SARGENT BICKHAM LAGUDIS

APRIL 2012

Market Commentary and Review

by Brad Bickham, CFA, CFP®

SUMMARY:

Stocks have had a very strong move over the last 6 months. The first quarter saw the best return in the S&P 500 since 1998.

In the last 66 years there have been 17 times where each of the first three months had positive S&P 500 returns. The average yearly return for those 17 years was 20.2%.

European debt risks flared up again in April. This problem is going to be with us for a while, but should be reduced to a chronic ailment rather than an imminent crisis.

A presidential election year and a number of changes to tax and fiscal policy means more distraction from Washington.

In This Letter

"The only problem with planning for the end of the world is that it only happens once."

Dear Clients and Friends,

They say that with age comes wisdom. Whether or not that is true, it definitely comes with experience. 2012 marks my 30th year in the investment management business. In 1982 Ronald Reagan was President and Paul Volcker was Chairman of the Federal Reserve. Unemployment was rising - on its way to over 10%, and the budget deficit was soaring. Reagan's approval ratings plummeted and the Democrats swept the mid-term elections.

Inflation was high and Fed Funds, the rate that determines everything from money market rates to mortgages reached a peak of 20%. Over 100 banks failed between 1982 and 1983, the most since the Great Depression. I stood in line to receive a check from the FDIC for the company I worked for in July 1982 due to the failure of Penn Square Bank in Oklahoma City. That failure led to the collapse of Continental Illinois of Chicago, then the fourth largest bank in the United States. Today that would be equivalent to Wells Fargo going bankrupt.

Five years later, in 1987 the stock market fell over 25% in the course of a few days. The Dow reached an all time high of about 2,700 and closed the year at about 1,900. Nothing like that had happened since 1929. Unemployment was still over 7%.

Returns as of March 31, 2012	1st Qtr 2012	Last 3 Yrs. Cumulative	Last 10 Yrs. Cumulative
Large Cap U.S. Stocks	12.6%	88%	50%
Mid Cap U.S. Stocks	13.5%	103%	84%
Small Cap U.S. Stocks	12.1%	104%	87%
Nasdaq 100	20.9%	128%	96%
Foreign Stocks - Developed	10.9%	59%	81%
Foreign Stocks - Emerging	14.1%	82%	286%
U.S. Bonds – Taxable	0.3%	20%	76%
U.S. Bonds – Tax-Free Municipals	1.8%	22%	68%
REITs	10.7%	176%	134%
High Yield Bonds	5.3%	83%	142%
Commodities	1.2%	38%	71%
Hedge Fund Index	2.8%	32%	93%
Gold	6.7%	80%	451%
60/40 Balanced Index	7.7%	62%	72%

Two years later, in 1989, at the height of the Savings and Loan crisis (remember those?) there were 534 bank failures. By comparison, in the recent financial crisis there were 'only' 305 from 2009 – 2010.

In 1997 an emerging markets crisis began in Thailand. This spilled over to Malaysia, then the Philippines, and Hong Kong. In October of 1997, the Dow lost 554 points for its biggest point loss ever. Trading on the U.S. stock markets was suspended. The International Monetary Fund bailed out Indonesia. Several banks and brokerage firms in Japan went bankrupt.

Russia's financial system was stretched to the breaking point as panic stricken stock and bond markets plunged, forcing the central bank to raise interest rates to 150%. In 1998, Russia defaulted on their debt. A little known (outside of Wall Street) hedge fund called Long Term Capital Management, received a $3.5 billion bailout from a consortium of U.S. banks as fear spread it could put the entire banking system at risk. It eventually failed anyway.

By 1999 the Nasdaq reached 5,048. Over the coming year stocks such as Cisco would decline 86%. Amazon fell from 107 to 7. The dot-com bubble busted and led to a recession. The 3 year market decline from March 2000 to October 2002 wiped out $5 trillion of market value. Half of the dot-com companies failed. Thirteen years later at 3,047 it remains 36% lower.

Next was the housing bubble and financial crisis of 2008 highlighted by the collapse of Lehman Brothers, an investment bank dating back to the Civil War; and the Madoff fraud case – the largest Ponzi scheme of all time.

And these are just the highlights. Over this period the Dow increased from about 1,000 to the 13,000 it is today. A 1,300% increase. Granted, the last 10 years have not been so good. In fact, two of the four worst market declines have happened in the last decade. For a myriad of reasons, I believe this has a lot to do with the extraordinary returns during the 1980s and 1990s. But the world didn't end, it evolved. So I think it's foolhardy to spend too much time planning for a collapse of our economic and monetary system.

