

Market Review

Global Equities

The global equity market had its best quarter in the 4th quarter, with the **MSCI All-Country World Index** (ACWI) rising more than 7%. That was not enough to overcome the 17.4% decline in the 3rd quarter, however, and so ended the year down 7.35%. The US Market fared better than the international markets, with the **Russell 3000 Index** finishing the year up 1.3%, attributable all to dividends. The International markets were hit with the perfect storm of natural disasters, debt crises, slowing economies, and a strengthening dollar, resulting in a 13.75% decline in the **MSCI ACWI ex US Index**.

US Equities

In a complete reversal of last year, large company stocks significantly outperformed small company stocks. The **Russell 1000** finished the year up 1.5% versus the **Russell 2000**'s 4.18% loss. This 'quality bias' was most evident in the performance of the largest of the large, the **Russell Top 200**, up 2.8%.

Growth Stocks outperformed Value stocks in 2011. The **Russell 3000 Growth Index** rose 2.18% versus the **Russell 3000 Value**'s decline of -0.10%. This was mainly due to the more than 20% weighting to Financials in the Value Index, the second worst sector in 2011, declining more than 12.8%. Basic Materials were the worst performers, but the fact that they are present in both indexes, with relatively small weighting, means they largely offset. Utility stocks, a traditionally defensive sector, were the best performer last year by a considerable margin, rising more than 19%. This emphasis on the defensive was also seen in the performance of dividend paying stocks, which far outstripped the broad market. The **Dow Jones Select Dividend Index** surged more than 12.6% in the 4th Quarter, finishing the year up 12.4%.

International Equities

The International Equity Markets experienced significant declines exacerbated by a strengthening US Dollar. The developed markets outperformed the emerging market, **the MSCI World Index** declining 12.2% versus the **MSCI Emerging Market Index**'s 18.4%. Much of this difference was attributable to currency, however, with local currency returns coming in a -11.99% and -12.74% respectively.

Within the developed markets, it should be no surprise that the European Monetary Union (EMU) countries were among the worst performers, down 17.6%. It may be surprising, however, that broader Europe was the best regional performer, declining 11.06% versus **MSCI Pacific**'s 13.74% and **MSCI Canada**'s 14.36% loss. **MSCI Japan** was the worst performer in local terms, down more than 20.5%, but the dollar declined versus the Yen, which added more than 4.3% to the return for US based investors.

The emerging markets were hit hard by currency in 2011, with more than 30% of the loss attributable to currency losses. The worst regional performer, contrary to the developed markets, was **MSCI EM**

Europe, declining more than 23.6%. **MSCI EM Asia** was the best performer, declining 17.4%. **MSCI EM Latin America** was the best performer in local currency, down just slightly over 10%, but currency almost doubled the loss to 19.35% for US investors.

The closely watched BRIC countries lost more than 22.8% for the year, led down by India, which lost almost 38%. India was also the worst performer in local terms, down more than 26.3%. China notched up the best return, declining just over 23.3%, but this was solely due to currency, as Russia and Brazil both posted better local currency returns.

Real Estate

Global REIT Markets outperformed the equity markets with the **Dow Jones Global Select REIT Index** gaining 2.8% for the year. US REITs were responsible for the gain, with the **DJ US REIT Index** rising more than 9.3% versus **DJ Global ex-US Select REIT Index**'s 7.6% decline. Every region of the international REIT market declined, led by Japanese REITs, down more than 20.5%.

Self Storage REITs posted the largest gain, rising more than 33% for the year, distantly followed by Healthcare REITs, up more than 16%. Hotel REITs led the decliners, down 14.8%.

Commodities

The general 'flight to quality' was also evident in the commodities markets. Precious Metals were the only sub index to post a positive gain, up more than 4.5%, driven by a 10.7% gain in the interbank price of gold. This was not enough, however, to overcome steep losses in Energy, down 16%, and Industrial Metals, down 24%, resulting in a 13.3% loss in the **DJ-UBS Commodity Index TR**. A persistent contango in the commodities market, where longer dated futures are priced at a premium to shorter dated, magnified the loss for investors, with the **DJ-UBS Commodity Spot Index**, which tracks the performance of the underlying physical assets rather than the futures, declining only 8.12%.

Fixed Income

Global Fixed Income posted another strong year, with the **Barclay's Capital Global Aggregate Bond Index** gaining more than 5.6%, mostly on the strength of a 7.8% showing by the **Barcap US Aggregate Bond Index**. The international bond market, despite the ongoing debt crisis in Europe, outperformed most sectors of the Equity markets, the **BofA Merrill Lynch Global Bond Market ex US Index** gaining 4.6%.

