



# CHARTWELL REVIEW

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## Yo-Yo Markets



The 4<sup>th</sup> quarter began with the S&P 500 index hitting its 2011 low, 1099.23, off nearly 13% for the YTD and 19.4% from its April 29<sup>th</sup> high. Then, just as it seemed we were sliding into another bear market (a decline of 20% from the last interim high), the market stopped going down. By 10/28, the index was up 17% from this low. It then fell 10% by November 23<sup>rd</sup>, only to rise 8% by year-end, plus another 4% so far in January. And that was only the 4<sup>th</sup> quarter. The 3<sup>rd</sup> quarter was *much* more volatile.

If you think this is one heckuva way to run a railroad, you are not alone. 2011 marked the third consecutive year investors pulled funds from equity accounts/funds, and added to bond/cash funds. Which is somewhat ironic, since we see from Figure 1 that even a buy-and-hold stock investment has returned considerably more than bonds during that timeframe, except high yield bonds.

The issue of the moment, as it were, is not long-term returns, even though the immediate past 10 years says nothing good about stocks in this regard. Rather, we think, it has become volatility itself. Absent strong positive conviction regarding the ultimate benefits of putting equity capital at risk, many investors are focusing on secondary factors, like mark-to-market risk. Which is another way of saying that volatility is the issue.

Another consequence of yo-yo markets is that folks have become much more concerned with return of capital, rather than return on capital. Thus, blue chip stocks with fantastic fundamentals trade at 10x PE's, which is a 10+% implied return on investment, but the same companies' bonds trade at 4% or lower yields (a very safe 4%, or less, total return). Given such a wide divide, we see tax-exempt investors increasingly playing in the middle: buy stocks paying premium current dividend yields (a less aggressive return on capital variation), or buy the higher coupon bonds issued by lesser-rated companies (a more aggressive return of capital variation).

**Figure 1: Index Benchmarks**

Market Index	Trailing Returns *				
	4Q 11	2011	3 Yr	5 Yr	10 Yr
S&P 500	11.8	2.1	14.1	-0.3	2.9
U.S. Top-cap Stocks	11.6	2.8	12.8	-0.6	2.1
U.S. Mid-cap Stocks	12.3	-1.5	20.2	1.4	7.0
U.S. Small-cap Stocks	15.5	-4.2	15.6	0.2	5.6
Non-US Stocks (devel)	3.4	-11.7	8.2	-4.3	5.1
Non-US Stocks (emerg)	4.4	-18.2	20.4	2.7	14.2
3 mo. LIBOR	0.1	0.3	0.5	2.2	2.4
U.S. Aggregate Bonds	1.1	7.8	6.8	6.5	5.8
High Yield Bonds	6.2	4.4	23.7	7.3	8.6
Global Bonds, unhedged	-0.1	6.4	4.7	7.1	7.8
CPI, annualized	-0.4	3.0	2.4	2.3	2.5
DJ-UBS Commodity	0.3	-13.3	6.4	-2.1	6.6
FTSE All REIT's	14.3	7.3	20.4	-2.1	9.5
Chartwell Global 65/35	6.6	-1.9	12.4	2.9	6.7

**Figure 2: Average Mutual Fund Returns**

Fund Category	Trailing Returns *				
	4Q 11	1 Yr	3 Yr	5 Yr	10 Yr
U.S. Large-cap	10.8	-1.1	14.1	-0.2	3.1
U.S. Mid-cap	11.7	-3.4	18.0	1.7	5.7
U.S. Small-cap	14.7	-3.4	18.2	1.2	6.1
International Lg. Cap	4.6	-12.8	8.6	-3.9	5.7
International Sm. Cap	1.7	-15.1	16.2	-2.0	9.3
Emerg. Mkt. Equity	4.1	-19.6	17.2	1.2	13.6
Balanced/Hybrid	6.1	0.4	11.5	2.3	4.6
General Bonds	1.4	7.1	9.3	6.2	5.7
Government Bonds	1.1	11.4	5.9	6.9	5.7
High Yield Bonds	5.8	3.3	19.3	5.6	7.2

\* Annualized trailing returns for periods ending 12/31/11.

