Market Commentary

Fourth Quarter 2011

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we'll get there together

If an investor slept through 2011, going to bed at the stroke of Midnight on Dec 31, 2010 and awakening at the same time exactly one year later, he would find the S&P 500 Index declined by 0.04 points (a price decline of just -0.003%) during his slumber. This investor would think the markets had done very little during 2011, but he would be very, very wrong. 2011 saw dramatic swings in prices of many asset classes during the year. Including dividends, the S&P 500 Index returned 2.11% with the entire return coming in the form of dividends. The modest full year return masked the volatility in the markets. Investors can divide the year into three segments. From the start of the year through late April, equity markets rose by approximately 9%. They then turned lower with the bulk of the declines coming during the summer months. By early October, the S&P 500 had declined 18.6% from its late April level and stood nearly 12% below where it had started the year. The fourth quarter saw a sharp snapback bringing the index to its year-end level, which was barely changed from where it started the year. However, the volatility left investors shaken and concerned.

Fixed income markets consolidated most of their year-to-date gains in the fourth quarter, with the benchmark 10-year U.S Treasury note ending the year with a yield of 1.89%, essentially where it was on September 30, but much lower than the 3.30% yield at the beginning of 2011. Fears of a wave of municipal defaults and further downgrades of state governments were unfounded as investors in almost all types of fixed income investments did very well during 2011. With concerns over European sovereign debt, the US Treasury market continues to see new buyers even at 50-year lows for yields. While fixed income performed very well during 2011, rates cannot decline at the same rate they have in the past 18 months, so the risk is skewed towards higher rates over the next two to three years. At Tandem Wealth Advisors, we believe strongly that fixed income is not the part of your portfolio with which risk should be taken and so we continue to counsel shorter-term, higher quality debt instruments to help protect against negative principal movements.

That is our look back into what happened in 2011. Looking forward to 2012, we think it will be another interesting – although hopefully more rewarding – year.

Our Outlook

When we look to Washington, it is not difficult to be disappointed in our leadership. While Wall Street used to hope for gridlock, what we have now is a malfunctioning government. Gridlock was good because the government would conduct the business it needed to – budgets, regular appropriations and the like – without too much in the way of new regulation or tax changes. This enabled businesses to plan for the future and for consumers and investors to understand the framework within they were working. This current Kabuki Theatre, which passes for Congress, cannot pass a budget, set tax policy more than a few months at a time, or agree on even the most basic of laws. When each side is more interested in destroying the other side than it is in doing the work of the people who elected them, the result is distasteful, disheartening, and worst of all – dysfunctional.

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We continue to believe there will be no U.S. recession, and though the struggles in Europe will be a drag on US growth, they will not damage the economy significantly. The European Union (EU) will continue to struggle for several years with most nations unwilling to take the strong medicine necessary to correct the imbalances. The underlying problem for the EU is the fact that they have a unified currency without a unified fiscal policy. This has led to many countries becoming uncompetitive with countries like Germany. The current disparity in the EU is best shown by the productivity differences among the 17-member countries. No matter how much the politicians may blather, one cannot mandate higher productivity. Germany is by far the most productive economy in Europe with the gap widening since the German reunification. Over the past decade, unit labor costs in Germany have risen by 20%-40% less than in the other euro countries. This has given Germany a large trade surplus within Europe while most other countries run deficits. The Deutsche Mark was quite undervalued to other European currencies when the EU was founded. When Germany locked its currency with slower growth countries like Greece, Portugal and Italy, it gave Germany a sustained competitive advantage. Ultimately, Germany will have to decide how much pain it wants to bear to revive European growth. No other European country has the financial strength to do much without Germany going along.

We point to a number of positives in the US Economy that are not getting much attention in the press. Last year, for the first time in 60 years, the US was a net exporter of fuel. There are signs of a revival in the American manufacturing base across many different industries. Housing is giving indications that it has bottomed and spending on technology continues to be robust. Ironically, the one economic indicator that is getting noticed is the one we disagree with the most – Unemployment. After 25 years of a Labor Force Participation rate between 65-67%, the rate has declined over the past three years to 64%. While a decline of 2-3% may not seem like much, it means that while the population of our country continues to grow, we have seen almost five million people leave the work force. If these people were still counted in the labor force, the true unemployment rate would be above 12%. Thus, unemployment continues to be a drag on the economy even in the face of other encouraging economic statistics. We do believe the employment picture will gradually improve. Private sector hiring has been positive for several months, but the continued headwind of net government layoffs is hampering the overall improvement in employment.

The true fundamental driver of stock prices is earnings. While we don't have fourth quarter earnings numbers yet, based on current estimates the S&P 500 should earn about $96-97 per share in 2011. This would be a record for earnings. Looking to 2012, the consensus is in the $103-107 range which would be an increase of 6-11%. While not a large increase, over 30% of this increase is expected to come from the banking sector. While this is quite possible, the twists and turns of the banks during the past five years would make this a less than certain bet. Excluding banks, earnings for the rest of the S&P 500 are expected to grow less than 5%. In fact, if we had to point to one potential disappointment for 2012, it would be that bank earnings do not rebound as expected which lowers earnings for the market as a whole.

Portfolio Positioning

Client equity portfolios have seen some modest changes in the past few months and we expect these changes to continue as we position portfolios for the slow and uneven growth we project for the US

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economy. Growth may continue below trend for another two years as companies, consumers and governments continue to deleverage their balance sheets. We do not believe this is the time to increase positions in unproven companies with weak finances on the hope that things will improve. Fixed income portfolios remain short in duration and focused on high-quality credits as they have been for most of the past two years. As we move through 2012, the Presidential election will garner more headlines and markets will begin to move based on the prospects of each party's candidate. While we should know the Republican candidate by late spring, we expect another hard-fought and close general election with markets held hostage to the vagaries of the most recent poll data.

Conclusion

While acknowledging that investors despise volatility, we believe that long-term investors cannot only survive, but benefit by taking advantage of short-term mispricing of assets due to volatility spikes. This requires the fortitude to stick with a well-planned, long-term investment discipline. During the past several years, we have seen many investors sell after a downturn only to miss the ensuing rebound because they are too anxious to commit capital after realizing a loss. Conversely, those investors that stay true to their investment discipline, rebalancing their asset allocation where necessary, will earn better returns over a full market cycle nearly every time.

Our current forecast is for forward 12-month returns in the high single-digits based on modest earnings growth, along with dividend yields of over 2%.

In closing, we at Tandem Wealth Advisors thank you for the trust you place in us. We know that finances can be not only challenging, but also the cause of significant stress and anxiety. We are here to help you navigate your financial road and encourage dialogue between us. If you have any questions or comments, please do not hesitate to contact us.

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