

CAPITALSTRATEGIES
INVESTMENT GROUP



Market Observations

Quarter Ended December 31, 2011

EQUITY BENCHMARK PERFORMANCE: RETURNS AND PERCENTILE RANKS

Q4 2011					2011				
		VALUE	BLEND	GROWTH			VALUE	BLEND	GROWTH
DOMESTIC EQUITY: Russell Series	LARGE CAP	13.11 (23)	11.84 (31)	10.61 (23)	DOMESTIC EQUITY: Russell Series	LARGE CAP	0.39 (38)	1.50 (26)	2.64 (10)
	MID CAP	13.37 (40)	12.31 (62)	11.24 (36)		MID CAP	-1.38 (30)	-1.55 (26)	-1.65 (33)
	SMALL CAP	15.97 (55)	15.47 (49)	14.99 (33)		SMALL CAP	-5.50 (64)	-4.18 (58)	-2.91 (46)
FOREIGN EQUITY: MSCI Series (In USD)	LARGE CAP	2.74 (86)	3.33 (80)	3.92 (81)	FOREIGN EQUITY: MSCI Series	LARGE CAP	-12.17 (43)	-12.14 (26)	-12.11 (50)
	FOREIGN SMALL CAP	-0.56 (92)	EMERGING MARKETS	4.42 (53)		FOREIGN SMALL CAP	-15.94 (54)	EMERGING MARKETS	-18.42 (36)

Returns Scale

	between -5% and -9.99%
	between 0% and -4.99%
	between 0% and 2.49%
	between 2.5% and 9.99%
	between 10% and 14.99%
	greater than 15%

- U.S. markets rallied in Q4, leading to a positive finish for large cap stocks in 2011. However, the rally was not enough to overcome Q3 losses in small caps. Foreign equities continued to underperform, leading to significant negative performance for the year.
- 2011 will rank among the worst years for active manager performance; many benchmarks ranked significantly above the median performance of relative peers.