## Economies, Economics, Prices, and Policy

Late in December, the final report on 3<sup>rd</sup> quarter GDP growth was issued. **Real GDP** grew at a rather low 1.8% annualized rate, which was improved from Q2 but quite a bit less than the original 2.5% estimate. Markets chose to focus on the fact that it was an improvement from Q2, rather than the absolute change. The reason investors were willing to accept weak final 3<sup>rd</sup> quarter figures with such equanimity was because better interim economic data for the 4<sup>th</sup> quarter was being reported out during the last weeks of 2011.

**Figure 3: Breaking Down Real GDP**

<u>% Change from Preceding Period</u> (seasonally adjusted)				
<u>Factor</u>	<u>4Q '11</u>	<u>3Q '11</u>	<u>2Q '11</u>	<u>1Q '11</u>
<b>Real GDP Growth</b>	<b>2.8</b>	<b>1.8</b>	<b>1.3</b>	<b>0.4</b>
<b>Nominal GDP Growth</b>	<b>3.2</b>	<b>4.4</b>	<b>4.0</b>	<b>3.1</b>
<b>Final Sales</b>	<b>0.8</b>	<b>3.2</b>	<b>1.6</b>	<b>0.0</b>
Personal Spending	2.0	1.7	0.7	2.1
Private Investment	20.0	1.3	6.4	3.8
- Fixed, Businesses	1.7	15.7	10.3	2.1
- Fixed, Residential	10.9	1.3	4.2	(2.4)
- Chg. In Inventories (\$bn)	\$56	(\$2)	\$39	\$49
Export growth	4.7	4.7	3.6	7.9
Import growth	4.4	1.2	1.4	8.3
Government Spending	(4.6)	(0.1)	(0.9)	(5.9)

The BEA has just now reported their “advance” estimate of 4<sup>th</sup> quarter real GDP growth, at +2.8%. The nominal growth rate is estimated at 3.2%, annualized. These are both disappointing numbers. A month ago the expectation was for real growth in the 3.5% range. Further, most of the quarter’s growth is estimated to have resulted from rising inventory levels. Final sales of domestic product--GDP less change in inventories--increased just 0.8% in Q4, compared with 3.2% in Q3. If these estimates hold, real GDP will have increased only 1.7% in 2011, compared with 3.0% in 2010.

**Price indices** finally “tipped over” in the 4<sup>th</sup> quarter. Seasonally adjusted, the CPI did not rise at all, after rising at an annual rate of 4.8% in the third. Over the twelve months ending December, headline CPI was up 3.0%, compared to 3.9% through September. The Core CPI (less food and energy) trailing one-year rate of change through December was 2.0%, up from 2.2% through September.

The PPI-finished goods index was also flat for the 4<sup>th</sup> quarter, after rising at an annualized rate of 4.9% in the third. The 12-month rate of change through December was 4.8%, compared to +6.9% for the year through September. On a seasonally adjusted basis, the PPI-Intermediate Goods index *fell* at a 5% rate in the 4<sup>th</sup> quarter. The PPI-Crude Goods index rose just 0.4%.

On the **import-export** front, exports fell 0.1% for the quarter ended November, while imports rose 1%. This reversed the prior quarter’s trend, and suggests that net imports will not contribute to 4<sup>th</sup> quarter GDP growth. Further, with the US\$ strengthening versus the Euro in the fourth quarter, one can expect a continued increase in our net trade deficit as 2012 unfolds.

The **US employment** situation continued to make positive progress in the 4<sup>th</sup> quarter, with many more persons added to the work force compared to the third. Data from the survey of employers indicated a +566k gain in total non-farm payrolls, compared to a +287k gain in the 3<sup>rd</sup> quarter. The “headline” unemployment rate dropped to 8.5% at the end of the year, versus 9.1% in September. Household-survey data reflected an increase of 683k persons identified as employed.

The **US industrial production** picture has moderated. For the fourth quarter as a whole, industrial production rose at an annual rate of 3.1%, its 10th consecutive quarterly gain. But, in the third quarter industrial production rose at an annual rate of 5.1%. Total industrial production for December was just 2.9% above its year-earlier level. **Capacity utilization** levels for total industry edged up a bit, to 78.1%.

