

Market Commentary

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Will Caution and Fear Give Way to a Stock Market Surge?

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A year ago, hopes were high among investors. The U.S. economic recovery was underway, and corporate earnings were projected to reach record levels. Corporate balance sheets were strong and getting stronger, with a record \$2 trillion in cash amassed in the tills of American companies. Europe's debt problems were no secret; surely, European leaders would take necessary steps to contain the problem and prevent its escalation into a full-blown crisis.

Through April 2011, stocks performed well despite spiking oil prices after revolutionary unrest in the Arab world, and a global supply-chain disruption caused by the Japan earthquake and tsunami.

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Quarterly Performance Benchmarks

Passive Benchmarks*	Q4-2011	YTD	1 Year	3 Year†	5 Year**
S&P 500 Index	11.8	2.1	2.1	14.1	-0.2
MSCI KLD 400 Social Index	11.2	1.6	1.6	14.4	0.2
DJIA (reinvested dividends)	12.8	8.4	8.4	14.9	2.4
S&P MidCap 400	13.0	-1.7	-1.7	19.6	3.3
Russell 2000 (Small Cap)	15.5	-4.2	-4.2	15.6	0.2
MSCI EAFE (Europe, Australasia, Far East)	3.4	-11.7	-11.7	8.2	-4.3
MSCI Emerging Markets	4.4	-18.2	-18.2	20.4	2.7
Barclays Capital Aggregate Bond	1.1	7.8	7.8	6.7	6.5
Lipper Mutual Fund Benchmarks*					
Average US Diversified Equity	10.8	-2.9	-2.9	10.4	-0.4
Large Cap Growth	9.2	-1.9	-1.9	15.0	1.0
Large Cap Value	12.1	-2.2	-2.2	10.8	-2.7
Mid Cap Growth	10.3	-4.3	-4.3	19.2	2.2
Mid Cap Value	13.2	-4.7	-4.7	17.0	-0.5
Small Cap Core	15.2	-3.4	-3.4	16.8	0.5
International Equity	4.3	-13.4	-13.4	8.4	-4.4
Real Estate	14.7	7.6	7.6	21.4	-1.8
Intermediate-term Bond	1.3	6.2	6.2	8.9	5.6

Performance data quoted represent past performance and are not guarantees of future results. Investing involves risk, including loss of principal. Passive benchmarks are unmanaged groups of stocks and are not directly available for investment. Lipper Mutual Fund Benchmarks are compiled by Lipper, Inc., a Thomson Reuters company. Information has been obtained from sources considered to be reliable; however, neither First Affirmative nor its agents guarantee the accuracy of the numbers reported.

*Sources: *The Wall Street Journal*, *The Financial Times*, and MSCI.

**The 3-Year and 5-Year returns are average annual returns for that benchmark.

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In late April major U.S. stock indexes reached their highest level since 2007, while small company stock indexes reached all-time highs. Prices then retreated as investors' focus turned to Europe's debt crisis and congressional bickering over the U.S. debt ceiling.

Debt Crisis

Stocks churned throughout the summer, jumping for a week or two, and then falling back, as European policy makers scrambled at summit after summit to ward off the debt crisis. Almost like clockwork, concerns about Greece defaulting, and even the possibility of breaking up the euro-zone, alternated with expectations that a crisis would be averted.

In early August, following a showdown in Washington over the U.S. debt ceiling, the rating agency Standard & Poor's (S&P) downgraded the U.S. government's credit rating. The stock market reacted swiftly and violently. The Dow Industrials gave up and then regained 400 points or more for four consecutive days. Even after that wild week, volatility remained high for months, with the VIX* reaching sustained levels not seen since the fourth quarter of 2008.

Stocks Go Nowhere in 2011

For all the sturm und drang that characterized the financial markets in 2011, the S&P's 500 finished the year virtually unchanged. But even this disappointing result is better than what well-diversified investors achieved. Small and mid-cap stocks both lost ground in 2011. International stocks got clobbered, especially emerging markets.

In spite of the slow economic recovery, American companies generated record profits last year, but the stock market's positive fundamentals were no match for the unceasing parade of negative headlines from Europe (debt crisis), Asia (Japan earthquake, tsunami and nuclear crisis), the Mideast (the "Arab Awakening"), and the U.S. (legislative gridlock).

