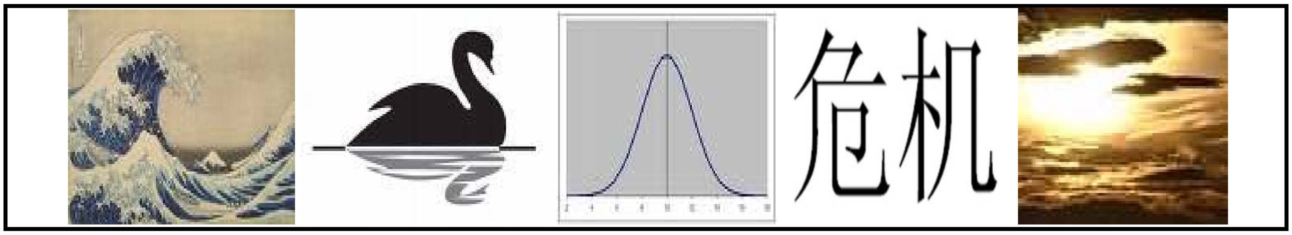

2012: The Year Ahead

MV Capital Management
Annual Market Outlook, January 2012

THE CONTINUATION OF HISTORY, AND MARKETS

Felix est qui potest causas rerum intelligere.
Happy is the person who can know the causes of things.

-Seneca

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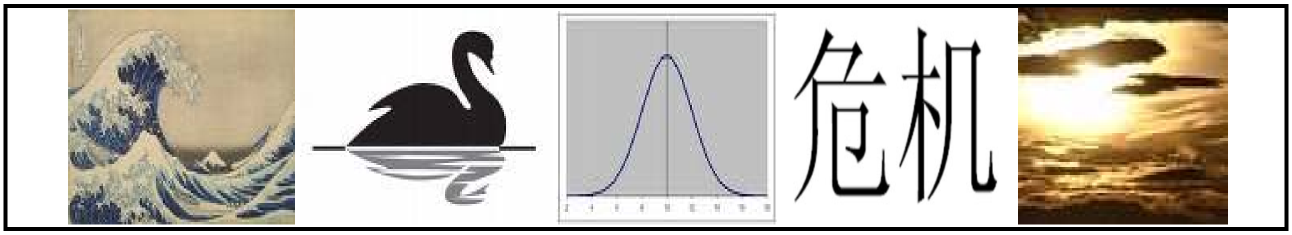
In 1989 a political scientist named Francis Fukuyama wrote an article titled “The End of History?” in the international affairs journal *The National Interest*. Due no doubt to the timing and the provocative title, the article became a must-read among the foreign affairs chattering classes and led to a 1992 book with the expanded title (and absence of a question mark) “The End of History and the Last Man”. Exactly two hundred years had bookended the onset of the French Revolution and the crumbling of the Berlin Wall. After numerous experiments and wrong turns, argued Fukuyama, the “last man standing” was the political system of small-l liberal, representative democracy. The days of the divine right of kings had come and gone, and the more recent Frankensteins of communism and fascism had likewise been consigned to the dustbin of history. All that would happen in the future, went this line of reasoning, would be ever more perfect forms of representative democracy – more suffrage, more freedom from arbitrary persecution, less discrimination against minorities and marginalized citizens. Truly, a more perfect union.

While Fukuyama was not an economist, there was a clear economic context to his “last man standing”. The representative democracy would be the Elysian fields of opportunity where anyone could dream a dream of a more prosperous life and see it come true within his or her lifetime. The so-called “invisible hand”, born in the fervid intellectual climate of the eighteenth century Enlightenment, would forevermore reign in the practical world of enlightened, free trade and commerce.

When we stand back and allow ourselves to take in a sweep of history that goes back more than two hundred years it is easy to identify some colossal markers of progress. In much of the world today there is indeed less discrimination. There is more participation in the mechanics of civil society, and more economic opportunity for more people than was the case even fifty years ago, let alone two centuries ago. At the same time, though, history is not over – it continues. In 2011 the continuation of history was a constant context for an exceedingly volatile year in investment markets. History continued in Tunisia, in Tahrir Square and Zuccotti Park, in Athens and Moscow, while the S&P 500 lurched up or down by more than 2% on sixty trading days (as compared to not accomplishing this feat on even one trading day just six years ago, in 2005).