On the **fiscal policy** front, the Super Committee failed in its spending reduction task, but Congress did agree to temporarily extend the 2% reduction of employee FICA taxes through 2012, and to continue extended unemployment benefits for long-term unemployed.

On the **monetary policy** front, the Federal Reserve’s “Operation Twist” program kicked in. Through June 2012, it will be buying 75-90% of all new long-term bonds issued by the Treasury, and selling the same amount of 0-5 year Treasury securities.

Per Figure 4, most economists again reduced their projections for **global growth** during the last three months, as they began peering ahead to 2012. The Euro area is projected to incur a recession in 2012, but not one deep enough to drag the US, Latin America or the Far East completely down with it. Japan is forecast to turn its economy around rather smartly, which would be a good trick given the Yen’s strength.

**Figure 4: 2011 and 2012 GDP Forecasts**

	October Forecast	Current Forecast	Current Forecast
	<u>2011 Real GDP, % change</u>		<u>2012 GDP Range</u>
United States	1.6	1.7	1.3 / 2.6
China	9.0	9.2	8.6
Germany	3.0	3.0	-1.0 / 0.8
Britain	1.2	0.9	-1.3 / 0.8
Japan	(0.4)	(0.6)	0.5 / 2.8
Brazil	3.6	3.0	3.8
EURO AREA	1.7	1.4	-1.8 / 0.5

## Fixed Income Market Review

Markets remained extremely volatile in the fourth quarter, as the European debt crisis continued to dominate headlines. Financial market and political instability along with evidence of slowing growth kept global investors on edge, with “risk-on, risk-off” sentiment seemingly flipping on a whim. Despite these challenging market conditions, risk assets rebounded very well from their 3<sup>rd</sup> quarter difficulties. Spreads across most sectors in the bond universe tightened. Figures 5 and 6 display bond yields and performance by sector for the 4<sup>th</sup> quarter and full year.

**Figure 5: Primary Bond Sector Yields**

	Dec-11	Sep-11	Dec-10	Y-T-D Change
<b>Treasuries</b>				
3-month	0.01%	0.03%	0.13%	-0.12%
2-year	0.25%	0.25%	0.60%	-0.35%
5-year	0.95%	0.97%	2.01%	-1.06%
10-year	1.92%	1.93%	3.30%	-1.38%
30-year	2.91%	2.92%	4.35%	-1.44%
BarCap Aggregate	2.28%	2.35%	2.97%	-0.69%
BBB Credit bonds	4.35%	4.48%	4.66%	-0.31%
AA Credit Bonds	2.41%	2.54%	3.39%	-0.98%
MBS	2.68%	2.82%	3.67%	-0.99%
Emerging Mkts	6.07%	6.59%	5.76%	0.31%
US High Yield	8.36%	9.51%	7.51%	0.85%
TIPS	1.69%	1.86%	2.78%	-1.09%
UST30y-US3mo	2.90%	2.89%	4.22%	-1.32%

The US Treasury yield curve was little changed from September to December, after declining significantly for most of 2011. Investment grade credit bond yields *dropped* by about 13bps in the quarter, leading to their overall excess returns for the quarter of 0.8%, after adjusting for duration differences. The positive performance gap was much greater as you moved down the quality spectrum. Option-adjusted spreads for CMBS, Corporate High Yield and Emerging Market (US\$) bonds dropped by 50-100bps, leading to outperformance for the quarter of 2.5%, 5.7%, and 4.5%, respectively.

Investment grade credit bond yields also declined over the full year, but not nearly as much as the Treasury curve. Thus, overall credit spreads widened, and the sector underperformed Treasuries by 3.7%. At 238bps, average spreads over Treasuries are well above long-term averages, despite good underlying fundamentals.

The full year picture was similar for Corporate High Yield bonds. Despite a very strong 4<sup>th</sup> quarter, earlier market turmoil was sufficient to see spreads jump by over 200 bps last year, as yields rose to 8.36%.

The overall US High Yield market underperformed duration equivalent Treasuries by 2.4% in 2011. And, lower-quality credits underperformed higher-quality names by 1.5 - 5.5%.