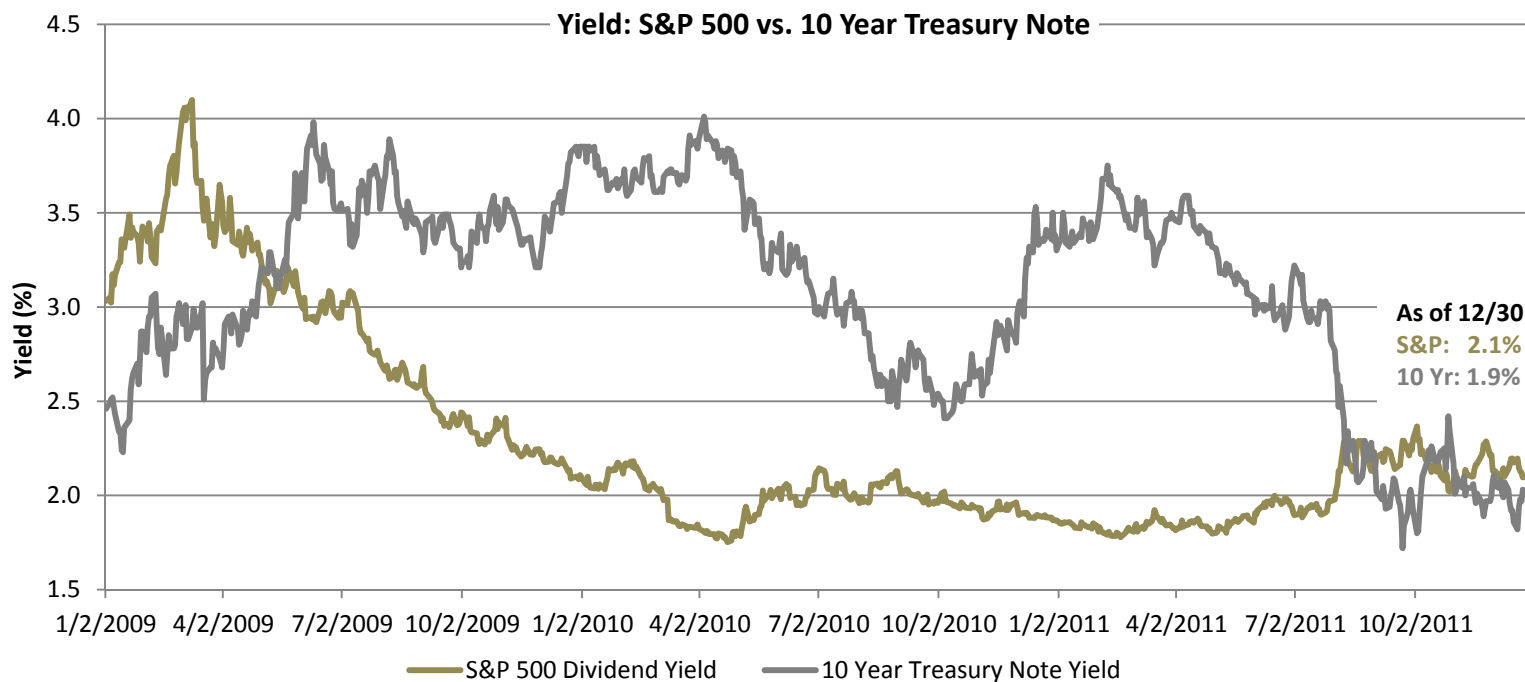
Returns Scale

	less than -13%
	between -5% and -12.99%
	between -2.5% and -4.99%
	between 0% and -2.49%
	between 0% and 2.49%
	between 2.5% and 4.99%

TRENDS IN EQUITY RETURNS

Cyclical sectors, such as Energy, Industrials, and Materials, rebounded strongly during Q4 due to softening concerns of a U.S. recession. However, defensive sectors such as Utilities and Consumer Staples were the top performers during 2011. The Financials sector underperformed during 2011 due to concerns over increased regulation and exposure to European sovereign debt.