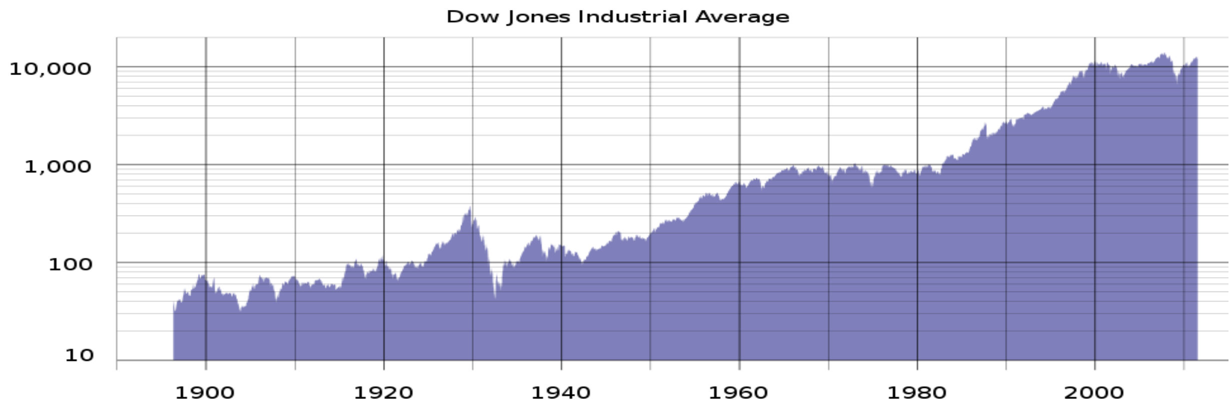
That’s what makes looking at historical progress so difficult. Draw a line between two points, say, one in 1789 and one in 2012 with no reference points in between, and you will most certainly have an upward-



sloping line that reflects how much freer and more prosperous so many more people are today. That gives the illusion that progress somehow marches forward in a smooth, straight line. But reality looks bumpier than a straight line connecting two points. It looks…well, more like a stock market index:

Table 1

Dow Jones Industrial Average: December 1896 through December 2010



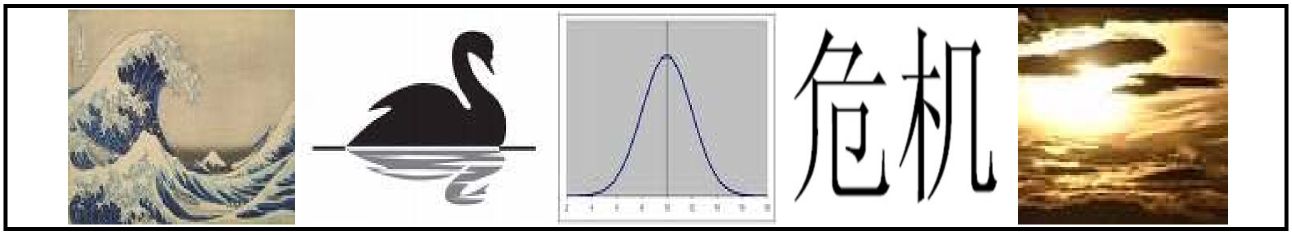
Source: StockCharts.com

The Dow Jones Industrial Average launched in 1896. Eleven years later it plunged during the Panic of 1907 back to levels close to its outset level. For much of the remainder of the first two decades of the twentieth century the markets lurched along, buffeted by war, the dying gasps of European monarchies and the Molotov cocktails of revolution. Then – inexplicably – they soared to vast new heights during the Roaring Twenties. The Great Depression brought an end to those good times and another protracted period of volatility ensued. It took until the mid-1950s for price levels to regain the losses suffered during the 1930s, but in essence the seeds of a long-term bull market took root in the late 1940s, when visionary American leadership (remember what that looked like?) helped Europe and Japan back onto their feet after total devastation and facilitated a golden age of international growth and trade.

Francis Fukuyama's error was in seeing this happy chapter of history – from the end of the Second World War to the demise of communism in Eastern Europe – as the final word. But humankind – civilization – just doesn't work that way. There are questions anew about freedom and economic security, governance and what it really means to be a nation. In the revolutions of Europe during the tumultuous year of 1848 the two questions at the forefront of political debate were simply these: the national question (what does it mean to be a nation?), and the social question (how do we relate among each other, take care of each other, ensure fairness and access to one's individual dreams without tearing apart the fabric of the society?). Those questions are still being hotly debated and challenged today. History continues.

So do markets. 2011 was a very strange year for investment markets, as we will see in this report. But look up again at that long-term chart of the Dow. Sometimes the market soars, sometimes it plunges. Most of the time it muddles along, and in the long run the direction trends up. When it behaves strangely people say that everything has changed, that old methods no longer work. People have said that since Dutch tulips cost more than a house in 17th century Amsterdam, and they have always been wrong.