Amid the uncertainty, investors rushed to safety wherever they could find it. Among the various categories of stocks, big, steady, dividend paying stocks did relatively well. The Dow Jones Industrials Average beat the Russell 2000 Index (small-cap stocks) by its biggest margin in 13 years.

* Often referred to as the fear index or the fear gauge, the VIX represents one measure of the market's expectation of stock market volatility over the succeeding 30 day period.

High Volatility, High Correlations

Volatility and correlations among stocks increased. Last year there were 69 days in which 90% of the S&P 500 stocks moved in the same direction—more than the combined total from two other very volatile years, 2008 and 2009.

Will 2012 provide a return to normalcy, where stock prices are supposed to reflect fundamental valuations? We can only hope. True, stocks are attractively priced, with expectations for continuing corporate profit growth intact and price-to-earnings ratios at relatively low levels. On the other hand, the political stalemate in the U.S. has not been remedied, and is not likely to improve in this, an election year. Europe's debt crisis is still unresolved as well. With so much geopolitical uncertainty out there, it would be unwise to expect normal markets any time soon.

Why Fundamentals Matter

The headlines about European and American debt crises mattered more than fundamentals last year. If the market just ignores fundamentals, why should investors pay any attention to them?

In *The Intelligent Investor*, Benjamin Graham wrote, "In the short run, the market is a voting machine, but in the long run it is a weighing machine." This sentence is an apt description of how the financial markets operate.

The **voting machine** combines behavioral finance, high frequency trading, money flows, demographics, trading on rumors and news, etc. When critics refer to the financial markets as a casino, they are referring to the voting machine.

But the market is also a **weighing machine**. This is the essential reason why financial markets exist—to determine the value of financial instruments.

The voting machine element of the market causes securities to become mispriced in the short term. The weighing machine aspect of the market causes securities to become accurately priced over the long-term.



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Fundamentals Are Improving

In a recession, top-line growth (increasing revenues) becomes difficult, and so companies typically manage what they have more control over, which means they are very focused on managing costs. This explains why companies have been slow to hire new workers, and inventories are being kept low.

A positive surprise on the economy causes consumers and businesses to spend, which translates into increased corporate revenues. With extraneous costs having been squeezed out, every additional dollar of revenue flows right through to the bottom line to enhance earnings. We have seen recent strengthening in U.S. economic indicators—never mind the bad news in Europe and in D.C. Furthermore, a strengthening trend can set a virtuous cycle in motion.

The S&P 500 Index ended calendar year 2011 at about 1,258. For the year, the Index generated about \$97 of profits per share, a record. Thus, its price/earnings ratio was about 13 (1258 divided by 97). If 2012 earnings for the S&P 500 companies reach \$107 per share (a reasonable estimate), and if the market's price-to-earnings ratio doesn't budge, the Index will rise more than 10%.

Is this a prediction? No; we are simply pointing out that fundamentally, stocks are attractive. What we cannot say is whether investors will notice. In 2011 they didn't, because the market behaved more like a voting machine.

Sentiment: A Contrarian Indicator

Normally, sentiment is a contrarian indicator. When there is excessive optimism, the market becomes extended, frothy, and vulnerable to a pullback, or worse. Conversely, excessive pessimism often causes stocks to become bargain-priced.

Market followers will recognize that they are not immune to the effects of emotion, and the urge to buy or sell at inopportune times. How concerned were you in the depths of the 2008 financial crisis? In retrospect, that was a good time to invest. Did you get caught up in the dot-com bubble of 1999–2000? If so, you probably got burned. Except for Apple and just a handful of other companies, technology stocks that survived are nowhere near their 2000 highs, twelve years later.

Current sentiment readings indicate that today there is still a fair amount of pessimism priced into stocks. In 2011 investors piled into Treasuries, despite the historically low yields available there, and the momentum has not yet shifted back toward stocks.

What Surprises Lie Ahead?

Perhaps the biggest surprise of 2011 was the gravity of the situation in Europe. Now that we are more aware of the challenges there, it is hard to see how Europe can continue to produce negative surprises. Certainly other surprises are in store; but will any of them disrupt the markets as much as the European debt crisis did in 2011?

