

January 10, 2012

Dear Valued Clients & Friends,

Looking Back – Moving Forward

The turning of the calendar to January marks a time when as investors we reflect on the year just past, get our bearings as to where we stand, remind ourselves about valuable lessons drawn from the past, resolve once again to refrain from making the same mistakes, and reinforce the eternal truths for what works and what doesn't in managing a portfolio.

Stock market investors experienced a wild ride during 2011. The widely-watched Dow bounced and bobbed around both sides of the 12,000 level, closing out the year at 12,217. For all the volatility, the major U.S. indexes ended the year very close to where they started, with the blue chip Dow up 5.5%, the large cap S&P 500 virtually flat, down a scant -0.003%, and the tech-heavy Nasdaq off -1.88%. Taking increasingly important dividends into account, the total return for the Dow was up 8.38% and the S&P 2.11%. After a robust 2010, when the small cap Russell 2000 Index led the way by rising 24.5%, small caps trailed large caps in 2011, losing -4.18%. International stocks dragged down the overall stock market performance in 2011, with the International Fund Index shedding -14.48% in a tough year.

Looking casually at these 2011 results, it is important to realize that over the past decade international, emerging market and small caps performed much better than did U.S. large cap stocks. This makes the case for broad-based diversification spread over all areas of the market. Asset classes go in and out of favor and, just as in baseball, you want to be sure to cover all the bases. In this way, you benefit by those investment categories that shine and prop up your portfolio. For example, small caps rose in 2010 (+24.5%), emerging markets in 2009 (+79%), aggregate bond index in 2008 (+5.93%), and international stocks in 2007 (+11.17%), 2006 (+26.34%), and 2005 (+13.54%).

Beware of Expert Opinions

An annual investment outlook pronouncement is no better than an educated guess. One case in point: if there was a sure-thing prediction at the start of 2011, it was that interest rates would surely rise, so disdain the bond market and treasuries. Against all expectations, bonds were the surprise clear winners in 2011. The benchmark 10-year U.S. Treasury bond, despite a U.S. credit rating downgrade, provided a return of 17% as yields, which go in the opposite direction of prices, unexpectedly fell below 2%. Putting a name to this bad call, well-respected bond king Bill Gross now admits to missing out on the biggest bond rally in nine years.

Burton Malkiel, retired academic, economist and author of the investment classic *A Random Walk Down Wall Street*, wrote a timely opinion piece in the *Wall Street Journal*, "Where to Put Your Money in 2012". In it, Malkiel readily admits it is virtually impossible to make accurate short-term predictions of asset returns, offering the notorious bad call on bonds for 2011 as exhibit A. However, he does believe it is possible to make reasonable

long-term forecasts.

Although bonds bested stocks in 2011, he cautions – and we concur, to not invest using a rear-view mirror. He finds stocks more attractive today. “U.S. stocks should produce returns of about 7% going forward, five points higher than the yield on safe bonds.” He goes on, “Moreover, price-earnings multiples in the low double digits, based on my estimate of the earning power of U.S. corporations, are unusually attractive today.”

Emerging stock markets, despite their generally favorable economic performance and future outlook, were the worst performers in 2011. He believes China will continue to grow rapidly and that a meltdown of the Chinese economy is highly unlikely. In Burton Malkiel’s considered opinion, “Emerging markets offer the best prospects for both equity and bond returns over the next 10 years.”

In yet another example of a presumed expert making an alarming and, in retrospect, wrong call in 2011 was high-profile analyst Meredith Whitney. She rocked the municipal bond market early in the year by predicting massive municipal defaults, which would devastate that corner of the market for tax-exempt bonds. Muni-bonds ended the year with the index up 10.7%. Her panic prediction of a wave of defaults did not come to pass.

Hedge fund manager John Paulson made a superb call and a tremendous fortune when he accurately foresaw the housing bubble and subsequent financial collapse in 2007 and 2008. He attracted a ton of attention and billions of dollars to manage from investors anxious to benefit from his rare genius. Speaking of 2011, the Wall Street Journal observed, “It was a year that made the smart money look dumb.” How true, as Paulson’s fund was among the biggest losers, tumbling nearly 50% on bad bets on financial stocks and gold mining companies.

Diversify, Diversify, Diversify

As stated earlier, the S&P 500 ended 2011 even for the tumultuous year. Despite this index ending where it started, there were almost an equal number of individual stocks that performed admirably by returning in the double digits. Conversely, there were other names that tanked.

The following is a sampling of a dozen representative stocks, six stalwarts and six clunkers, in terms of 2011 performance. If your holdings were concentrated too heavily in the losers, you badly underperformed. If you were prudently diversified, such as in a stock mutual fund that by design has scores of holdings, the winners and losers for the most part evened out. If your stock portfolio pretty much managed to hold its own in 2011, for the most part protecting the gains of 2009 and 2010, you are in a position to at least enter 2012 standing.