That, we believe, is one thing that has not changed. Markets, too, continue. It's time to go back to basics.



INVESTMENT THESIS

Summary of Last Twelve Months and Outlook for 2012

- For traditional diversified portfolios one phrase could perhaps sum up 2011 better than any other: **diversification hurt**. If you benchmark your portfolio to the Barclays US Aggregate for fixed income and the S&P 500 for equities – which for reasons of both tradition and inclusion are the industry's overwhelming consensus choices – then you very literally could only weaken your allocation mix by diversifying into style, geographic, credit quality or other asset classes.

- In many ways this was a sort of **bookend anomaly** to 1999. If you recall, that was the year when the S&P 500 and the NASDAQ outperformed everything else. You were in either a small subset of technology and telecom stocks or you lost out. In 2011 you were either in a small subset of income-oriented high dividend stocks or you lost out – the mirror image of 1999.

- In between 1999 and 2011 diversification has generally paid off, and we believe it will continue to do so. This is at the core of our "back to basics mindset". For a more detailed description of our asset class observations and commentary please refer to the "Asset Class Review and Outlook" section below.

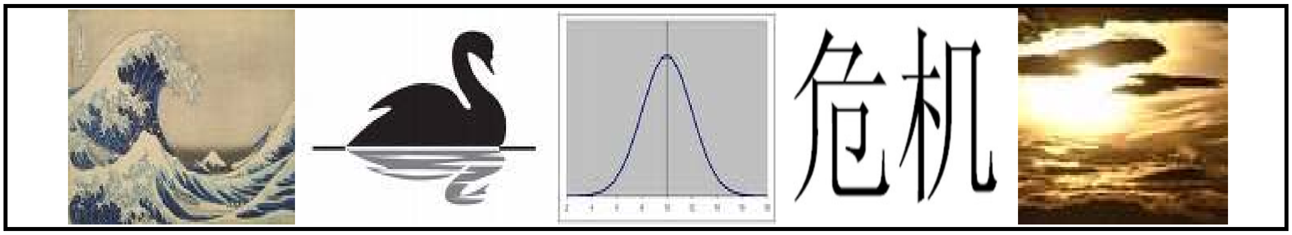
- The Eurozone crisis will continue to be an issue in 2012 because the underlying problems are deep and structural. So far the crisis management approach has been a series of quick fixes and if nothing else that has kept the single currency together. At the same time Europe is looking at a high likelihood of falling back into recession. This could either hasten the demise of the Euro or, alternatively, raise the level of urgency to the point where Germany ends its resistance to endowing the European Central Bank with new stimulus powers.

- If Europe manages to avoid an all-out crisis then the economic focus switches back to the US, where a slightly firmer than expected recovery is gaining some traction. Corporate earnings continue to mostly please investors, unemployment has given ground and retail sales for 2011 were strong. A firmer tone for the world's largest market will help the rest of the world. However the vulnerability to a worst-case development in Europe is still a meaningful risk.

- Emerging markets suffered in 2011 – again, the prospects for rebound depend largely on the delicate *pas de deux* between the US recovery and the Eurozone crisis. We believe that the cyclical peaks and troughs for performance in these markets are shorter than the more structural issues currently befalling Europe. This could mean that growth and frontier markets outperform non-US developed markets this year and possibly US markets as well, though the latter outcome is subject to much more variance.

- Yields on the 10-year US Treasury note were over 3% at the beginning of 2011 and the asset class outperformed every other. Yields are under 2% in early 2012 and we do not expect a repeat performance this year. Look for a return to fundamentals, where strong corporate balance sheets could give a tailwind to investment grade and high yield corporate bonds.

- Commodities as an asset class fared poorly in 2011 with the exception of gold, which for a period took on the mantle of a safe haven asset rather than a simple commoditized store of value. Slower demand from Europe continues to weigh on industrial and energy commodities, though geopolitical risks in the Middle East could keep supply-side pressures high.

