QUARTERLY NEWSLETTER

January 31, 2012

Market Commentary:
After two years of extraordinary returns, the likes of which we are not likely to see again in our lifetime, global equity markets largely retreated during 2011 in favor of safety vis-à-vis the U.S dollar and bonds. Below are the cumulative pre-tax returns as of December 31, 2011 for most of the major market indices.

Benchmark	1 Year	3 Year	5 Year	10 Year
S&P 500 Index[1]	2.11%	48.59%	-1.24%	33.35%
MSCI® US Small Cap Value Index[2]	-4.04%	56.29%	-1.26%	79.79%
MSCI EAFE Index[3]	-12.14%	24.75%	-21.48%	57.78%
FTSE Developed Small Cap ex-North America[4]	-16.71%	52.50%	-19.46%	-
MSCI® US REIT Index[5]	8.69%	21.72%	-1.07%	10.21%
MSCI® Emerging Markets Index[6]	-18.42%	73.11%	12.60%	262.96%
Barclay Capital US 3-7 Year Treasury Bond Index[4]	8.24%	13.91%	-	-
Barclays Capital US TIPS Index[4]	13.40%	35.58%	48.62%	112.68%
Barclays Capital U.S. MBS Index[4]	6.23%	19.06%	38.56%	76.41%
Barclays Capital U.S. 5-10 Year Corporate Index[1]	8.03%	-	-	-
Barclays Capital U.S. Aggregate Bond Index[4]	7.84%	22.45%	38.28%	78.00%

Perhaps the most striking one-year return is that of Treasury Inflation Protected Securities (TIPS), especially given 2010 consensus. Some background: each fall leading industry analysts and asset managers meet to discuss their forecasts for the coming year. During the fall 2010 meeting virtually no one present believed inflation was a worry, thus strayed from TIPS. In retrospect this was a huge mistake on their part!

1 Source: Vanguard

2 S&P SmallCap 600/Barra Value Index through May 16, 2003; MSCI US Small Cap Value Index thereafter. Source: Vanguard

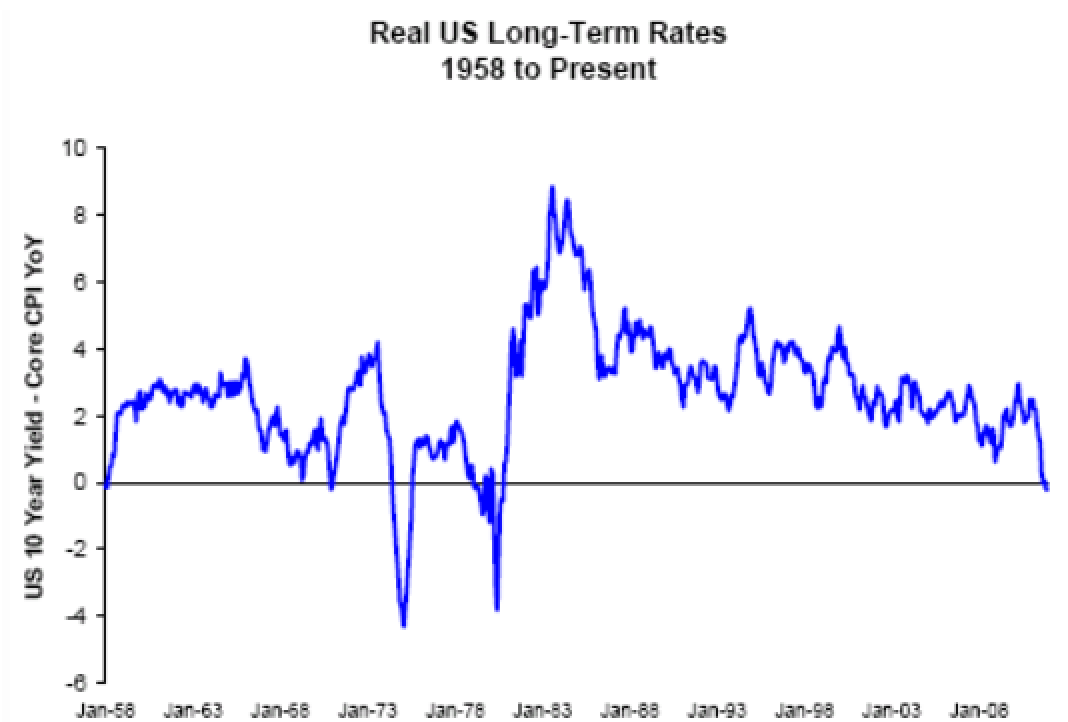
3 Tracks more than 1,000 stocks from more than 20 developed markets in Europe and the Pacific Rim. MSCI EAFE Index returns are adjusted for withholding taxes applicable to Luxembourg holding companies. Source: Vanguard

5 MSCI US REIT Index adjusted to include a 2% cash position (Lipper Money Market Average) through April 30, 2009; MSCI US REIT Index thereafter. Source: Vanguard

6 Select Emerging Markets Index, administered exclusively for Vanguard by MSCI, through August 23, 2006; MSCI Emerging Markets Index thereafter. Index returns are adjusted for withholding taxes applicable to Luxembourg holding companies. Source: Vanguard

If you've worked with me for any amount of time you will know that I do not attempt to time the market. Did I know that TIPS would be a great performer during 2011? ABSOLUTELY NOT. What I did (and do) know is that inflation is a very real risk over the long term and the spread between Treasuries and TIPS with similar duration was less than the historic inflation rate (you'll recall that this spread is indicative of the market's inflation expectation plus a bit of an "insurance" premium). I also know that the time to purchase insurance is *before* the negative event, not after it since by the time it occurs it's too late to act. The resulting advice was to include TIPS within portfolios during 2011 even though this advice ran counter to industry consensus.