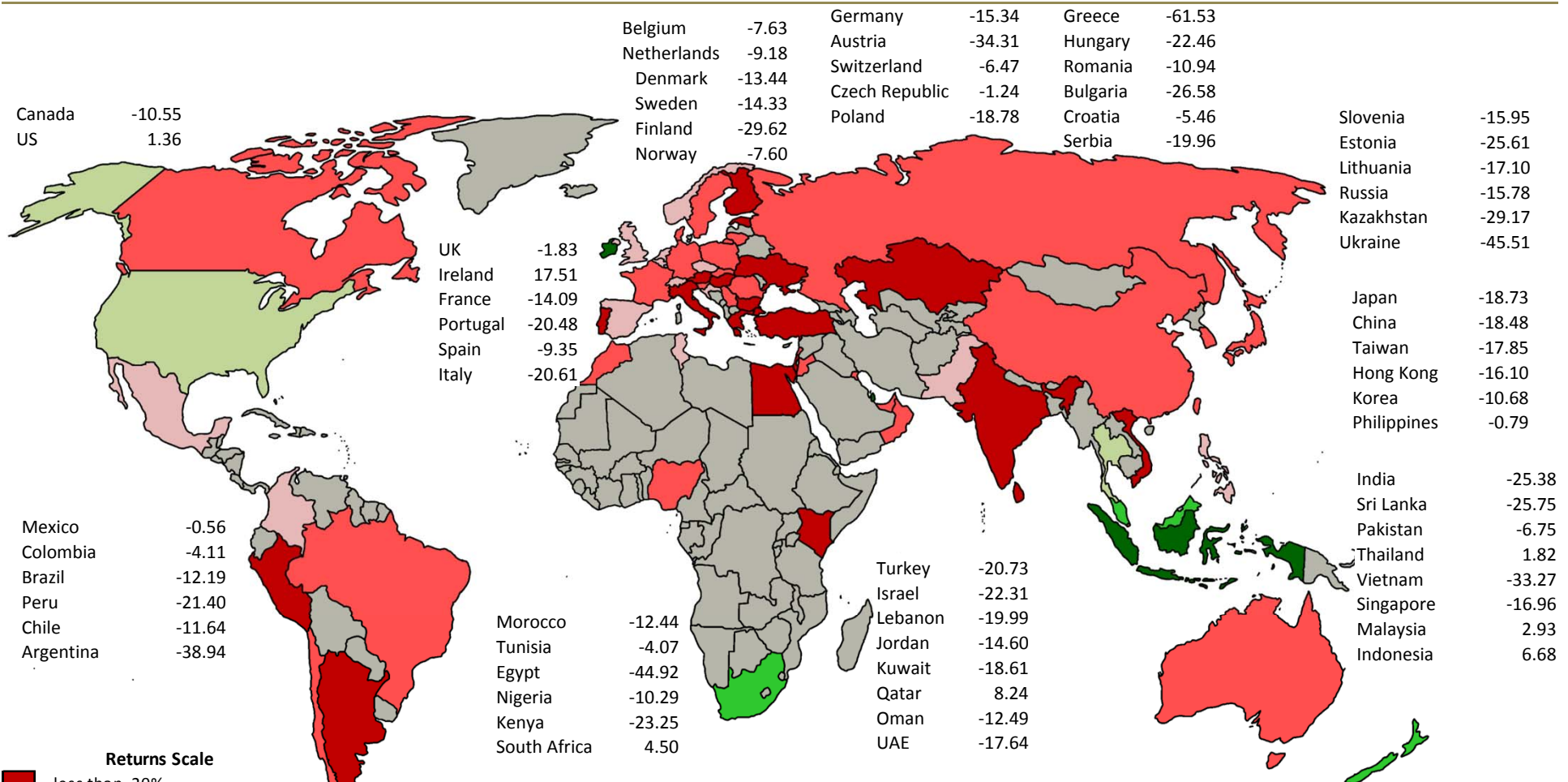
	Info Tech	Financials	Energy	Health Care	Consumer Staples	Consumer Discretion	Industrials	Utilities	Materials	Telecom	S&P 500
Last Quarter Q4 2011	8.7%	10.8%	18.2%	10.0%	10.3%	12.6%	16.5%	8.3%	15.4%	7.9%	11.8%
1 Year 2011	2.4%	-17.1%	4.7%	12.7%	14.0%	6.1%	-0.6%	19.9%	-9.8%	6.3%	2.1%
Since Market Low March 6, 2009	28.8%	32.3%	23.4%	20.4%	23.6%	38.7%	35.1%	22.8%	29.1%	19.3%	26.8%
Since Market Peak October 7, 2007	0.3%	-19.4%	-0.3%	1.2%	6.7%	2.5%	-3.4%	1.3%	-2.9%	-2.4%	-2.7%
Weight in S&P 500 (largest first)	19.51%	13.64%	12.15%	11.76%	11.40%	10.61%	10.51%	3.80%	3.50%	3.12%	100%



Following the market sell-off and Treasury rally experienced during Q3 2011, the dividend yield on the S&P 500 has exceeded the yield on the 10 Year Treasury Note for the first time since the '09 market rally.

Strong corporate balance sheets, increasing dividends, and cheap valuations have made dividend yielding equities very attractive relative to Treasuries.

GLOBAL EQUITY RETURNS: 2011



Canada -10.55
US 1.36

Belgium -7.63
Netherlands -9.18
Denmark -13.44
Sweden -14.33
Finland -29.62
Norway -7.60
Germany -15.34
Austria -34.31
Switzerland -6.47
Czech Republic -1.24
Poland -18.78
Greece -61.53
Hungary -22.46
Romania -10.94
Bulgaria -26.58
Croatia -5.46
Serbia -19.96

Slovenia -15.95
Estonia -25.61
Lithuania -17.10
Russia -15.78
Kazakhstan -29.17
Ukraine -45.51

UK -1.83
Ireland 17.51
France -14.09
Portugal -20.48
Spain -9.35
Italy -20.61

Japan -18.73
China -18.48
Taiwan -17.85
Hong Kong -16.10
Korea -10.68
Philippines -0.79

Mexico -0.56
Colombia -4.11
Brazil -12.19
Peru -21.40
Chile -11.64
Argentina -38.94

