

January 13th, 2012

Here is our newsletter for the 1st quarter of 2012.

The Markets

Stocks rebounded in the 4th quarter of 2011, with U.S. stocks gaining about 12% and international stocks gaining 4%. For all of 2011, despite huge volatility during the year, large-cap U.S. stocks gained 2%, all of the return coming from the 2% dividend yield of the S&P 500 index. All other stock markets had a down year with the small-cap U.S. market losing 4%, developed foreign losing 12% and emerging markets down the most at -19%.

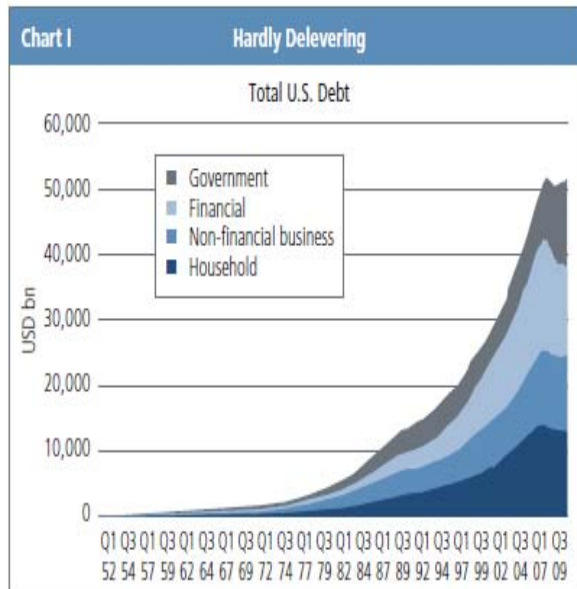
The highlight for the bond market for the year was the flight to safety to the U.S. as the Barclays Aggregate Bond Index gaining 7.8%. U.S. government Treasury bonds gained over 9%. Municipal bonds also bounced back from a poor 2010 with a gain of 10% for 2011. High-yield bonds gained 4.5% while emerging market bonds lost 1.7%.

Our Outlook on the Economy and the Markets

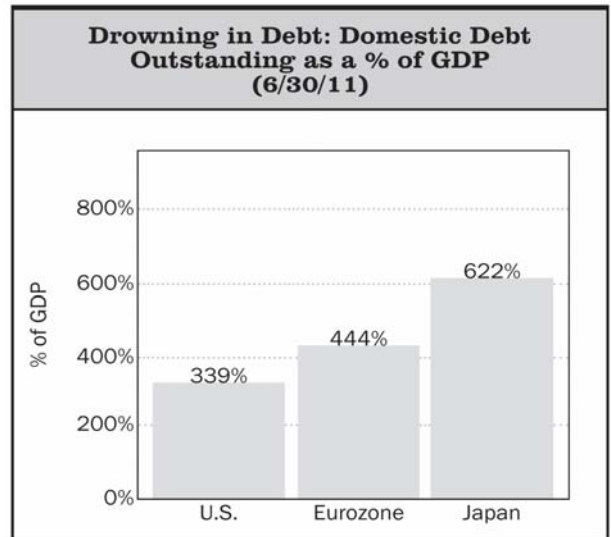
The worsening European debt crisis and the potential global implications have increased the risks of a slowdown in the global economy. The following is a quote from our newsletter one year ago. "I went back to our outlook one year ago in our newsletter and I could almost use the same outlook for now. The economies in the U.S. and the rest of the developed world are recovering, but at a slow pace that will mean many years for the economy to fully recover from the financial crisis that hit in 2008. This is primarily due to the mountain of debt households and banks piled up over many years".

Have we made any progress in reducing our mountain of debt over the last year? While households, businesses and financial firms have made progress, the U.S. government has increased its debt load such that the total debt load has hardly changed since the financial crisis in 2008, per the chart on the next page. The debt situation in Europe and Japan is worse. The stress on the banking system in Europe is intensifying and banks are downsizing by aggressively reducing lending, being forced to sell assets and pulling out of many markets as funding has dried up. After the mortgage crisis in 2008 they were essentially told by their regulators to quit buying risky mortgages from the U.S., but rather load up on safe European government bonds. As it became obvious that this debt was far from safe, especially that of Greece, Portugal, Ireland and now even Spain and Italy, their bond interest rates spiked, further worsening their situation as they have to rollover that debt at higher interest rates. This increases the chance they will not be able to pay off their debt as their interest costs go up, thus lowering the prices for current bond holders and perpetuating the downward spiral

of prices. In 2012 it is estimated the developed nations (U.S., Europe and Japan) will need almost \$11 Trillion in funding, mostly maturing loans needing to be rolled over. This could trigger a banking crisis similar to that we saw in 2008 in the U.S...



Source: Bianco Research



Sources: U.S. Federal Reserve, Bank of Japan, and Eurostat.