Nevertheless, we are concerned about the risks primarily emanating from Europe. Monetary schemes do change periodically. After all, the Euro only came into existence as a physical currency 10 years ago. If it collapses, there will be significant economic and market gyrations throughout the world.

There are possible changes the European countries could adopt that might be less dire than completely disregarding the Euro. For example, they might re-introduce local currencies and still keep the Euro as an accepted currency. This might allow certain countries to devalue their currencies, print more money, and make their economies more competitive. Any major change such as this would be disruptive, but it would be temporary. After an adjustment period, economies and markets would stabilize around the new system.

Recent Events

The world continues to gradually recover from the financial and economic crisis of 2008. The rolling crisis has been centered in Europe for the last two years. After almost two years of negotiations, treaties, posturing, obfuscating, and lying, Greece finally restructured their debt and even defaulted on some of their bonds. The market's reaction was a yawn. Why? By the time it finally happened, the negotiations had minimized the current damage and the markets had time to adjust to the new information. It is surprise and uncertainty that sends the market into convulsions. The first Greek shock came in 2010, then again in the summer of 2011, and the default/restructuring was early this year. The markets powered right through because it had become old news and was priced into the market.

So I guess you could say that kicking the can down the road worked. The Europeans kept pushing the day of reckoning into the future. Markets adjusted.

That is likely to continue to be the modus operandi for governments everywhere around the world. Politicians are good at avoiding difficult decisions. While this is morally reprehensible, it is economically logical. What they hope for is to give the economy enough time to grow, and thereby make the debt problem easier to deal with.

The least painless way to reduce your debt is to grow your way out of it. Think of it this way. If you have $12 trillion of debt and your economy is $15 trillion (think United States), then your debt to GDP ratio is 80%. If you could limit your debt increase to 1% per year and grow your economy at 3% per year, then in 10 years your debt will be about $13 trillion and your GDP will be about $20 trillion - a ratio of 65%. Add in a little inflation and it gets even easier. For example, if you have 3% real growth and 3% inflation then your nominal GDP growth is 6% per year. In the example above, GDP will grow to $24 trillion. The debt/GDP ratio would be only 54%. A critical assumption in this example is that debt is kept to a growth rate of 1% per year.

It is easy to blame the politicians for not making the hard choices and obfuscating the truth. However, as Jack Nicholson said to Tom Cruise, *"You Can't Handle the Truth!"*. People are not willing to give up anything. They want their social security checks, their Medicare, an armed forces that polices the world and spends billions of dollars in the Middle East and elsewhere. But, we are not willing to pay taxes for these things. According to the Congressional Budget Office, federal taxes are at 14.8% of GDP, the lowest level in over 60 years. The average is 18.2%. Spending is just as bad, or worse depending on your perspective. Since 1950, Federal outlays have averaged 16.9% of GDP. Today, they are 21%.

There were good reasons behind both the Bush tax cuts and increased Federal spending, so do not get too influenced by the political rhetoric from either side. When the government taxes people, they take money out of the economy. When the government spends money, they add money into the economy. Economists and politicians like to argue about the efficiency and effect of each, but they are dishonest if they don't admit these basic facts. So both these programs were economically stimulative, but they were paid for by borrowing – by increasing the debt; and it is time to start paying it back. But, if the government stimulus is reduced too quickly we risk derailing a fragile recovery.

Europe has received the payback notice first. The markets have lost confidence and that can make a liquidity crisis become a solvency crisis. European policymakers have to continue to make progress toward reducing deficits, meeting fiscal targets, and implementing backstops through the IMF and other means. It's difficult work. Spain has a 24% unemployment rate and a shortage of capital in their banks. They probably do not need an imminent bailout, but they are living on borrowed time. The markets are nervous. There is likely to be increased market volatility in the coming weeks. This could come to the U.S. too. We are not immune from market forces. We just happen to have the best house on a bad block.

China is now the second largest economy in the world, and it has slowed from its blistering pace over the last decade. GDP growth has ranged from 8.3% to 14.2% for the last 10 years. Going forward growth expectations are for 7% to 8% growth. According to Matthews Asia, a company that specializes in managing Asian mutual funds, a relatively slow pace of growth may help China over the long-run as it can provide an opportunity for the country to rebalance itself economically. Over the past decade, the lion's share of China's growth has come from fixed asset investment—namely the construction of such things as factories, real estate, roads, airports, railways and bridges. As a result, fixed asset investment as a percentage of China's GDP surged from 34% in 2000 to 46% in 2010. Meanwhile consumption as a percentage of GDP declined from 62% to 47%. While infrastructure development will continue to play an important role, the rapid expansion of fixed assets is not sustainable over the long term.

