

Newsletter – January 2012

Fourth Quarter Market Recap

MARKET TRENDS 12/31/11

<u>US Stock Markets</u>	<u>Q4</u>	<u>2011</u>
S&P 500 Index	11.8%	2.1%
S&P MidCap 400 Index	13.0%	-1.7%
S&P SmallCap 600 Index	17.2%	1.0%
<u>Int'l Stock Markets</u>		
EAFE Index	3.3%	-12.1%
Emerging Mkts Index	4.4%	-18.4%
<u>Fixed Income</u>		
Barclays Intermediate Gov't/Credit Bond Index	0.8%	5.8%
Barclays Capital Muni Bond 3 Year Index	0.3%	3.4%
<u>Commodities</u>		
SPDR Gold Shares (NAV)	-2.9%	11.2%
Goldman Sachs Commodities	9.0%	-1.2%
<u>Real Estate</u>		
Dow Jones US Real Estate Index	13.8%	6.1%
<u>Interest Rates</u>	<u>12/31/2010</u>	<u>12/31/2011</u>
10 Year US Treasury	3.3%	1.9%
90 Day T-Bills	0.1%	0.01%

Sources: Total Returns from WSJ Market Data Group, Standard & Poor's, Barclays

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In the fourth quarter, equity markets remained volatile, but recovered with a sharp rebound from the September lows. Domestic equity performance was led by small caps (S&P Small Cap 600 Index +17.2%) followed by mid caps (S&P Mid Cap 400 Index +13%) and large caps (S&P 500 Index +11.8%). Although international equity markets produced small positive returns in the quarter, they significantly lagged U.S. equities both for the quarter and for 2011. In the quarter, fears about a “double dip” recession in the U.S. abated as economic news (retail sales, job growth, car sales, etc.) turned slightly positive. Valuations had been at recession levels – an example of market inefficiency providing an entry point for long term investors as indicated in our last newsletter. Developed international equities were weighed down by the debt crisis and recession fears in Europe. Emerging markets continued to face concerns about economic slowdown, higher inflation and aversion to “risky” assets.

During the quarter, domestic bonds (government, corporate and municipals) produced a positive return while international bonds generated negative returns. Investors continued to pour cash into bond mutual funds, over \$130 billion in 2011, even with the 10 year U.S. Treasury yield down to 1.89%. The Goldman Sachs Commodity Index was up 9% on higher oil prices but gold retreated 2.9% as recession fears subsided. The Dow Jones U.S. Real Estate Index shot up 14% led by the apartment segment.

2011 Summary

For the year, global economic headlines and political dysfunction in Washington, D.C. dominated financial markets and resulted in extreme market volatility. The Euro Zone debt crisis began in Greece but spread to Portugal, Spain, and Italy with investors fearing contagion in Europe reaching the U.S. The political upheaval in the Middle East/North Africa and the natural disasters in Japan were also major detractors from performance. Domestic markets were particularly resilient considering these global events and Standard and Poor's downgrade of U.S. debt from AAA. However, investors sold international equities and bonds.

Domestic large and small cap equities finished in positive territory while mid caps were slightly negative. International equity markets were down significantly, with developed markets -12.1% and emerging markets -18.4%. Domestic equity mutual funds continued to experience significant redemptions even with strong corporate earnings, higher dividend yields and attractive stock valuations. Domestic bonds outperformed equities in 2011 as a move from “risky” assets continued, and interest rates reached multi-decade lows. Municipals produced strong returns in spite of persistent worries about local government deficits.

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“...dividend yields exceed 10 year U.S. Treasury yields for the first time in the last 50 years.”

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Of the main investment alternatives, real estate gained 6.1%, gold was up 11.2% while the broader commodity basket was down 1.2%.

Although gold produced strong results, one has to question whether it is a true “safe haven” as speculation increased throughout the year evinced by the higher correlation with equities – gold and equities moved more in synch instead of inversely. Ultimately, equity markets reacted fairly well – little price change while earnings improved over 15%. Buying on dips worked, as did diversification, except for international holdings. Fears remain about debt laden Europe, U.S. political gridlock and our high debt load, and a possible emerging market slow down/hard landing.

Looking Ahead 2012

Stocks are attractive and we continue to focus on investing in high quality, dividend-paying stocks with attractive valuations, strong balance sheets, and the ability to generate robust cash flow. Also, we will buy attractively valued growth stocks, taking advantage of periodic market pullbacks and occasional indiscriminate selling.