**Figure 6: Primary Bond Sector Returns**

Index	4Q '11	2011	3 years
BarCap Aggregate	1.1	7.8	6.8
Treasuries, 1-3 Yrs.	0.2	1.7	3.6
US Treasuries, long	1.9	29.9	7.4
U.S. Inflation-Linked	2.7	14.0	10.2
Mortgages	0.9	6.4	5.9
CMBS	3.1	6.5	18.1
ABS	0.2	5.1	11.6
Inv. Grade Credit, 1-10yr	0.9	6.0	5.8
Inv. Grade Credit, 10+yr	3.5	16.3	15.5
US High Yield Credit	6.2	4.4	23.7
Municipal Bonds	2.1	10.7	8.6
Non-\$ Global	(0.9)	4.2	4.7
Non-\$ Global, Hedged	0.6	3.9	3.7
Emerg. Mkts Bonds (US\$)	5.3	9.2	15.4

Policymakers took steps to stabilize the situation in Europe, boosting the firepower of the European Financial Stability Facility (EFSF), providing medium term bank liquidity facilities, recapitalizing European banks, and imposing structural reforms in weaker countries. Nonetheless, rating agencies remained active throughout the quarter, downgrading Italy, Spain, and Portugal, and placing the ratings of 15 other eurozone countries on negative credit watch. In January 2012, France was also downgraded.

**Figure 7: Sovereign Bond Trends, selected countries**

10-year gov't bonds	12/31/11	9/30/11	12/31/10	Y-T-D Change
<b>United States</b>	<b>2.01</b>	<b>1.93</b>	<b>3.30</b>	<b>-1.29</b>
Germany	1.94	1.84	2.98	-1.04
Switzerland	0.70	0.93	1.62	-0.92
Britain	2.04	2.35	3.60	-1.56
Poland	5.83	5.82	5.99	-0.16
Italy	6.84	5.51	4.68	2.16
Spain	5.61	5.07	5.44	0.17
<b>Greece</b>	<b>34.74</b>	<b>22.19</b>	<b>12.20</b>	<b>22.54</b>
China	3.57	3.88	4.01	-0.44
Australia	3.74	4.10	5.68	-1.96
South Korea	3.81	3.76	4.40	-0.59

Emerging markets (EM) debt has become a strategically important sector for many investors. 2011 was a decidedly mixed bag for this very diverse sector. US\$-issue bonds outperformed, gaining 5.3% in the 4<sup>th</sup> quarter as spreads declined, and returning 9% for the year. However, the other half of this market is local currency denominated sovereign debt, and that index lost -1.75% for the full year.

## Domestic Equity Markets

In the third quarter, a sentiment-fueled sell off clobbered US stocks, as investors grappled with globally weakening economic data, European and US political gridlock, downgrades of sovereign debt (including our own), and fears of escalating contagion in the unresolved and seemingly intractable euro zone debt crisis. However, economic releases at the onset of the 4<sup>th</sup> quarter pointed to an improving domestic economy and the S&P 500 posted its largest monthly gain in October (+10.9%) since December 1991. A strong year-end rally saw US stocks finish 2011 in positive territory (the S&P 500 returned 2.1%, counting dividends), outperforming all other major regions.

In a year in which volatility prevailed, the S&P moved more than  $\pm 2\%$  (intraday) in nearly half of all trading days during the last six months of 2011. Defensive sectors, including utilities, consumer staples, and health care, outperformed. However, in the 4<sup>th</sup> quarter cyclical themes played out better, as demonstrated by strong returns in the energy, materials, industrials, and consumer discretionary sectors (see Figure 8).

