



January 2012

The US equity markets moved modestly higher in 2011 despite a tumultuous year. Economic growth is tentative and may be dependent on the outcomes in Europe. Low interest rates and volatile equities present unusual challenges for investors. We remain cautious on bonds and believe portfolios of select equities will reward the patient and disciplined investor.

Financial Markets

In a year marked by dramatic natural, economic and political events, stocks prices in 2011 were volatile but ended the year essentially unchanged. The S&P 500 Index (including dividends) returned 2.1% for the year following a gain of 11.8% in the fourth quarter. Reflecting investor's low tolerance for risk, stocks of large capitalization companies, particularly those with above average dividends, generally outperformed cyclical and mid and small-cap securities. Of note, as tracked by Lipper, the average return of growth mutual funds in 2011 declined -3.0%. Overseas, ongoing concerns over the European Union's crisis and weakening economic conditions weighed heavily on most markets. The EAFE index of developed country stocks declined -12.3% for the year and emerging markets lagged even more.

Bond yields remain at unusually low levels as the Federal Reserve pushed rates down to stimulate the economy and as fixed income investors around the world sought the relative safety of US Treasury debt. The 10-year Treasury yield reached an all time low of 1.7% in September and the 90-day Treasury bill closed the year at a mere 0.01%.

Market Indicators 12/31/2011

	Total Return	
<u>US Stock Markets</u>	<u>4th Quarter</u>	<u>2011</u>
S&P 500 Index	11.8%	2.1%
S&P 400 Mid Cap	13.0%	-1.7%
Russell 2000 Small Cap	15.5%	-4.2%
<u>International Stock Markets</u>	<i>ETF Returns in US\$</i>	
EAFE Index <i>(Europe, Australia, Far East)</i>	4.9%	-12.3%
Japan (MSCI Index)	-2.6%	-14.8%
China (Xinhua 25)	13.4%	-17.6%
Emerging Mkts Index	9.2%	-18.8%
<u>US Fixed Income Yields</u>	<u>12/31/10</u>	<u>12/31/11</u>
90 Day T-Bill	0.13%	0.01%
2 Yr US T-Note	0.63%	0.24%
10 Yr US T-Note	3.33%	1.88%

The Economy

Economic conditions in the US, while improving, remain tentative and uncertain. At 2.5%, GDP growth in the third quarter was modestly positive and incoming data suggests fourth quarter growth could accelerate to over 3%. Consumer spending is on the rise and employment is slowly expanding. Housing, a key component of the economy, appears to be stabilizing. However, at least a portion of fourth quarter growth is due to one-time factors such as inventory restocking and incentives created by the year-end expiration of a government stimulus program. In 2012, government spending cuts will be an ongoing economic drag. Furthermore, the instability in Europe and a slowdown in Asia and other emerging markets create significant headwinds for growth in 2012. Even in the best case scenario where Europeans are able to forge a solution that puts the financial crisis behind them, the region seems poised for a recession this year with at least some spill-over effect on the US economy.

A resolution in Europe will be critical for a sustained US recovery. Uncertainty created by the crisis is, in itself, a significant deterrent to growth. While the probability of a failure in Europe may be low, the consequences of a meltdown could be quite severe to economies around the world. Fearful of being hurt, many businesses and investors are deferring decisions or simply taking the safest course of action; projects are being postponed and employees are not being hired. The safest investments are among the most popular.