A Sampling of 2011 Winners and Losers

Bank of America: -58%

Citigroup: -44%

Hewlett-Packard: -39%

Ford Motor: -36%

Johnson Controls: -18%

Best Buy: -32%

IBM: +25%

McDonalds: +30%

Pfizer: +23%

Apple: +25%

Home Depot: +20%

Starbucks: +43%

We can look at the sad story of M&I bank stock for a prime example close to home of the perils of what is referred to as single-issue risk. Until late in 2007, M&I stock was generally viewed as a high quality growth stock. It paid a nice dividend and was even considered a so-called conservative investment holding. For thousands in the Milwaukee area, with M&I a home-grown success story, its stock constituted a major holding

in their portfolios. This did not necessarily alarm these unsuspecting investors, who generally did not see or comprehend the inherent risk this concentration imposed.

M&I's downward spiral started in 2007 with the subprime market meltdown. M&I's speculative loans made to developers in faraway Arizona and Florida suddenly turned bad. The result was an unraveling of the bank's financial condition, a string of quarterly losses, a plunging stock share price, the dividend cut to nil and, finally, a bank bailout. All this led to M&I, the largest Wisconsin bank, being rescued in a sale to a Canadian bank. The steep losses of recent years for M&I shareholders left undiversified investors with badly shattered portfolios.

Not diversifying when investing, be it in M&I stock, Kodak, General Motors, Enron or Harnischfeger, for example, amounts to speculating. This is simply a form of gambling. The best you can do is to always adhere to the oft-pronounced risk-reduction technique: diversify, diversify, diversify. A useful rule of thumb to mitigate risk has been to ensure no individual stock (single issue) accounts for more than 10% of your total portfolio. More recently, in the wake of so many blow-ups, the recommended percentage has been reduced by 50% to just 5% of your total portfolio to protect against big hits.

All That Glitters Is Not Gold

It is a cautionary tale to recall that as recently as last August gold was all the rage, having soared to a record \$1,888 an ounce. Radio ads inundated the airwaves promoting gold as the ultimate safe-haven asset, preying on the emotions of fear and greed and breathlessly implying you needed to buy gold. The strong implication was you must act now, as gold was certain to continue its run to \$2,000 an ounce and beyond. It is ironic that the absolute best time to promote and market a given investment is usually the worst time to buy. Think of Arizona, Florida and Nevada real estate in 2007, or high-flying tech stocks in early 2000, right before these once torrid, can't miss investments crashed and burned.

As is turned out, gold suddenly lost its luster and finished the year at \$1,565, down \$325 (-17%) from its 8/8/11 high. In truth, this precious metal was up a solid 10% for the full calendar year. But many fickle investors who chased this hot performer did not jump in until gold was at or near its historic peak. It was yet another case of buying high and regretting it.

During the same late summer stretch, when gold was garnering investors' interest, stocks were plummeting, off almost 20% from their highs for the year set back in April. The prospects for stocks were dismal, and many investors thought seriously of bailing out of the topsy-turvy market all together. More than a few did just that, and were easily persuaded to put their money into gold, congratulating themselves it was a prudent and wise move.

This turned out to be a big mistake, as this rush to gold and fleeing of U.S. stocks was a classic case of buying gold high and selling stocks low. Rather than repairing or improving one's fortunes, these moves inflicted a big-time hurt. Against the sentiment and expectations of the thundering herd, the performance of gold and U.S. stocks suddenly and dramatically reversed course. Gold abruptly fell back and stocks sharply rebounded in October.

Something to keep in mind is that many stocks earn a portion of their total return in the form of a dividend. Gold, on the other hand, can only win if it goes up in value, as there is no other form of return.

Keep Hope Alive

To be a successful long-term investor requires allocating a significant percentage of your portfolio to stocks. To do so requires a confident view of the future, not the gloom and doom that is so prevalent today. What is called for is adopting a psychologically healthy mindset. Hope is an essential attribute to conquer the many negative forces encountered while investing in the uncertainty of the stock market.

Joe Queenan, a regular Wall Street Journal columnist, penned an interesting take by resolving, "In 2012, I'm Getting My Hopes Up." He hammered home his point that during the whole of 2011 any good news, be it on the economy, employment, housing, the stock market or Europe, elicited a quick rejoinder: "But don't get your hopes up."

From his Moving Targets column, "I for one am tired of being told not to get my hopes up every time it looks like there is something to get my hopes up about. Just once I would like to see a report reading: Housing stocks grew at their fastest pace in five years. That's it. No caveats."

Queenan claims not to be a Pollyanna, nor to view real world challenges like the European debt crises through rose-colored glasses. Rather, he contends the currently in-vogue practice of constantly hedging one's bets, giving weight to the worst possible outcome, is not the American way. He queries, "Imagine what would have happened if previous generations of Americans spent all their time worrying about those gathering storm clouds instead of keeping their eyes peeled for the silver lining?" Rather than dwell on the negatives for the year ahead he is planning on keeping his hopes up and looking at the bright side.

As for your Anxiety Removal Team® , we have long suggested that when it comes to the investment world, you view the glass as half full rather than half empty. This year is no exception.

Please accept our best wishes for a prosperous year ahead for you and yours. May 2012 bring you an abundance of good health and happiness.

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