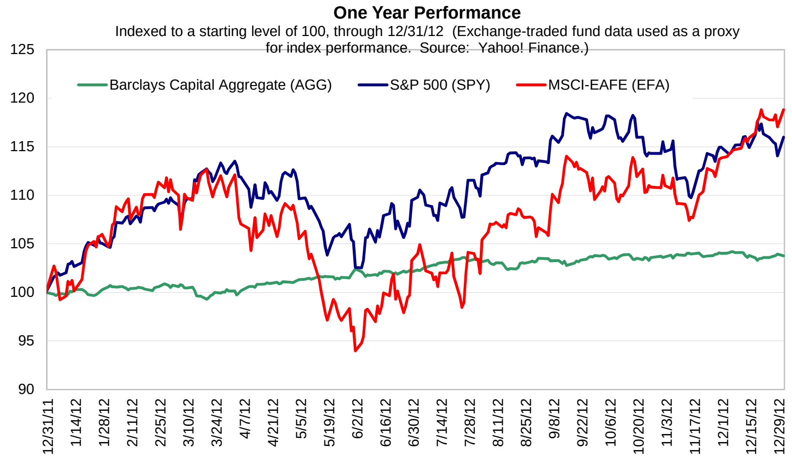
Ron Kelemen, CFP® | Mary Way, CFP®, CPA | Larry Hanslits, CFP®

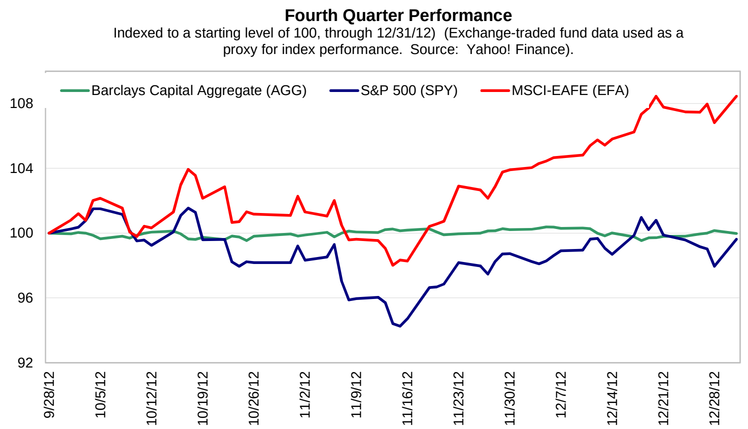
Fourth Quarter & 2012 Portfolio Review

January 3, 2013

Happy New Year! We started the year 2012 with worries about Europe, continued economic headwinds, a contentious election year, the potential of a "fiscal cliff," and slowing growth in several key emerging market nations such as China and Brazil. But as with the rest of life, not everything we worry about happens, or becomes worst-case scenarios. Europe turned out to be better than most people had anticipated. The European Central Bank (ECB) finally stepped up to become the lender of last resort for European banks, removing a huge global risk. The Greek stock actually market did much better than ours, as did China's. Even though the fiscal cliff issue is not resolved and Europe is still stagnating, the year 2012 turned out to be pretty decent from an investor's standpoint, especially for those in equities.



This last quarter followed a similar pattern. It started with high hopes, hit bottom in mid-November, and then struggled back. Fortunately our positions in foreign stocks and bonds gave most of our portfolios higher returns than common indexes, such as the S&P 500.



As is our tradition for this time of year we want to share with you our detailed analysis of the major asset classes, our thinking, and our portfolio management actions. Whether you are a long-time client, or a recent addition to our extended client family, we hope you will find this helpful.

Bonds – Government
Fixed income investors generally look for income from interest payments and price stability. We believe bonds also add portfolio diversification and flexibility. While this conservative cornerstone has served investors well over the years, times have changed. During the last few years, the Federal Reserve has used the government bond market as a tool to kick-start the economy—the theory being that low interest rates stimulate growth. This has left conservative bond investors with few choices, low yields, and often negative returns after inflation.

We have tried to cope with this by underweighting the asset class, and investing in higher-yielding **government mortgage bonds** (such as GNMAs) that aren't likely to be refinanced. And for the taxable accounts, we have used **municipal bonds** effectively. During 2012, these sorts of bonds generally performed well against the broader government bond benchmark.

Bonds – Corporate
To offset the underweight to government debt we have **over-weighted corporate bonds** because of their more reasonable prices, higher yields, and the potential for upside. These investments as a group performed very well in 2012.

Earlier in the year we changed the composition of corporate bond holdings by taking some nice profits in our **convertible bond** holdings, which we have held since late 2008.

Currently your corporate bond holdings have weightings in **high yield** (below investment grade) bonds. They have appreciated nicely since we purchased them in 2008, but unlike the convertible bonds, we continue to hold them because we think there is still more upside as the economy improves.

We have a sizable allocation to high quality **investment-grade bonds** as well as a **floating rate debt fund** that doesn't change value as interest rates change. This helps us to better manage the interest rate risk of bonds.

Bonds – Foreign
For several years, we have operated under the theme that **emerging markets** have become more liquid, efficient, transparent, and credit-worthy. In many cases, they surpass traditional **developed market** economies, such as Western Europe and Japan. We continue to believe that foreign bonds hold promise but we have been de-emphasizing heavily-indebted developed economies in your portfolio.

During 2012, our foreign bond positions provided strong performance versus the broader foreign bond market. Mid-year we made a several small portfolio adjustments that bore fruit with strong improvements in emerging market debt and currencies.

Stocks – US Large Company
Despite news-driven concerns throughout the year, large American blue chip companies performed strongly in 2012 relative to historical averages. **We continue to overweight the largest companies** because they have compelling valuations, diversified product lineups, wide global reach, and the highest-quality balance sheets in several decades.