So what does all of this mean? Most economists see a European recession already underway. How deep a recession is a huge unknown but a major meltdown is not out of the question. The European Union and European Central Bank have been implementing changes, but these have been very incremental and slow in coming. They just do not have the fiscal, monetary and political union and strong Central Bank that the U.S. has. A contracting European economy and banking system in crisis will have negative consequences all over the world as our financial institutions and economies are highly linked.

The U.S. economy will continue its slow recovery at best, or fall into a recession at worst over the next year. While U.S. banks do not have a large direct exposure to European debt, they do have exposure through derivatives that is a concern to some, as a lack of transparency in these makes it impossible to fully understand their nature and size. The Federal Bank has done a tremendous amount to stimulate the economy over the last 4 years, but with interest rates at record lows and having danced every dance they can dance, they are pretty much out of bullets. The U.S., like our friends in Europe will have to spend less and raise taxes to put us on a sustainable path to recovery. The economy could continue to improve over the next few quarters if Europe takes strong steps to address their problems and if China orchestrates a soft-landing. However, in the longer term our structural problems will keep the developed economies in a challenging period for several more years. The emerging markets are also slowing down (especially in China, India and Brazil) and there is some concern China, whose economy accounted for almost 20% of global growth in 2010, may have a hard landing.

Nobody can predict what will happen with any high level of certainty. Litman Gregory has done an analysis of three possible scenarios they see could happen to the world economy and how markets could perform over the next five years under those scenarios. We use their analysis to help us understand the potential risks and rewards and to guide our investment decisions. Here are the three scenarios and highlights of their analysis.

1. Another financial crisis with deflation and a deep world recession. This scenario could be characterized by enormous downside for equity assets, potentially 30% to 50% from current levels to a stock-market bottom. Other “risky” assets would also suffer, including emerging markets local currency bonds, high-yield bonds, real estate, and commodities. U.S. Treasuries would likely be the asset of choice. We expect investment grade fixed income would return about 5% cumulative over that time period. We believe this “worst-case scenario” is improbable but not so improbable to justify dismissing the possibility.

2. No major financial crisis, but growth remains slow. This is our base case, meaning we believe it is the most probable outcome. It assumes the headwind to growth from deleveraging is unavoidable regardless of government policies and that it will be a long, slow process, as is consistent with similar past periods in economic history. Returns for a diversified portfolio could be in the mid-single digits over five years but volatility would be high because of macro risks.

3. Policymakers hit the bull’s eye, emerging markets lift all boats, and growth is higher than we expect. This scenario suggests stronger earnings growth and higher multiples as macro risks subside. U.S. and other developed country equities could return in the low to mid-teens and emerging markets equity returns could be even higher. Bonds would perform poorly. We view this scenario as the least likely of the three.

Our Portfolios

For 2011 our equity-tilted composite was down 3.2% compared to a 0.9% gain for the benchmark and our balanced composite gained 0.2% compared to a 2.3% gain for the benchmark. For the year most of our underperformance relative to our benchmarks can be attributed to our underweight to U.S. Treasury bonds and overweight to emerging market stocks, bonds and currencies. Note our benchmarks do not have any emerging market stocks or bonds and the bond benchmark is dominated by U.S. government debt. While our performance has been hurt in the last year, we feel confident our strategies will pay off in the long run.

We reduced the risk in our portfolios this past December by reducing our emerging market equity holdings and switching one of our bond funds for a safer alternative. We sold VVO Vanguard Emerging Markets fund as this fund is very volatile and while we like the long-term prospects for the emerging markets, short-term losses could be large.

We sold Loomis Sayles Bond Fund and bought DoubleLine Total Return Bond Fund. Doing so will reduce the volatility in our bond holdings and improve the diversity our portfolios.

We have been following DoubleLine since its inception in April of 2010. We usually do not invest in funds this new, but the manager Jeff Gundlach is well know and had a long and successful track record at TCW before he started up his own fund company two years ago. He is an independent investor and his fund should act much differently from our other bond funds in our portfolios. We also added a Vanguard short-term bond fund in our more conservative portfolios and this fund should provide stable income.

Overall this puts our equity allocations at less than one half of our neutral allocations and puts our fixed income holdings on a more stable footing. The above changes should help to limit the downside in our portfolios and give us the opportunity to invest more aggressively when the markets present a better opportunity to do so. It has been four years since we started reducing the risk in our portfolios and over that period our clients have benefited as a result. One of my favorite quotes from Warren Buffet summarizes our current thinking: the best way to make money in the markets is to not lose a lot of money.

Thank you for your continued interest and give me a call anytime to discuss any of your specific needs.

Sincerely,

Stan Johnson, CFP(R)
Comprehensive Financial, Inc.
Registered Investment Advisor