Our view is supported by the following:



- **Historically Cheap Equity Valuations:** The trailing price/earnings (PE) ratio on the S&P 500 Index is trading at levels only seen twice in the last 20 years, briefly in March 2009 and in 1991. In addition, the S&P 500 Index is trading below the average PE for the market during recessions over the last 50 years. We do not think the domestic economy is heading into a recession in the near-term. This below average valuation is occurring even as companies generate

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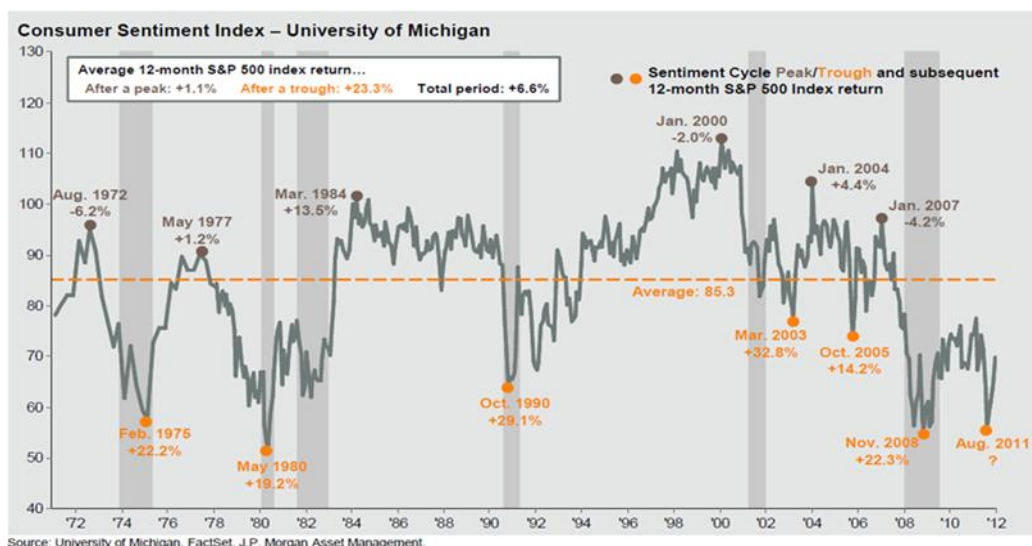
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record profits, hold record amounts of cash on their balance sheet with dividend yields exceeding 10 year U.S. Treasury yields for the first time in the last fifty years. As the fourth quarter earnings reporting season continues, companies are still generating strong growth. Even with an expected slowdown in 2012, we still expect positive earnings and dividend growth which we believe is not reflected in the equity markets.

- **Attractive Dividends:** With interest rates at multi-decade lows, dividend paying stocks provide an excellent alternative for investors. Even as the yield on stocks has increased, corporate payout ratios (percent of income/earnings) are still at very low levels on an absolute and historical basis which bodes well for future dividend growth and the initiation of dividends. Dividends can make corporations more disciplined with balance sheet cash and cushion stocks prices during market corrections. As investors focus on replacing their income in their retirement years, dividends become critical in meeting income needs.
- **Contrarian Indicators:** Investor sentiment is still negative with concerns about the high debt levels in Europe and the U.S., a possible recession in Europe, and a lack of leadership/plan in Washington D.C. Historically, equity and bond mutual fund flows have been excellent contrarian indicators. For example, huge equity purchases and bond redemptions preceded a bear market in equities and bull market in bonds. In 2008/2009, equity redemptions again preceded a huge equity rally in late 2009. With back to back years (2010 and 2011) of significant equity fund redemptions, we might be in for a sizeable equity rally!



- **More Stable U.S. Economic Environment:** US economic data has turned more constructive with positive domestic economic growth and improving retail and car sales. The manufacturing sector seems to have turned the corner and housing prices seem to have stabilized. On the jobs front, we are seeing a slow but steady growth and lower unemployment claims.

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The main risks to our positive view have not changed:

- The Euro Zone debt crisis and the possible negative impact to Europe's economies spreading to global markets and economies. These problems will continue to exacerbate global market volatility but are more of a condition than a calamity.
- The possible negative impact to economic growth in emerging markets and especially China is still a major worry. After all, we need these economies to continue to expand to drive demand for goods and services from U.S. multinationals. So far, growth has remained robust and China reported GDP recently increased by 8.9%.
- Gridlock and dysfunction continue to dominate the political discourse in Washington D.C. which is unlikely to change with the 2012 Presidential Election. However, major issues need to be addressed in 2012 such as: extension of unemployment benefits and payroll tax cuts, spending reductions, and the expiration of Bush tax cuts. Will politicians ever be pragmatic?

Conclusion

As we enter a new year, we thank you for your patience through these difficult times. We are a few years into the post-crash recovery. While it is a tepid recovery at best, this low degree makes some sense. Through debt, our country and several others have tested and explored the limitations of leverage and the accompanying foolish products and practices that supported the markets' latest mutual hallucination. In borrowing from future generations, and by bringing that prosperity into the present, we owe some repayment - and a low growth world for some time would be a lucky result.

U.S. policy makers, either through cynical planning or dysfunctional bargaining, have chosen to wait it out, to do bail-outs, to devalue our currency, to print money, and to hope for eventual demand growth. Time will tell whether this "strategy" will work, and we won't know for several years the result of this unique mish-mash of approaches. All we can tell you is that stocks are very cheap historically, and interest rates are very low.

The bear case is in full supply as evinced by investor sentiment and the media. As contrarians, we will take the other side of the argument between bulls and bears played out daily in the market place. Some day in this lifetime, rates will be high, stocks expensive and growth more ebullient. There will be talk about a new paradigm, how it is different this time. Pundits will argue why historically higher valuations of stocks are warranted. If we are worth our salt, we will be decreasing stock holdings into that rising tide in search of sound moorings. But until then, we are more optimistic about the next 3-5 years **because** so many are not.

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