**Figure 8: U.S. Equity Market - Sector Returns**

<i>GICS Sector</i> (as of Dec '11)	4Q 2011	FY 2011	Since Market Low	Since Market Peak
Energy 12%	18.2	4.7	77.5	(3.1)
Industrials 11%	16.4	(0.9)	135.0	(14.5)
Materials 3%	15.4	(9.8)	105.9	(13.6)
Cons. Disc. 11%	12.6	6.1	156.8	11.0
Financials 13%	10.8	(17.1)	118.0	(60.1)
Health Care 12%	10.0	12.7	68.7	4.6
Technology 19%	8.7	2.4	111.3	0.8
Utilities 4%	8.3	19.9	82.2	4.1
Telecom Svcs 3%	7.9	6.3	72.2	(9.8)
Cons. Staples 11%	7.3	13.9	83.7	31.0
S&P 500	11.8	2.1	97.2	(11.8)

Since the market lows of March 2009, higher beta small-cap stocks have generally outperformed large-caps (by 20-27%), but this was reversed for much of 2011. We can see from Figure 9 that the size effect (*smaller > larger*) was once again clearly observable during the 4<sup>th</sup> quarter, as the “risk on” environment favored smaller-cap stocks. Since the last market peak in early October 2007, which has generally been thought of as a risk-shedding environment, large-cap stocks have modestly outperformed smaller (i.e., declined less). The notable exception has been with very large-cap value stocks, which have been by far the worse performing size/style sector since then, largely because financial services stocks account for 25% of Large-value indices and just 4% of Large-growth.

Accordingly, from a style perspective, the 4<sup>th</sup> quarter represented a bit of an aberration. The value effect (*value > growth*) was observable in the quarter for large-, mid-, and small-cap stocks. But, calendar year 2011 again saw value strategies underperform growth (see Figure 9), led down by the very weak financial services sector.

**Figure 9: U.S. Equity Market - Size/Style Returns**

	4Q 2011	FY 2011	Since Market Low	Since Market Peak
<b>Growth</b>				
Large Cap	10.3	4.6	99.4	(2.2)
Mid Cap	11.2	(1.7)	122.8	(3.6)
Small Cap	15.0	(2.9)	126.8	(3.9)
<b>Value</b>				
Large Cap	13.0	1.1	100.6	(19.6)
Mid Cap	13.4	(1.4)	137.0	(7.2)
Small Cap	16.0	(5.5)	121.3	(10.5)

Value stocks have underperformed growth stocks since the late 2007 market peak, and during four out of the past five calendar years. This is easily one of the longer such periods since the Great Depression, and the longest in more than 20 years. But, as Figure 9 reinforces, the medium term underperformance is really more associated with the '07-09 decline, rather than the rally since then.

**Figure 10: Global Markets - Price/Earnings Ratios**

(1yr fwd)	Value	Blend	Growth
US Large	11.0x	12.3x	13.8x
US Mid	12.3x	13.9x	15.7x
US Small	13.0x	14.6x	16.4x
EAFE		10.2x	
Emerg. Markets		9.4x	

Per Figure 10, the first quarter of 2012 is starting out with stocks even more attractively priced than a year ago: earnings and dividends are higher and interest rates are lower, yet stock prices are mostly unchanged. There seems to be two basic reasons for the more favorable valuation of stocks: (1) fear of the European financial crisis spilling over to the United States, and (2) the disappointing pace of the United States' (and the world's) economic recovery.

## International Markets Finish in the Red

After what had been a crushing third quarter, the last three months of 2011 provided some relief for global equity markets. Most countries posted positive returns in both US\$ and local currency terms. Developed markets, as measured by the MSCI World ex-US index, rose 3.6% in the quarter, but finished the year down -11.8%. Growth stocks moderately outperformed value in the quarter, but underperformed for the year. Emerging markets stocks rose 4.5% in US\$ terms during the quarter, but declined -18% for the year. Currency conversion effects were ultimately negligible across developed markets in 2011, as weaker European currencies were offset by a stronger Yen. However, the Dollar's strength detracted nearly 6% from emerging markets (see Figure 11).

Overall, non-US stocks declined further than US stocks through September, and then rebounded much less than US stocks during the 4<sup>th</sup> quarter. The result was 14% relative underperformance by the developed markets in 2011, after 4% underperformance in 2010. The last time we saw that pattern was 2001 and 2002.