Conversely, there is the promise of at least some clarity. One way or another, on November 7, 2012, the results of the U.S. Presidential election will be in. The stock market hates uncertainty, and in an election year, some amount of certainty is pre-ordained. As far as the stock market is concerned, it may not even matter very much what the election outcomes are—just knowing that there will be a certain outcome may be beneficial.



Summary

If the hyper-attention to headlines that characterized investor behavior last year gives way to fundamentals, and assuming the US economic recovery continues, there is good reason to expect stocks to do well in 2012. Competing investments are not very attractive: bond and savings deposit yields are low, and offer no growth potential. Meanwhile, corporate balance sheets are very strong. Sentiment is pessimistic, a favorable indicator. And although election years are not always good for stocks (e.g. 2008), when political gridlock is one of the major problems, the promise of clarity may provide a boost.

In 2011 investors fled from risk. At some point, the fundamental case for stocks will once again attract investors. Maybe this year...

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Bonds Beat Stocks, but Uncertainty Dogs the Fixed Income Markets

Charles Sandmel AIF®, CFP®

Generally, bonds beat stocks last year. High quality paper outperformed lower quality, and longer-term bonds beat shorter-term bonds. Most of the nightmare scenarios that surfaced in late 2010 failed to materialize, although there were some bad scares.

1. The U.S. did not default on Treasury bonds.
2. Standard & Poor's downgrade of the U.S. credit rating hit stocks rather than bonds. The yield on the 10-year Treasury note dropped from 2.88% to 1.88% between July 29th and December 31st.
3. The U.S. economy did not go into double-dip recession.
4. Europe postponed the day of reckoning for its economic, social and monetary crises—at the cost of austerity.
5. Municipal bonds did not experience widespread defaults. Issuers adapted to financial constraint by reducing new bond issuance to a ten-year low.

The Barclays Capital US Aggregate Bond index returned 1.12% in the fourth quarter and 7.84% over the year. By contrast, the S&P 500 returned 11.8% during the final three months of 2011, but only 2.11% for the year.

For the three years starting near the depth of the 2008/09 meltdown, the S&P (stocks) returned 14.1% per year while the Barclays returned 6.77%. Within the bond universe, the US Government sector returned 9.02% and the US municipal index returned 10.7%. High yield bonds, which had rallied with stocks through 2010, returned less than 5%.

We invest in bonds to generate income, preserve capital, and diversify the risks inherent in all-equity portfolios. Last year's robust bond returns are largely attributable to

price appreciation (bond prices and yields move in opposite directions), which is not the primary reason to buy bonds. And both sides of that equation now make us cautious.

First, bond yields are very low by historical measures. The “yield to worst” on the Barclays Aggregate Index yields 2.48%, and the longer municipal aggregate yields 2.82%, whereas the average dividend yield of stocks represented in the S&P 500 is 2.00%. The yield advantage that bonds have enjoyed over stocks for decades has almost entirely disappeared. Advantage, stocks.”

Second, the bonds in the indices are trading, on average, above face value. This hinders capital preservation; if you buy bonds at the index average of \$109, your return of capital at maturity (if held to maturity) will be nearly 9% lower than your investment.

The U.S. economy is in modest and tentative growth mode. Inflation is currently under control due to weak demand, and the Federal Reserve has stated it will keep interest rates low through mid-2013. Those factors imply stability and continued low bond yields for 2012. Expiring tax provisions next December present challenges.

Because there are so many uncertainties dogging the markets today, clients must be candid and current about their needs, expectations, and risk concerns. We do not see a one-size-fits-all “case for bonds” today, any more than we see an overwhelming case for any other investment. However, we would caution investors against cycling out of bonds today in the face of low yields, in the hope that they can get back in when the next bond market panic occurs (and there will surely be another panic sometime, somewhere). Such attempts usually result in poor performance.

Charles Sandmel is an Investment Advisory Representative of First Affirmative Financial Network, LLC. A 30-year veteran portfolio manager and past Director of the National Federation of Municipal Analysts, Mr. Sandmel manages fixed-income separate accounts for First Affirmative clients.



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