Focus: The Investor's Dilemma

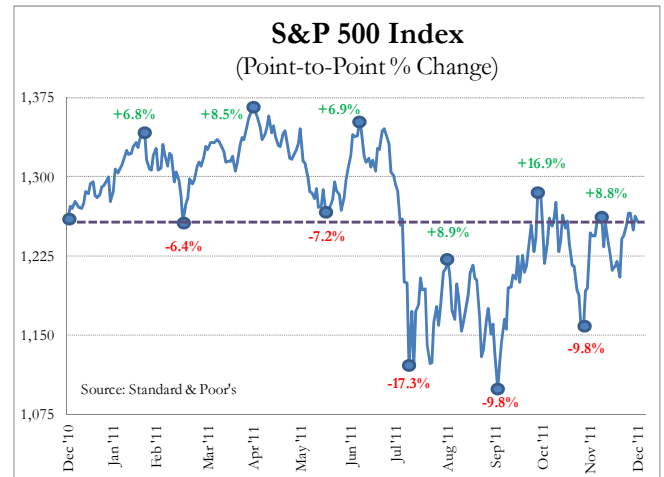
For years, the traditional approach to portfolio management has been to diversify investments by including assets classes that may be relatively uncorrelated. In the 1990s, equities added significantly to the returns generated by bonds, and in the 2000s bonds were an excellent diversifier by adding stability and return when stocks declined.

Today, investors face an unusual dilemma in which neither of these major asset classes is without warts: bond yields are at historically low levels because of their safety, and equity volatility is high and unnerving because of the global uncertainty.

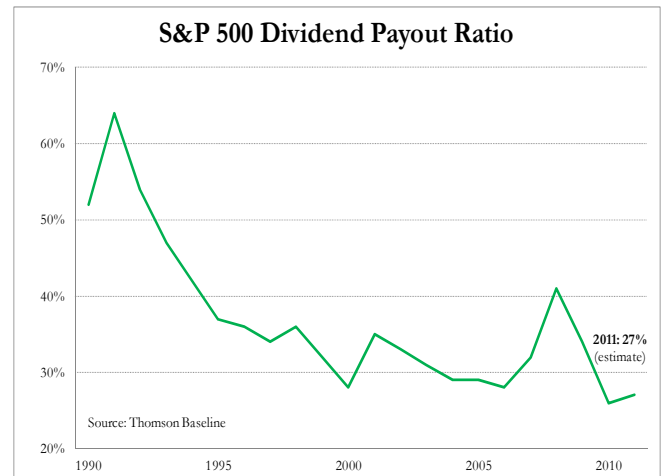
The 10-year US Treasury bond yields roughly 1.9% which is below the current inflation rate of 3.4%. Even if inflation over the next 10 years declines to the Federal Reserve's informal target rate of 2%, investors will have realized a near-zero inflation-adjusted return. Higher inflation will result in negative returns. Investors searching for current income will likely not be compensated for potential capital losses as interest rates rise.

While the outlook for bond returns is not favorable, bondholders can minimize their risks by keeping maturities short and investing in moderate-risk securities where yields are higher than Treasuries and the likelihood of default is low. Select bond mutual funds, such as those with absolute return or high yield strategies, can also provide special opportunities for enhancing bond returns.

Although the net change in stocks was modest in 2011, volatility during the year was notably high. Intraday and day-to-day swings were occasionally dramatic and, as the chart nearby illustrates, wide market swings within just a few weeks were not uncommon. While there is some debate about whether this volatility is at a new heightened level, its cause likely centers around stock investors' unwillingness to accept risk during a period when economic events, such as those in Europe, could unfold with particularly severe outcomes. With uncertainty so high and interest rates so low, investors vacillate between rushing to generate a positive return and fleeing to safety in fear of losing money.



For the disciplined investor focused on the long term, we believe the volatility can present an opportunity to buy uniquely positioned companies with above average growth rates, increasing dividends and relatively attractive yields. With interest rates at such low levels, the income provided by common stocks is now competitive with bonds. At roughly 2.1%, the dividend yield of the S&P 500 index exceeds the 10-year Treasury bond yield, a rare occurrence since the 1960s. Unlike interest payments on a bond, stock dividends tend to rise over time. Over the last 10 years, for example, dividends for the S&P 500 companies increased roughly 40%. With dividend payouts today accounting for only 27% of company profits compared to an average of almost 40% over the past 20 years, further dividend increases are likely.



While there is an abundance of concerns, we continue to believe patient investors will be rewarded by maintaining investments in high quality companies with solid growth prospects. Please call us with any questions.

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