In the past, China has benefited from a steadily growing labor force, and its quick economic expansion helped to absorb this surge in its workforce. However, China's one-child policy has lessened this pool of workers. At the current pace, the growth in China's labor force is expected to level off and start shrinking by 2017. Chinese companies already commonly face both labor shortages and wage inflation, and government priorities have also shifted from creating jobs to raising living standards.

China's new plan includes strengthening its social safety net with better education, health care and social security. In the meantime, minimum wages are expected to increase by at least 13% each year. While spending on the social safety net may not generate immediate payoffs compared to investments in infrastructure, a strong social welfare system combined with higher wages should eventually lead to higher domestic consumption, and help cultivate a sustainable economy. This may be good news for the environment as well. China's rapid economic development and construction have turned it into the world's largest energy consumer as well as the largest polluter. A slowdown in growth may help China in its efforts to develop new technologies, bolster energy conservation and nurture environmental protection.

Another surprising result we have discovered is that investment returns from emerging markets is not as correlated with economic growth as one might think. It turns out that returns are more correlated with monetary policy than GDP growth. Over the last year or so, China has been restricting monetary policy due to rising inflation. Their stock market fell 16.8% last year vs. our market being up about 2% (using the ETFs GXC and SPY as indicators). It is believed by some analysts that China is now prepared to be more accommodative, which could presage better performance in the future.

The Pillars

Let us revisit the principles we use to help us allocate capital in our portfolios.

The Economy: Growing: 2% - 2.5% this year in the U.S.; Global growth is 3% - 3.5%.

Earnings growth: Growing, but at a slower pace. Note, we surpassed the pre-recession earnings peak of $83.77 for S&P500 companies two years ago and are expected to be 25% higher in earnings this year ($104.89), yet the market is still 13% lower in price than in 2007.

Year	Operating	Change
2007	82.54	-6%
2008	49.51	-40%
2009	56.86	+15%
2010	83.77	+47%
2011	96.44	+15%
2012	104.89	+9%

Interest Rates: No change. Rates will remain low through 2012.

Valuation: Attractive. Current P/E is 13x – 14x. Well below historical average.

Financial Stress: Elevated. Lower than last fall, but still higher due to European concerns.

Political Policies: Neutral but worsening. Nothing of substance is going to happen before the November elections. However, many tax rates are scheduled to rise in 2013 and budget cuts are also scheduled (more on this later). This concern will rise as the year goes along. Plus, the election rhetoric is likely to be negative and distracting.

Being raised in Oklahoma, I was often presented with the wit and wisdom of Will Rogers. There is something about cowboys and the west that captures the imagination, and their simple old fashioned values could do a lot more than thousands of pages of regulations from the government. A few years ago, I came across an article by Baxter Black, a cowboy poet that listed the following:

Cowboy Ethics – What Wall Street & Washington Could Learn from the Code of the West:

1. ***Live each day with courage.***
2. ***Take pride in your work.***
3. ***Always finish what you start***
4. ***Do what has to be done.***
5. ***Be tough, but be fair.***
6. ***When you must make a promise, keep it.***
7. ***Ride for the brand.***
8. ***Talk less, say more.***
9. ***Remember that some things aren't for sale.***
10. ***Know where to draw the line.***

Strategy & Analysis

By Kreighton Bieger, CFA

U.S. Stocks: Between last August and this spring, we observed dramatic swings in returns and volatility, with the month of September 2011 capping the worst third quarter for stocks since 1928. Over that time, in addition to a downgrade of the U.S. debt rating, we experienced a steep selloff in equities around the globe, a stampede into the relative safety of U.S. Treasury bonds, and then a complete reversal of both of those things! I note that the safety of Treasury bonds is "relative", because the most forgiving assumptions about inflation put it at just over 2%, and many argue that it is in fact a good bit higher. Parking money in U.S. Treasury bonds yielding 2% or less is, as Bill Walker might say, "a lead pipe cinch" that you will lose money in real terms over time.

We have observed for some time that U.S. equities were cheap relative to their historical valuations, and that despite European debt crisis fears, the profit growth and prospects were better than the market was anticipating. In the fourth and first quarters we put cash back to work in U.S. large cap stocks, and also shifted allocations away from developed international (Europe, Japan, the UK) into

U.S. stocks. Year-to-date we saw U.S. equities appreciate just over 12% before correcting a bit. Developed markets rose initially, but it is looking like the classic "dead-cat bounce" as they have reversed course and are up just about half of U.S. stocks now. Emerging markets have been volatile on concerns that China's growth is slowing from more than 8% to around 7%, but stock valuations there are cheap relative to where they have historically traded against the U.S., and we have seen about an 11% rise year-to-date.