Morocco -12.44
Tunisia -4.07
Egypt -44.92
Nigeria -10.29
Kenya -23.25
South Africa 4.50

Turkey -20.73
Israel -22.31
Lebanon -19.99
Jordan -14.60
Kuwait -18.61
Qatar 8.24
Oman -12.49
UAE -17.64

India -25.38
Sri Lanka -25.75
Pakistan -6.75
Thailand 1.82
Vietnam -33.27
Singapore -16.96
Malaysia 2.93
Indonesia 6.68

Australia -10.97
New Zealand 5.69

Returns Scale

- less than -20%
- between -10% and -19.99%
- between 0% and -9.99%
- between 0% and 2.49%
- between 2.5% and 9.99%
- greater than 10%

Outside the U.S., equity markets were mostly weak for the year, with many countries experiencing significant losses. Despite a volatile year for currency, many currencies ended the year with only slight gains/losses.
(Returns on this page are reported in local currencies)

Region/Country:	EAFE	EM	Germany	UK	Switzerland	Japan	Australia	Canada	Brazil	Russia	India	China
USD\$ Return	-12.14	-18.42	-18.08	-2.56	-6.77	-14.33	-10.95	-12.71	-21.85	-19.55	-37.17	-18.41
Local Currency Return	-12.15	-12.74	-15.34	-1.83	-6.47	-18.73	-10.97	-10.55	-12.19	-15.78	-25.38	-18.48
Difference	0.01	-5.69	-2.74	-0.73	-0.30	4.40	0.01	-2.16	-9.66	-3.77	-11.79	0.07