**Figure 11: International Equity Markets - Returns**

thru Dec. 31, 2011	U.S. Dollar Returns (%)		Local Currency Returns (%)	
	4Q '11	2011	4Q '11	2011
<b>World ex-USA</b>	<b>3.6</b>	<b>(11.8)</b>	<b>4.0</b>	<b>(11.6)</b>
- MSCI Growth	4.0	(12.4)	4.4	(12.2)
- MSCI Value	3.1	(11.1)	3.5	(10.9)
- Europe ex-UK	3.5	(14.5)	6.6	(12.1)
- Pacific, ex-Japan	6.0	(12.7)	2.2	(12.8)
- Japan	(3.9)	(14.2)	(4.0)	(18.6)
- United Kingdom	9.1	(2.5)	9.4	(1.8)
<b>Int'l Small Cap</b>	<b>0.5</b>	<b>(18.2)</b>	<b>0.5</b>	<b>(17.1)</b>
<b>Emerging Mkts</b>	<b>4.5</b>	<b>(18.2)</b>	<b>4.9</b>	<b>(12.5)</b>
- EM Asia	3.3	(17.2)	3.6	(14.2)
- EM Europe & ME	0.5	(23.3)	1.7	(16.4)
- EM Latin America	8.8	(19.2)	9.3	(9.8)
- EM BRIC	4.4	(22.7)	5.7	(17.1)

The European debt crisis remained the focal point for investors throughout the quarter, as politicians and the ECB worked to stem the rout in bond and equity markets. For the quarter, Ireland was the best performing country in the primary index, jumping 22.4%. Greece was the weakest, dropping -27.5%. Of the major countries, the UK led the way with a 9.1% return, followed by Norway (9.6%), Sweden (8.8%) and Denmark (8.3%). Germany and France were up a modest 3.9% and 2.8%, respectively.

The Pacific region was significantly impacted by Japan's performance. Japan fell -3.8% during the quarter and -14.2% for the year. The Pacific region *excluding* Japan was up 6% for the quarter.

**Figure 12: World ex-USA Sector Returns (in US\$ terms)**

thru Dec. 31, 2011 (GICS Sector)	Large/Mid Returns (%)		Small-cap Returns (%)	
	4Q '11	YTD	4Q '11	YTD
Energy	14.7	(2.8)	13.6	(16.7)
Cons. Staples	5.8	4.6	1.5	(1.5)
Health Care	5.7	7.3	1.4	(9.6)
Info Technology	5.2	(14.4)	0.2	(18.7)
Industrials	4.8	(14.7)	1.3	(15.3)
Telecom Services	2.6	(0.2)	(1.3)	(10.5)
Materials	2.4	(22.7)	1.7	(21.3)
Cons. Discretionary	0.7	(12.6)	(0.3)	(12.8)
Financials	0.2	(19.9)	(1.7)	(14.3)
Utilities	(4.2)	(18.2)	6.7	(2.1)
Large/Mid   Small	3.6	(11.8)	0.5	(17.1)

Australia and Hong Kong posted robust gains in 4Q11, while New Zealand and Singapore joined Japan in negative territory.

After a terrible 3<sup>rd</sup> quarter, energy companies were the top performing sector in the fourth (+14.8%), followed by consumer staples and healthcare. The latter two sectors were the only ones to break through with positive returns for the year, although energy and telecom services came close (see Figure 12).

The weakest performing sector during the quarter was utilities. Financial services (primarily the larger national banks) and consumer discretionary stocks were also notable laggards, with weakness in all three respects tied to Europe's incipient recession.

Emerging markets countries are in much better financial shape than developed world countries. The average EM country has a budget deficit and debt balance (both as % of GDP) that are ½ that of the average DM country. Stronger growth prospects, better fiscal balances and credible policy making added up to 35 EM debt upgrades in 2011, versus 32 downgrades for DM countries. Yet, EM stock markets were more negatively affected by the global "risk off" environment in 2011. Many emerging markets are commodity and natural resource driven, and the global economic slowdown drove down commodity prices and negatively impacted the industrial and materials sectors.

India, one of the largest emerging markets, was the second worst performer for the quarter (-14%) and the worst for the year (-37%). Despite this, and China's 18% decline, emerging Asia was the best performing EM region for the year, falling "only" -17%. Many of the smaller Asian markets posted modest positive returns. Emerging Europe was dominated by weak performance from eastern European countries (Hungary, Poland and Russia). Within Latin America, Brazil and Chile both fell over -20% for the year, while Colombia and Mexico posted better than index results (-5% and -12%, respectively).