When we look at growth prospects around the world, we see that Europe and the developed foreign markets are facing negative to 1% GDP growth, tremendous debt problems and rapidly expanding central bank balance sheets, fractious relations between Eurozone member countries and severe austerity budgets all in addition to the typical Western problem of aging workforces and declining global competitiveness. The U.S., by comparison, continues to be the "cleanest dirty shirt", with GDP growth estimates ranging from 2% to 2.5% and incrementally positive economic data continuing to trickle in. For example, through March 31st the U.S. created 1.9 million new jobs in the last year, a growth rate of 1.5%, more than double the current rate of population growth, which is 0.7%. Retail sales just capped a third straight month of better than expected sales, both with and without gasoline prices. People are buying more cars, kitchenware, clothing and other goods. Consumer debt service relative to incomes has improved, and is below the long term average. And, we watch commercial and industrial ("C&I") lending as a harbinger of broader commerce. We continue to see steady improvement here; C&I lending has risen 16.7% since it bottomed in late 2010. Companies are also cracking open the cash boxes. Yes, Apple announced it will initiate a dividend, but did you also know that S&P 500 stocks paid 14% more in dividends in the last twelve months than the year before?

With U.S. stocks continuing to trade at about 80% of their long-term average P/E multiples yet earnings are expected to grow about 10%, we find this the most attractive sector of the equity markets.

Fixed Income:

Treasury and high grade bonds have gone mostly nowhere this year, with the benchmark aggregate bond index rising less than 1%. We know that interest rates will begin rising at some point, and the Fed has indicated that 2014 is the likely time frame. As bond prices fall when rates rise, we have positioned portfolios with shorter maturities to both avoid these paper losses and also be better situated to invest maturing bonds into rising rates. Unfortunately, yields on short bonds are staggeringly low, well below inflation (1% or less for five years). To that end, last year we started leveraging our equity research process to find value in higher yielding corporate bonds. We closely cover over 150 stocks and can leverage our research and experience to look at the higher yielding debt of public companies. This has led us to find bonds from companies such as Ecolab, Ball Corporation, Williams Partners and American Express that are 2-4 years from maturity but yielding 3-5x as much as comparable U.S. Treasury bonds.

We saw a nice bounce in municipals in the first quarter, with the index rising about 2%. We continue to do our own research on municipal bonds, and have had several instances where our research led us to sell bonds that later were downgraded. In one case, we identified as risky a Stockton, California bond, did some additional digging and sold it. We learned earlier this month that Stockton may soon earn the dubious distinction of largest municipal bankruptcy in history. The tax advantages of municipal bonds, provided they survive the political process, continue to make them attractive relative to Treasury bonds.

Alternative Strategies

Most alternative assets are lagging stocks while outperforming bonds year to date, and we have allocated a portion of portfolios away from alternatives for U.S. equities. Gold and commodities were up about 4% and down about 1%, respectively year to date, while real estate rose about 9%. The core hedge fund index rose 3%. Acknowledging that due to continuing European debt fears and the looming election we may see additional volatility until those waters calm, we have modestly tilted portfolios back toward our fixed income strategy and slightly away from our more aggressive income alternative strategies.

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Company News

By Patty Meneley, COO

December and the first quarter of every year is a busy time at SBL. December can be a heavy trading period and then, after the first of the year, we prepare and send out tax reports and correspond extensively with you and your tax preparers to answer tax related questions. That all happens in a normal year. 2011 was certainly not a normal year in terms of cost basis questions because Schwab and other custodians are now required to provide cost basis information to the IRS. This inevitably causes problems and confusion. We are available to discuss the issues and details with those of you who have specific questions. It will take many years for this to be completely worked out but we will continue to work with our clients and their accountants to get the most accurate cost basis information. We'll be preparing our Realized Gain/Loss schedules and providing them to you for as long as we need to, which we anticipate will be for many years to come.

On a more personal note, Meagan has been enjoying her time off with her daughters and will be back at work on May 1st.

You recently received your quarterly report either via email or in a printed copy. If you received a printed copy and would like to change that to email, contact me at Patty@SBLFinancial.com and we can make that change. Also, if you need log in information either for Schwab or our website, please contact your client service manager (Steve, Lieschen or Eileen) for help with that. We are hoping to launch a much needed overhaul of our website this summer and hope to start providing more interesting content there.