COMMODITIES

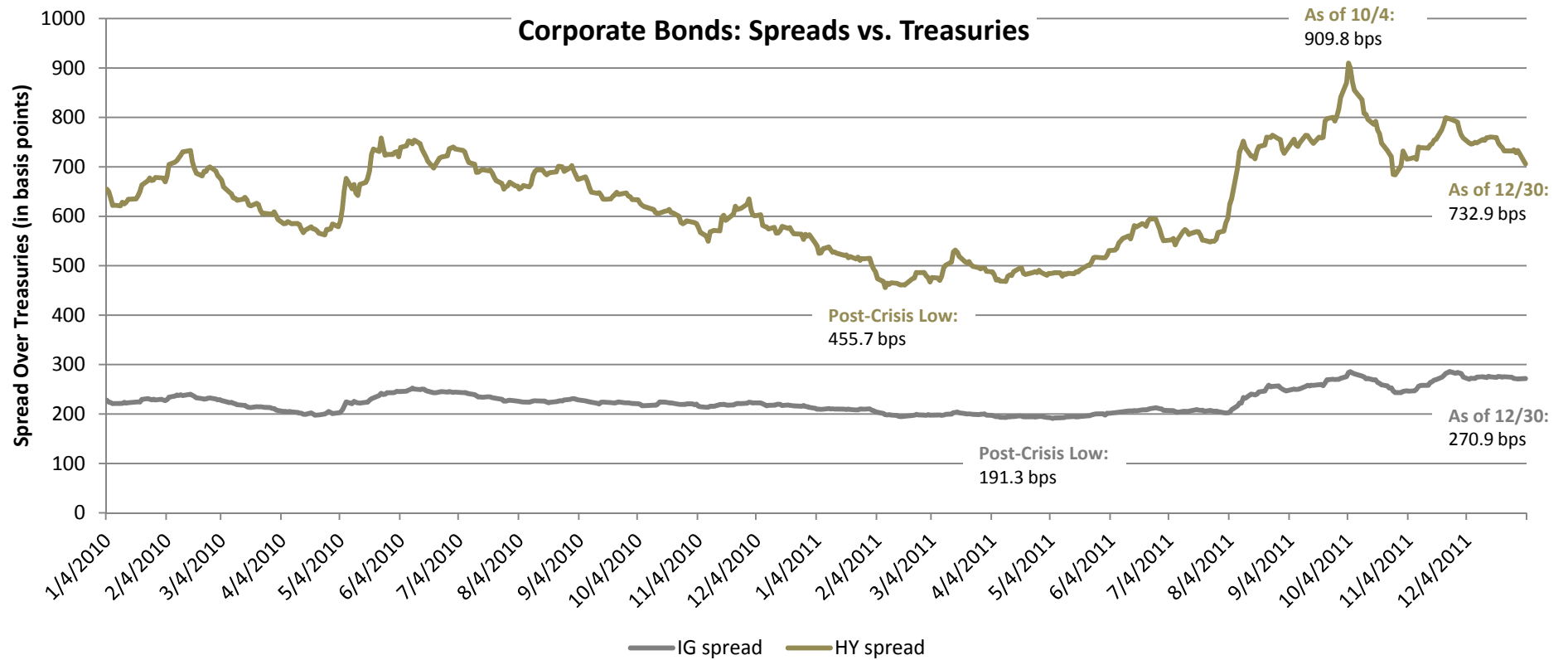
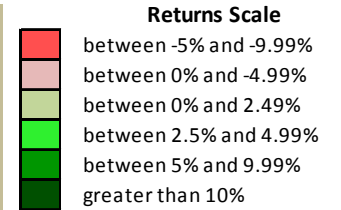
2011 Sector Return		Last Quarter	1 Year	Begin Price: 10/3/2011	End Price: 12/30/2011	Measure	Weight in Index	
Agriculture	-14.35%	Coffee	0.1%	1.7%	\$2.27	\$2.27	\$/lb	2.6%
		Corn	6.7%	17.2%	\$6.06	\$6.47	\$/bushel	7.9%
		Cotton	-5.0%	-2.8%	\$0.97	\$0.92	\$/lb	2.5%
		Soybean Oil	3.8%	-8.1%	\$0.51	\$0.52	\$/lb	2.8%
		Soybeans	0.8%	-5.6%	\$11.98	\$12.08	\$/bushel	7.3%
		Sugar	-6.2%	2.6%	\$0.25	\$0.23	\$/lb	3.0%
		Wheat	-0.6%	-24.4%	\$6.57	\$6.53	\$/bushel	4.5%
Energy	-15.97%	Crude Oil	26.3%	5.5%	\$78.25	\$98.83	\$/barrel	15.1%
		Heating Oil	6.8%	11.2%	\$2.73	\$2.91	\$/gallon	3.9%
		Natural Gas	-27.2%	-43.7%	\$4.11	\$2.99	\$/MMBtu	9.8%
		Unlead. Gas	9.3%	12.3%	\$2.43	\$2.66	\$/gallon	3.9%
Industrial Metals	-24.23%	Aluminum	-9.6%	-21.1%	\$2,208.75	\$1,997.00	\$/metric ton	5.0%
		Copper	8.4%	-19.5%	\$3.17	\$3.44	\$/lb	7.3%
		Nickel	-1.6%	-24.6%	\$19,035	\$18,731.00	\$/metric ton	2.5%
		Zinc	-3.5%	-26.8%	\$1,897.25	\$1,830.75	\$/metric ton	2.7%
Livestock	-2.30%	Lean Hogs	-7.2%	6.3%	\$0.91	\$0.84	\$/lb	2.1%
		Live Cattle	-2.7%	8.7%	\$1.25	\$1.21	\$/lb	3.3%
Precious Metals	4.56%	Gold	-5.6%	12.6%	\$1,659.60	\$1,566.80	\$/ troy ounce	10.1%
		Silver	-9.5%	-6.2%	\$30.83	\$27.92	\$/ troy ounce	3.6%
Index: DJ UBS Commodity		0.3%	-12.1%	140.30	140.68			
National Avg Gas Price		-2.8%	8.0%	\$3.62	\$3.52	\$/ gallon		

- Commodity prices generally declined during the year due to U.S. dollar strength and rising concerns over a global economic slowdown.
- Industrials Metals was the hardest hit sector, falling 24.23% during the year.
- Crude Oil prices rebounded sharply during Q4 after reaching almost two-year lows during September. The rally was primarily attributable to decreased fear of a U.S. recession. Growing long-term demand from emerging markets continues to support prices.
- Natural Gas prices fell significantly during 2011 as production and inventory levels far outpaced demand – both industrial and residential.
- Gold faced a multitude of forces throughout the year. Prices surged as investors continued to use it as a source of diversification as well as a “safe haven;” however, speculation by hedge fund managers and increased margins for traders hurt prices later in the year.