In the middle of the year we began a consolidation of positions in this area removing a separate sector weight to technology and further diversifying into other sectors. More recently, following an extensive analysis, we made several fund changes which we believe may provide even more consistency in this very efficient part of the market. We still lean towards growth industries (such as consumer stocks, healthcare and some technology) rather than more cyclical value sectors.

Stocks – US Medium Company

We have used medium sized company stocks in the portfolio for a number of reasons during the past decade. This part of the market occupies a "sweet spot" of companies that offer better financial stability than smaller names. They have more flexibility and growth potential than many larger companies. Valuations here have also been compelling, but not quite as attractive as large company stocks. Just as with their larger cousins we focus on high quality growth companies. Prospects continue to look attractive, so **we are overweighting mid-cap stocks slightly**.

Asset Class Weightings as of December 31, 2012

(Compared to our normal long-term allocations)

Asset Class	Underweight ⟵		Neutral		⟶ Overweight
FIXED INCOME					
Government	X				
Corporate					X
Foreign			X		
EQUITIES					
US Large Cap					X
US Mid Cap				X	
US Small Cap	X				
ALTERNATIVE					
Real Estate		**X**			
Commodities			**X**		

Stocks – Small Cap

Smaller firms have done well in the past, but their underlying fundamentals don't justify their high prices. Therefore, we are **underweighting them** as much as our investment policy permits.

Stocks – Foreign

In spite of the news and concerns about Europe, many foreign equities performed decently in 2012 and, in some areas, even better than U.S. stocks. We continue to hold **normal weightings** to foreign stocks at the time.

Earlier this year we shifted from a strategy that focused on regions and sectors to a more broadly diversified exposure across sectors and countries. However, what we said on the previous page about the bonds of foreign emerging markets, also applies to their stocks. Therefore, our holdings in the foreign stock category still lean slightly toward emerging market regions, such as the Far East and Latin America.

Real Estate

Real estate investment trusts (REITs) are on the upswing, and they are an important diversifying element in our portfolios. The REIT market traditionally includes Class A office buildings in major US and global urban centers. More recently it encompasses healthcare facilities, apartment buildings and self-storage complexes—each with their own economic dynamics.

Until early this year, we have underweighted the real estate asset class because we found more compelling opportunities elsewhere. Our move back into them with a **slight under weighting** has been a good one, and we favor the valuations of those that are more globally focused. We are planning an extensive analysis in this area during early 2013.

Commodities

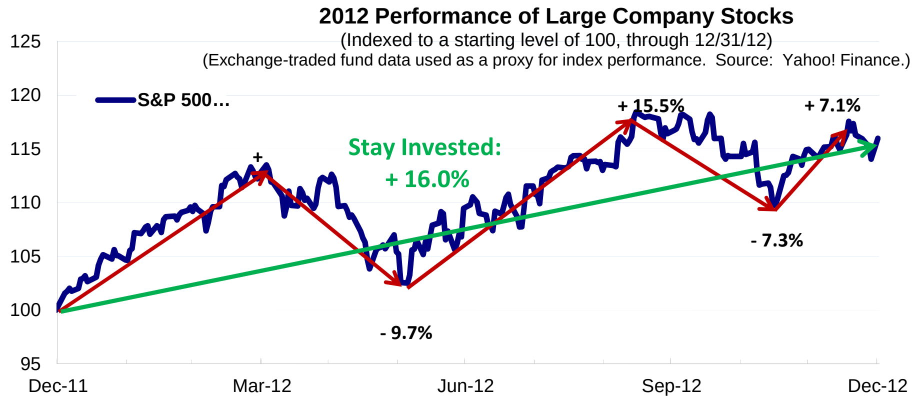
Commodity holdings are one of the more effective diversifying pieces of a portfolio. When other asset classes "zig," commodities usually "zag" (low correlation). They can also be a good inflation hedge. Commodity groups can be divided into three distinct clusters:

1. Economically-sensitive (such as oil and industrial metals like copper)
2. Geopolitical risk-sensitive (precious metals like gold and silver as well as crude oil)
3. Other (which includes the less-predictable and often weather-dependent components like wheat and corn).

In 2012 we have used a fund that tracks a more balanced index that doesn't place a high weighting in energy. So we had a more even weighting in grains and other areas. As a result, our commodities allocation performed well despite a generally flat commodity market. We retain a **neutral weighting.**

Outlook

Every year begins with a set of challenges, and 2013 is no different. The challenges change from year-to-year, but we <u>always</u> have them. This year, chief on our minds is the uncertainty and potential fallout from the failure to get a comprehensive deal regarding the fiscal cliff issues. Economic growth in the U.S. and Europe remains slow and unemployment remains high. On the positive side, we now have tax certainty. The Fed is helping the economy and equity markets with low interest rates. Balance sheets are strong, housing and manufacturing are turning around, and earnings and exports continue to grow. In spite of these fundamentals, many individual investors remain fearful of the stock market, making current valuations attractive. An emotional sell-off as a result of the debt ceiling and budgetary issues will only make them more attractive.



As you can see by the chart above, the path to portfolio gains in 2012 wasn't a straight line. It's like that every year. Those who waited for certainty missed out. If anything, yesterday's impressive 2.5% stock market rally should teach long term investors that timing the market around short-term political events is difficult, if not impossible. We expect 2013 to trend upward, but not in a straight line. Opportunities hide behind uncertainties and challenges. We look forward to helping you successfully navigate them in the year ahead.

Thanks for giving us the opportunity to serve you this past year. Happy New Year!