Financial Planning

By Gary Powell

Beginning January 1, 2013 many of the income, estate, and payroll tax rates are scheduled to revert back to the prior rates if Congress does not act to extend them. The major tax rate changes are summarized in the table enclosed.

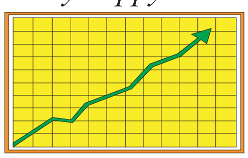
However, some economists estimate the resulting contraction caused by the tax increases and spending cuts would reduce economic growth by 3.5% to 4% - effectively throwing the economy into recession. Both political parties are likely to want to avoid that outcome, so for this reason, we believe Congress could very well kick the can down the road further into 2013. They have only about eight weeks after the election, including Sundays, Thanksgiving, and Christmas to address the issues.

An oversimplified example of impactful income tax planning before 2013 would involve recognizing a significant capital gain in 2012 versus 2013. Assuming a capital gain of $1.25 million and assuming a taxpayer has modified adjusted income above $250,000 the change in tax rates between 2012 and 2013 would cost additional tax of approximately $100,000.

From an estate prospective, two planning strategies should be considered. With the potential reduction of the estate tax exemption from $5,000,000 to $1,000,000, titling of your assets between spouses to equalize ownership continues to be viable. And secondly, individuals with larger estates should consider large gifts in 2012 to take advantage of the $5,000,000 lifetime gift exemption that may be reduced to $1,000,000 in 2013.

As we say in every letter, all of our growth over the years has come from referrals from clients and other professionals. We thank those of you who have referred your friends and colleagues, remind the rest of you that if you know of anyone who might be interested in our services have them give us a call or check us out at www.sargentbickham.com.

Many happy returns,



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Beginning January 1, 2013, many of the income, estate and payroll tax rates are scheduled to revert back to the prior rates without any Congressional action. The major tax rate changes are summarized below.

INCOME TAX	2011 & 2012	2013
Top Federal Tax Bracket	35%	39.6%
Qualified Dividends	15%	Ordinary Income
Long-Term Capital Gain Rate	15%	20%
Medicare Tax on Investment Income	N/A	3.8%**
Additional Medicare Tax on Wages	N/A	0.9%***

ESTATE TAX	2011 & 2012	2013
Top Estate Tax Rate	35%	55%
Generation Skipping Tax (GST) Rate	35%	55%
Estate and GST Tax Exemption	$5,000,000 ($5,120,000 in 2012)	$1,000,000 (GST exemption subject inflation adjustment)
Lifetime Gift Exemption	$5,000,000	$1,000,000
Annual Gift Exclusion	$13,000	$13,000*
Basis	Full step-up in basis	Full step-up in basis

*Inflation adjustment to apply.

PAYROLL TAXES

	2011 & 2012	2013
FICA – Employee Share	4.2%	6.2%

** The Medicare tax on investment income of 3.8% will be imposed on net investment income if the taxpayer's modified adjusted gross income is greater than the defined threshold of $250,000 for married filing jointly and $200,000 for individuals.

Investment income includes: interest, dividends, annuities, royalties, rents, net gain on capital assets and passive income.

***The additional Medicare tax of 0.9% on wages will be imposed on self-employed earnings or wages in excess of $250,000 for married filing jointly and $200,000 for individuals.

Prospects for Tax Changes in 2013

Many under currents, other than the 2012 election, are influencing the prospects of the tax changes in 2013. Among the most published under currents are:

- Congressional stipulated formulaic spending cuts of $1.2 trillion would kick in after the bipartisan Joint Select Committee on Deficit Reduction - commonly known as the "super committee" - failed to trim at least $1.5 trillion from the projected deficits over 10 years. The $1.2 trillion of cuts are starting January 15, 2013.
- Unemployment benefits will be severely curtailed in 2013.
- The national debt ceiling will need to be addressed following the election.

Some economists are estimating the resulting fiscal contraction – consisting of both tax increases and spending cuts- would be in the neighborhood of a contraction of 3.5% to 4.0% to GDP. That result would be unacceptable to all parties making the prospects for the 2013 tax changes highly unlikely.

Congress has about eight weeks left in 2012 after the election – including Sundays, Thanksgiving, Christmas and New Year's Eve to address the tax issues. Does "kicking the can down the road" sound like an alternative? Congress is also making the tax code more complicated every day: in 2010, lawmakers voted in 579 changes to the code. Right now it tops out at 3.8 million words, four times as long as War and Peace.