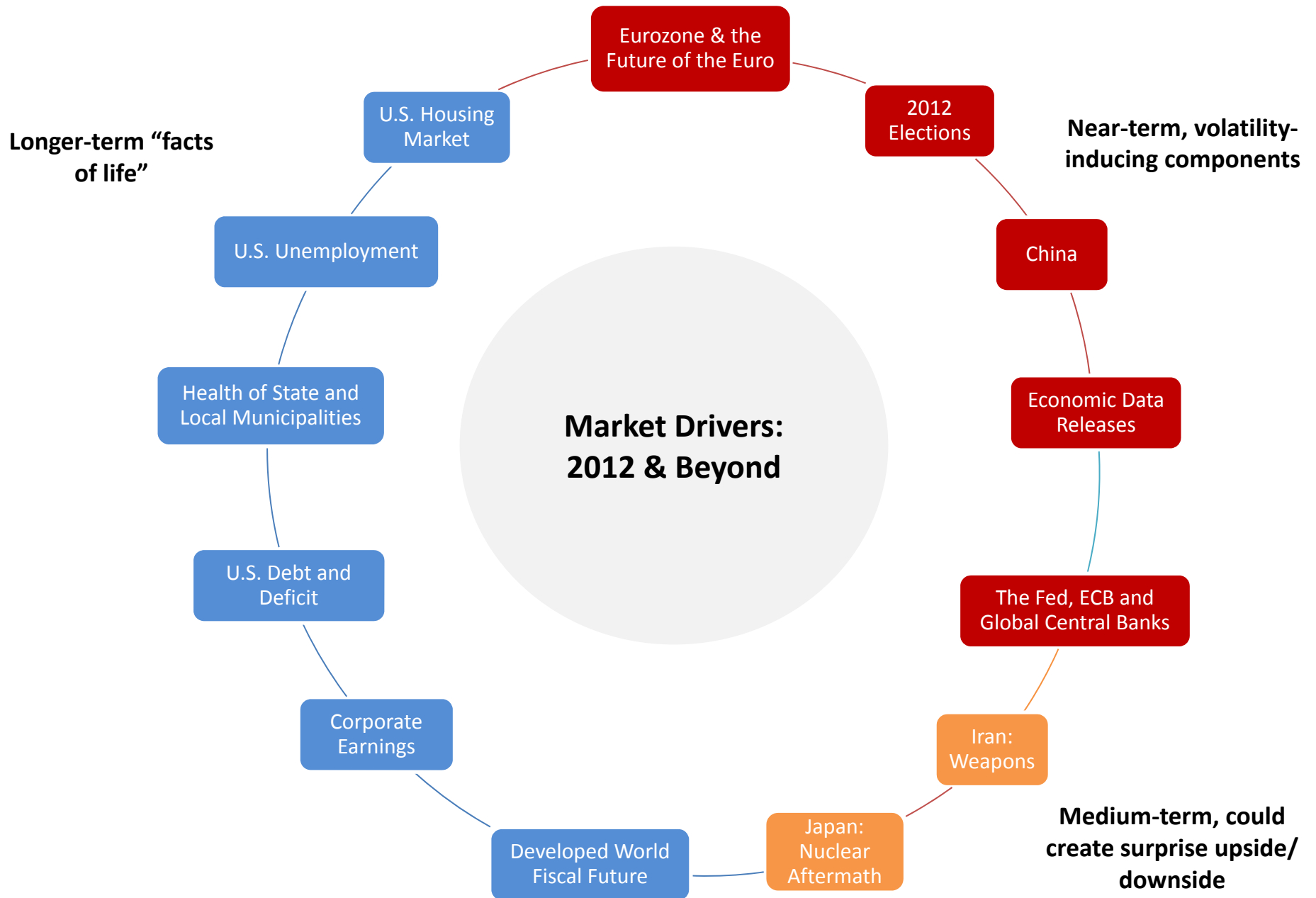
FIXED INCOME: RETURNS AND INTEREST RATES