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## **Back Page Perspectives**

One thing increasingly on our mind these days is the continuing debate over whether one should implement investment programs using passive indexed investment “products,” or engage *active* investment managers to do the heavy lifting. What’s rekindled our interest in this discussion recently has been the fact that some index benchmarks rose very high in the peer universe rankings during 2011, to top quartile status. Which means that the bulk of active managers in those categories are failing to meet/beat their objectives.

We wanted to see how pervasive this was, so we queried Morningstar and developed a profile of “average” fund returns by broad size/style category. We then compared these averages with the returns of the most common index benchmarks used to gauge performance. The results are summarized below –

<b>Excess Returns - Active Funds vs. Passive Indices</b>			
<b>fund category</b>	<b>2011</b>	<b>3 Years</b>	<b>5 Years</b>
US Large Growth	(4.84)	(2.06)	(1.30)
US Large Value	(0.85)	0.72	0.98
US Midcap Growth	(2.34)	(3.53)	(0.13)
US Midcap Value	(1.95)	(1.23)	0.53
US Smallcap Growth	0.17	(0.09)	(0.06)
US Smallcap Value	2.06	5.27	2.98
Int'l Large Cap	(1.04)	(0.51)	(0.30)
Emerg. Markets	(1.44)	(3.24)	(1.55)
General Bond	(0.77)	2.55	(0.27)

The past year was certainly a very challenging one for active managers. Based on our very broad analysis, it appears that you’d be lucky to find a US Large-cap Growth, or a US Mid-cap fund, that beat its benchmark in 2011. This is not true at all, because these numbers are simple averages, but it is true that more than half of domestic large-cap and mid-cap growth active managers have not produced any cumulative “alpha” during the current three-year recovery. Conversely, small-cap value managers look to have been value-adding machines over the past three years.

What gives? Some of the answer, we’re afraid, is style-drift. For example, over this review period growth indices have handily outperformed value indices, across all cap ranges. Value managers have been able to outperform by being (ahem) *flexible* about the characteristics of the stocks they own. Growth stocks in value clothing, as it were. This sets academics and consultants atwitter, although clients are often more pragmatic about style-drift (until the scheme doesn’t work).

The more difficult question is the reasons behind the sharp underperformance of active large/mid growth managers. Managers point to the very high short-term volatility of the past two years, the sharp rise in correlations between individual stocks, and the increasingly large trading volumes accounted for by ETF managers and high frequency traders. One only has to observe the identical closing price of the S&P 500 index on the last trading day of 2010 and 2011 (a statistical impossibility), to appreciate the power of stock traders to seemingly bend prices to their will.

This topic deserves further and more sophisticated study, to be sure. But, for the time being we’re sticking with the following concept: hold onto growth managers who have outperformed their benchmarks over the long-term, even if they stumble briefly, for they are hard to identify. Absent that, invest your US large/mid growth assets in low cost, low turnover, index funds.

Third quarter US corporate earnings were the highest ever. The S&P printed \$25.29 per share operating earnings. That made eleven straight quarter-over-quarter gains. Unprecedented. However, 4<sup>th</sup> quarter earnings are now forecast at \$24.05, down from a \$25.50 estimate just one quarter ago. And, just half the companies have beat their estimates so far. The current 2012 “no-growth” running rate for S&P 500 earnings is still right around \$100/share, compared to a December 31<sup>st</sup> index closing price of 1258. We think the index is back up over 1300 this January because recent macro developments in Europe, China, and the US have combined to reduce the chances of a sharp drop in 2012 corporate profitability. Investors are no longer ascribing much weight to an \$85/share year for the S&P. But, that’s not the same as saying it can’t happen.

The US equity market has rallied 20% off its October 3<sup>rd</sup> bottom. The German DAX is up 25%. Investors *with short-term liquidity needs* might want to address them by selling some stock into this rally.

**Sell high, buy low. See you next quarter!**

*Natalka Bukalo*

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