High Grade US Fixed Income

After rising early in the year, interest rates reversed themselves, dropping to levels that haven't been seen since the 1940s. By the end of the year yields on Treasuries were below that of the CPI Inflation rate, as reported by the BLS. As one investment professional put it, investors are now paying the government for use of its mattress. This drop in yields propelled Long-Term Treasuries to almost a 30% return for the year, as measured by the **BarCap Long-Term Treasury Index**, but one has to continue to

ask how long investors will accept such low yields, and how quickly these gains will be reversed if confidence returns.

Of course investors have been asking themselves that very question for several years now, and yields keep falling. Those who acted to aggressively on this premise, including some of the most well-known professional investors, cost themselves dearly in 2011, proving John Maynard Keynes' maxim, "The markets can remain irrational longer than you can remain solvent."

High Grade Corporate Bonds also fared well last year, up more than 7.5% as measured by the **BofA Merrill Lynch US Corporate Master Index**. This was in spite of the spread, the amount they pay over comparable Treasuries, widening by 91 basis points (0.91%).

Mortgage-Backed Securities were among the worst performers in the broad US investment grade market. Yet the 6.23% return on the **BarCap Mortgage Backed Index** still was well ahead of most of the 'risk' categories.

High Yield US Fixed Income

With threat of rising rates diminishing, investors in floating rate bank loans focused more on credit risk resulting in sub-par performance relative to other fixed income categories. The **Credit Suisse Leveraged Loan Index** rose 1.52% for the year, thanks to a strong 4th quarter rally of 2.9% after the dismal 3rd quarter loss of more than 3.75%.

High Yield Bonds also posted returns well behind the last 2 years, the **BofA Merrill Lynch High Yield Master II Index** posting a 4.38% return for the year, again saved by a strong 4th quarter performance of 6.2%. Again, investor's aversion to risk was shown by the widening of the spread from 5.4% to 7%.

Municipal Bonds

'The municipal bond market posted one of its best years ever in term of total return' according to Breckinridge Capital Advisors, one of our municipal bond managers out of Boston. The **S&P National AMT-Free Municipal Bond Index** finished the year up an astounding 11.22%. This was despite the predictions by one well-known market analyst of 'billions of dollars of municipal defaults.' Instead the 44 new defaults last year were less than half of what was seen in the 2 previous years. Her prediction nevertheless spooked the market, resulting in 29 consecutive weeks of outflows from municipal bond mutual funds in the first half of the year. The market proved resilient, however, and municipal rates ended 2011 significantly lower than where they started the year. The largest declines in yields were seen in the middle of the curve with the 10 year AAA Muni yield dropping 1.33% over the course of the year. The reason for the drop, according to Belle Haven Investments, another of our bond managers out of White Plains, NY, was '...twofold. First, extremely low yields at the front-end of the curve did little to entice investors to lower short-term yields further [by buying more]....Secondly, investors are still somewhat reluctant to wholeheartedly commit to the long-end of the curve.'

International High Grade Fixed Income

International government debt significantly underperformed US Treasuries, but still outperformed most risk assets. The **BofA Merrill Lynch Global Government Bond II ex US Index** gained 5.5% for the year, after losing 0.29% in the 4th Quarter. Currency added an almost 1% boost to the index for the year. Like we saw in other markets, the end results mask a fair amount of volatility for the year. The index had risen as high as 10.2% through August, only to give virtually all the gain back in the next 3 months, followed by a December rally of more than 2%.

Non-Sovereign International bonds fared far worse than their counterparts, either International Government or US non-government, with the **BofA Merrill Lynch Non-Sovereign ex US Index** posting just 2.79% for the year on the strength of a 1% rally in the 4th quarter. Currency was a detractor, costing US Investors more than 1.5%.

Global Emerging Market debt also had a slightly disappointing year, relative to broad developed and US markets. The **BofA Merrill Lynch Global Emerging Markets Sovereign & Corporate Index** posted a 3.47% return for the year after a strong 4th quarter rally of more than 4.5%. Currency was only a slight detractor for the year, costing US Investors roughly 0.5%. Dollar denominated Emerging Market debt fared much better as the **BofA Merrill Lynch USD Emerging Market Sovereign & Corporate Index** outperformed the broader index by more than 2.4%, closing the year up 5.89%.

High Yield International

International High Yield Bonds fared much worse than their US counterparts, falling more than 5% as measure by the **BofA Merrill Lynch Global High Yield and Emerging Markets ex US Index**. The market began the year strong, climbing more than 15% through May, only to fall more than 19% through the beginning of October. A brief October rally, which brought the index up to a 5.7% year-to-date return, gave way to a 10% slide through the end of the year.