	Agg Bond Index	Aggregate Bond Index Components:				Additional U.S. Dollar Fixed Income			Long Bonds		Global Agg Ex-USD	Emerging Markets		
		Treasury	Govt Related	Corporate	Securitized	High Yield	TIPS	Munis	Treasuries	Corp A - AAA		USD Sover.	LCL Sover.	Corporate
Last Quarter														
Q4 2011	1.1%	0.9%	0.7%	1.9%	1.0%	6.5%	2.7%	2.1%	1.9%	3.0%	-0.4%	5.1%	0.9%	5.1%
1 Year 2011	7.8%	9.8%	6.7%	8.1%	6.2%	5.0%	13.6%	10.7%	29.9%	16.9%	4.4%	8.5%	-1.9%	3.2%

- High Yield spreads compressed 1.76% from their 10/4 peak, driven primarily by an improved outlook for the U.S. and Global economy. Despite the significant rally, current spreads remain attractive relative to post-crisis lows and expected default rates.
- The Treasury yield curve continued to flatten during the quarter due to Euro concerns and Federal Reserve policy. Despite lower Treasury yields, inflation expectations increased during the quarter, fueling a continued rally in TIPS. The TIPS market currently implies annual inflation of 1.59% per year over the next five years, well below the most recent headline CPI year-on-year change of 3.4%.



OUTLOOK FOR 2012



NEAR-TERM TACTICAL RECOMMENDATIONS

Review

We view 2012 as a pivotal point in the long-term direction of the global economy. The developed world is heavily debt ridden and in need of extreme fiscal reform. Global debt is nearing \$200 trillion dollars, with a total debt/GDP ratio at 310%, including government and private debt. The key theme of 2012 will be policymakers in the developed world; we expect that their actions will be center stage in determining the future viability of their economies. All eyes will be on Eurozone leaders in 2012 as they wrestle with this enormous financial and political crisis, but the U.S. will be a significant focus as well, with the potential for important long-term plans to emerge regardless of a political regime change. Global central banks will keep the world awash with liquidity long through 2012. The greatest risk we see for 2012 and beyond is the risk of policy mistakes.

We expect the global market volatility to continue into 2012—or until a clear paths to resolve these major issues are determined. We believe it is prudent for investors to remain well diversified in 2012. Quality and yield will be a core focus in the coming year.

US Economy

The presidential election season is set to begin amidst a slow growing but seemingly stable economy. However, risks of recession are elevated, and we expect them to remain elevated, due to external factors. Core election issues will be the economy—especially unemployment, taxes, regulation, and fiscal reform. Given the utter failure of the Super Committee to propose deficit reduction, we hope that the 2012 elections will bring leadership to take up the daunting task of tackling the US debt and deficit problems—even without a full regime change. In the short term, we expect that both payroll tax cuts and unemployment benefits will be extended, putting further pressure on goals to reduce the budget deficit.

We expect GDP growth to remain low in 2012: 2.0% to 2.5%. Consumption has been strong in the fourth quarter of 2011; however, anecdotal evidence suggest that strong holiday spending numbers have been due to personal credit expansion. Unemployment will remain high as companies are still reluctant to hire without clarity on taxes and regulation. Housing will continue to languish as the previously mentioned problems must be addressed before we can see any significant rebound. QE3 is looking increasingly more probable—although we remain skeptical that it would be beneficial, as the size of the program would need to be massive in order to have even a marginal impact.

Eurozone

The Eurozone remains mired in a severe debt crisis, with many of their financial institutions on the verge of collapse. With Greece insolvent, Portugal and Ireland on life support, and growing questions regarding the liquidity and solvency of Italy and Spain, the Eurozone has significant financial and political hurdles to restoring confidence in the region and the currency union. Talks of credit rating downgrades in France and Spain, coupled with credit default swap levels and Germany's recent failed auction revealed concerns about even the ability of the euro's strongest members to withstand the crisis. Doubts about the future of the Euro will dominate the headlines in 2012. There is not enough room in this piece to discuss all the possible outcomes and variations of proposed solutions; however, we do believe that viable solutions exist if policymakers are willing to make difficult decisions.

