News / Commentary - 2011

- Economic activity picked up in the 4th quarter.
  - GDP growth increased from 1.3% in Q2 to 1.8% in Q3, and could reach 3% to 3.5% in Q4 2011. For the whole year of 2011, real GDP growth was about 1.75%.
  - Employment growth picked up some in December. Non-farm payrolls increased by over 200,000 and the unemployment rate fell to 8.5%. Not robust, but over 1.9 million private sector jobs were added in 2011 and 280,000 government sector jobs were lost. There are still 12.1 million unemployed Americans.
  - Commercial and Industrial Loans continued to increase – an important early indicator of economic activity.
  - Real estate is still weak.
  - Exports and business investment are leading factors for economic growth. The manufacturing sector, while significantly smaller than it was 20 years ago, is showing strong growth.
- Inflation continues to be low enough that we expect interest rates to remain low and the Federal Reserve to remain accommodative.
- The U.S. Dollar has been rising since September reflecting concerns about Europe.
- Most commodities were down for 2011. An equal weighted index fell 9%. Oil and gold were exceptions. Both were up about 10%.
- Most stock indexes were down – exceptions being mega-cap, defensive U.S. stocks.
  - S&P 500 + 2.1% (no price change, all from dividends)
  - Russell 2000 - 5.5%
  - EAFE Index -11.7%
  - Emerging Mkts. -18.2%
  - China -16.8%
- S&P 500 earnings were up approximately 13% over 2010 to about $95.
- Valuation improved further. The market P/E is now 12.8x estimated 2012 earnings of $100. The historical average is 15x – 18x during periods of moderate inflation such as today.
- The European Debt Crisis was the key driver of negative returns in 2011, and remains the largest near term risk to the economy and markets. Risk spreads remain elevated, though nowhere near levels seen in 2008 when Lehman Bros. collapsed.

- Treasury bonds outperformed all other bonds in 2011; however Municipal bonds did not suffer the risks predicted by some (aka Meredith Whitney). The muni bond index was up 10%. High yield bonds returned 5% on a total return basis.
- Other notable index results were:
    - Preferred stocks -2.0%
    - Convertible bonds -7.7%
    - Credit Suisse Hedge Fund Index -2.3%
- All in all, 2011 was a tough year to make money. SBL did a good job in 2011 in forecasting the economy, earnings, stock picking, and manager selection. Our weaknesses were in expecting interest rates to rise, and underestimating the extent of the problem in Europe. Portfolios allocated broadly - including international equities and fixed income, and small and mid-capitalization equities underperformed indices made up of only the S&P 500 and U.S. bonds in two crucial months (August and September) . Our bond returns were good, but we typically own few if any U.S. Treasury bonds and they were once again the highest performing area of the bond market. This all led to a flat year for most portfolios. Depending on allocations and individual portfolio factors, most clients' portfolios returned +/- 1% to 2%. Recognizing that most other managers probably did worse, we nonetheless are not satisfied with last year's performance and are committed to improving in 2012.

Investment Actions and Strategy - 2012

- Expect the unexpected.
    - Going into 2012, we are adjusting our processes in an attempt to be somewhat more nimble in our tactical asset allocation. We have also tightened the ranges for fixed income allocations so portfolios will be closer to their long-term averages.
    - During the summer and fall, we began monitoring about ten different indicators of financial stress in order to better anticipate market reactions to events in Europe. Recognizing that events can happen that will drive markets much faster than we can react, we are nonetheless analyzing credit, currency, and liquidity in more detail than we were a year ago.
    - The political sideshow. This is an election year in many parts of the world. Here in the U.S. the outcome of the election will probably have an important effect on tax policy. It will be important to monitor the winds of change throughout the year.

- Equities:
    - In our equity targets, small/mid cap U.S. and international equities have been reduced from about a 26% allocation at the beginning of 2011 to 14% currently; and we are likely to reduce international even further. When the situation becomes more stable in foreign economies, markets, and currencies we will increase these allocations once again.
    - We currently hold cash of 6-10% in the equity portfolio –ready to invest on market declines if perceived to be temporary. We anticipate sometimes making tactical adjustments using index funds, thereby leaving our core equity positions principally intact.

- Fixed Income - The problem with core fixed income strategies today is that yields are at historic lows. Not only does that mean low yields, but also means there are greater risks to principal values if interest rates rise. Like most investors, SBL wrongly assumed in 2011 that rates were more likely to rise than fall, but few could argue there is good value in bonds yielding 2% for 10 years, which is where they are today. In the attempt to increase yields but not sacrifice our emphasis on principal protection, we will include selected corporate bonds with below investment grade ratings into portfolios when they pass our due diligence process. Companies such as Xerox, Alcoa, Ball Corporation, L-3 Communications, Best Buy, Limited Brands, and Chesapeake Energy have ratings of BB to BBB. The yields on these bonds are in the 4% to 5% range compared to 1% to 2% for Treasury bonds. When interest rates rise, all interest bearing investments have risk of losing present value. One advantage of individual bonds with maturities is that because we generally hold them until maturity, month to month price fluctuations are less important.

  Examples of current bonds:

Issuer	Rating	Yield	Maturity/Call
• L-3 Communications	Baa3/BBB-	3.35%	11-15-16
• Alcoa	Baa3/BBB-	3.60%	2-1-17
• Xerox	Baa2/BBB-	3.14%	2-1-17
• Chesapeake Energy	Ba3/BB+	5.30%	8-15-20
• Nokia Corp	Baa2/BBB	4.96%	5-15-19
• Ball Corp	Ba1/BB+	4.26%	9-1-14
• Best Buy	Baa2/BBB-	5.92%	3-15-21

Administrative Actions/Changes – 4th Quarter 2011

- By now hopefully you have talked with our newest team members – Anne Kimmell and Eileen Evans. Anne is our smiling Receptionist and Eileen is a Client Service Manager extraordinaire.
- Babies! Congratulations to Luke and Lisa who had a beautiful baby girl last year; and to Meagan who is expecting another little girl in February. Meagan will be out most of the spring and back to work sometime this summer.
- New e-Delivery of Quarterly Statements – Many of our clients now prefer to receive their quarterly statements from us via email. If you want to receive yours this way and you did not this quarter, please contact Patty at patty@sblfinancial.com and she'll get you set up. Also, if you aren't already using our website and/or Schwab's, Fidelity's, or TD Ameritrade's, please contact your Client Service Manager to get set up.

Financial Planning

- Over the last couple of years Gary Powell has been working along with Meagan and Viktoria to improve our software and our processes. If you haven't had your plan updated lately, please call to schedule an appointment.
- At the end of 2012, a number of very important tax rates and laws change. This year is going to be another difficult one for planning, and very likely there will be maneuvering in the last few weeks and days of the year. It is very important that you begin working early if you are considering any changes to your estate plan. Accountants and lawyers are likely to be swamped at year end. We strongly encourage you to call us if you have any questions about whether your plan is up to date. You should have your documents organized – Wills, Trusts, insurance policies, beneficiary designations – and we can help you look over them.
- Similarly, capital gains rates are scheduled to increase beginning in 2013. We can't predict now whether this will be changed. If you have highly appreciated property you may want to consider this.