Bonds going forward
Looking forward, however, results are not likely to be as good. As the graph below indicates the current yield on 10-year US Treasuries minus Core Inflation equals zero. The good news is that current interest rates would seem to maintain the purchasing power of these investments, at least in the short run. Further, the current nominal interest rate yield of 10-year TIPS is negative, but when compared to their Treasury counterparts the interest rate spread is still less than historic average rate of inflation (recall that TIPS earn not only interest, but also an inflation "kicker").



Source: Bloomberg, 12/31/2011

What does all this mean? I do not know what future inflation will be, but I do know inflation is perhaps the worst enemy facing the long term investor, thus investors should develop an investment policy to deal with that very real threat. I also know that inflation worries, when they do arise, tend to cause a rapid rise in the interest rates that bond investors demand. This is especially true for long-term bonds.

You will recall that changes in prevailing interest rates magnify changes in a bond's valuation as its duration increases. This valuation sensitivity to changes in prevailing interest rates is approximately reflected by the equation:

$$- (D - (I \times 100)) \times IC \approx Loss$$

Where: D=duration; I=interest rate; IC=interest rate change; and Loss=% loss in value

For example, let's take two hypothetical bonds of the same general qualities, but with differing durations. The first is a 10-year Treasury with a yield of 2%, and the second is a 2-year Treasury with a yield of .5%. The unsophisticated investor may opt for the higher yielding 10-year bond. This might be a big mistake. Why? Let's run through the math.

Assuming the future rates on both bonds increase by 1%, then:

10-year Treasury: $-(10 - (.02 \times 100)) \times 1\% \approx 8\%$ loss

2-year Treasury: $-(2 - (.005 \times 100)) \times 1\% \approx 1.5\%$ loss

Yield curves largely aside, this elementary analysis depicts the risk of holding longer term bonds (especially during periods of historically low interest rates when there does not appear to be much room for rates to decrease further). That is, the longer term a bond's duration, the more sensitive its value is to changes in prevailing interest rates. Further, the chart on the first page shows that real interest rates have rarely and only briefly dropped below zero, but when they have rapid and unexpected increases in real interest rates have followed. Individual investors holding long duration bonds during those periods would have suffered steep losses in the valuation of their bond holdings. Similar events in the future would yield the same result. Such an event would seem highly probable within the next few years.

Bond investors should be aware of these risks, and then modify their investment policy to deal with them. DO NOT CHASE YIELDS! Though higher monthly interest payments may appear attractive in the near term, the downside principal risk over longer periods of time can easily outweigh higher initial interest payments. In sum, investors should pay mind to not only the credit quality of their bond holdings, but also duration, especially in times when real interest rates are near or below zero.

In Brief: Equity Markets

Equity markets, in general, had disappointing returns during 2011. Given the extraordinarily positive returns of 2009 & 2010, as well as uncertainty abroad this recent poor performance is understandable and certainly not out of the ordinary.

Though we have witnessed relatively good performance thus far during 2012 (especially in foreign equity markets), currency concerns, government deficits, and fundamental valuations should hamper expectations going forward. That is, on a fundamental basis domestic valuations are trading in-line historic averages; and while foreign equity valuations are trading below historic fundamental averages concerns surrounding currency risk, governmental fiscal policy, and potential international contagion remain.

These concerns should not tempt us to stray from a well thought out investment policy, however. As John F. Kennedy said during a 1959 speech in Indianapolis:

> *"When written in Chinese the word 'crisis' is composed of two characters: One represents danger, and the other represents opportunity."*

This applies to investing as well. Though "buying low" may sound like an easy concept, the fact is that buying low generally means buying when things seem at their worst. Out of fear, most investors fail to actually do so.

In Closing

It's important to stay focused on long term results. Historically, 1 in 3 years have provided negative stock returns, and we have just experienced such a year. Intelligent and disciplined investors recognize that higher volatility (i.e., risk) explains why stocks have outperformed bonds over long periods of time, and periodic rebalancing seeks to take advantage of relative strength and weakness in the marketplace as well as maintain the anticipated risk/return profile of an investor's portfolio consistent with their risk tolerance and time horizon.

Remember: *Diversify according to a well thought out and documented investment policy, and then remained disciplined. You will be rewarded.*

If you need assistance developing an investment program and identifying appropriate investment vehicles, then seek the assistance of a fee-only NAPFA registered financial advisor who is also a CERTIFIED FINANCIAL PLANNER™ professional having the proper education and experience.

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Troy Sapp, CFP®
Commencement Financial Planning LLC