NEAR-TERM TACTICAL RECOMMENDATIONS

China

In 2011, the Chinese government undertook unprecedented policy measures to fight inflation, which rose toward 6% during the year. These measures, such as capping property prices and halting lending, were designed to fight inflation by purposefully slowing growth. As inflation has now begun to subside, we expect monetary easing and stimulus action to propel Chinese growth forward.

After growing at double-digit rates for most of the past year, we expect Chinese growth to slow. However, “slow growth” in China still means growth above 8%, as large numbers of people “urbanize” each year. The government will continue to manufacture growth—and jobs—to avoid social unrest.

Japan

Japan, the world’s third largest economy, will continue to struggle with fiscal and economic growth issues of its own. With a debt-to-GDP ratio of 229%, Japan, arguably, sports the worst balance sheet in the world. In the aftermath of the nuclear disaster, the Japanese government is set to spend approximately \$245 billion rebuilding the areas devastated by the earthquake and nuclear fallout. While this investment should support growth in 2012, the longer-term prospects for Japan are beginning to deteriorate. The population has begun to decline and more people are leaving the workforce than entering leading to less personal savings suggesting that their main funding mechanism is in decline. That decline will leave them at the mercy of the markets to fund their debt and create their own funding crisis within the next few years. We’ve already seen Japanese bond yields starting to rise. Further complicating matters is that the \$1.5 trillion state pension fund is selling bonds to support payment .

Emerging Markets

In the emerging world, the ever present threat of inflation and fear of slowing exports will lead to slower growth. However, we believe these countries will continue to “emerge,” as their populations become increasingly more urban and middle classes continue to develop. In our opinion, most EM countries are undervalued; with their strong balance sheets and financial reserves, they should be able to weather any significant slow down in demand for their products.

NEAR-TERM TACTICAL RECOMMENDATIONS

Domestic Equity	<p>We are positive on the U.S. equity markets going into 2012. We continue to favor dividend-paying stocks, as corporate balance sheets remain healthy and earnings strength looks to continue. Pressures that have affected markets since Q2 have been largely external. We expect cautious guidance from corporations, given uncertainties about economic growth, regulation, taxes, and outcomes of the Euro debt crisis.</p>
Foreign Equity	<p>After a significant decline, the market outlook for Emerging Markets looks even more positive. Concerns about a “hard landing” in China are overblown, in our opinion; a slight decline in the annual GDP growth rate is much more likely. We recommend avoiding Chinese financials, especially Real Estate. We remain cautious toward Europe, and retain favorable long-term outlooks on commodity-linked countries, especially Canada and Australia. Frontier markets, especially non-oil linked, offer attractive opportunities.</p>
Fixed Income	<p>The nearly 1% decline in interest rates resulted from the “flight to quality” of money away from euros and concerns over a potential global economic slowdown. The Fed’s “Operation Twist” appears to have minimal obvious effect. After corporate bond spreads have widened vs. Treasuries, both Investment Grade and High Yield look attractive, despite low absolute rates. Spreads of Emerging Markets bonds remain wide vs. Treasuries, also creating opportunities.</p>
Alternative Investments	<p>Commodities remain attractive. Oil still remains highly speculative therefore we are buyers when the price is in the \$80/barrel range and sellers over \$100/barrel. Agricultural commodities also appear attractive, given continued severe weather worldwide and increases in demand.</p> <p>Managed futures have struggled recently, given the lack of “trends” in global markets. Generally, markets have experienced swift declines and/or increases, or have been trading in relatively narrow ranges.</p>

UNDERWEIGHT

- Global Financial equity sector
- Bonds, especially Sovereign Euro-based Economies and Treasuries

NEUTRAL

- Europe: Select Euro-based Equities
- Commodities (broad)
- China
- Australia
- Canada
- Japan
- Managed Futures

OVERWEIGHT

- Dividend-paying stocks
- Agricultural commodities
- Emerging market equities
- Corporate bonds—investment grade and high yield
- Emerging market bonds