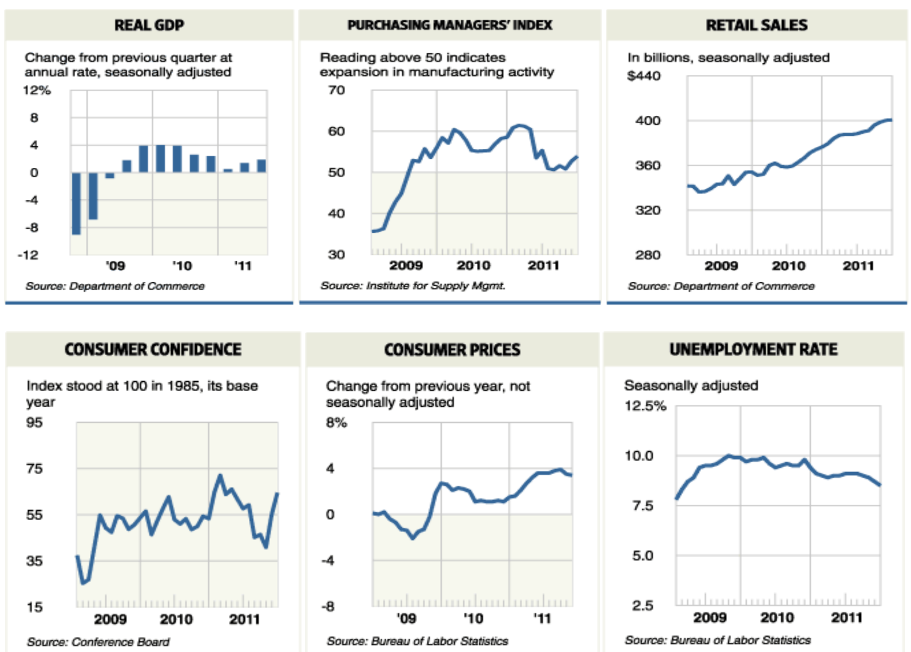


Market Flashpoints: Key Questions for Assessing 2012 Performance

US Economy: Are We Turning the Corner?

One of the notable outcomes of 2011 was the relative strength of US markets versus their counterparts in Europe, Asia and Latin America. The Russell 3000 finished the year with a total return of 1.03% (S&P 500 earned 2.1%) while the MSCI EAFE index limped across the line with a loss of (11.3%) and the MSCI Emerging Markets index lost its luster by falling (18.2%) for the year. Much of that disparity between US and non-US markets occurred in the 4th quarter during which the Russell 3000 got a tailwind of 12.1% to sail through the end of the year into (barely) positive territory. Consensus took hold that however anemic the recovery in the US, the data points still indicate a recovery and ever less to a return to recession.

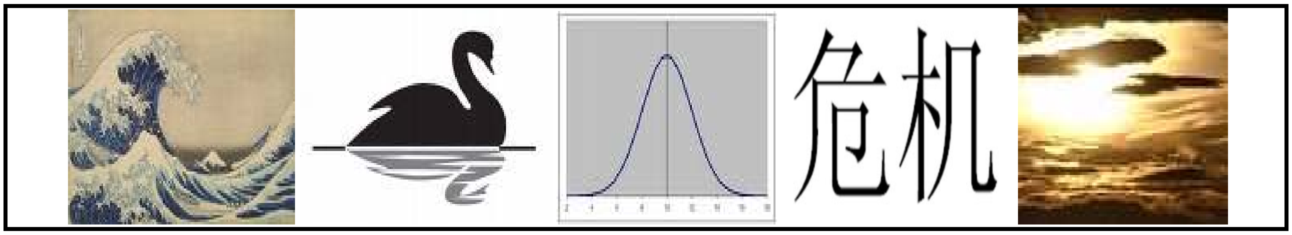
Table 2
Selected U.S. Economic Indicators



Source: Wall Street Journal Online

That assessment has carried into the first couple weeks of 2012 as various signals from the housing market, consumer confidence levels, retail sales and payroll data point to a firmer undertone in our economy. US markets are continuing their upward orientation with the Russell 3000 putting up 3.1% in the month (January '12) to date. All that having been said, the outlook is not an endless bed of roses. The Wall Street Journal's pool of economic forecasters predicts on average a 2.4% rise in real GDP in 2012. That is slightly up from earlier estimates but still below the 3%-plus levels most believe necessary to make a meaningful dent in unemployment and under-employment.

It is a Presidential election year, of course, and that adds to the cocktail of potential surprises that may emerge over the course of the year. However there are reasons to believe that the election season by



itself may not have an undue effect on markets or the economy. If there is any such thing as a universal consensus it is that we will see absolutely nothing in the form of policymaking coming out of the executive or legislative branches of the federal government this year. It is possible that we will see a bit less of the reckless brinksmanship that characterized moments like the debt ceiling debacle last summer – as the first Tuesday in November draws near politicians up for re-election may be mindful of alienating their voting constituents any more than they already have. And although it can be a fool's game to predict the market response to the actual election outcome, we would be surprised if it moved much one way or the other depending on whether Barack Obama or his eventual Republican opponent wins the keys to 1600 Pennsylvania Avenue.

Eurozone Crisis: Quo Vadis Pulchra Europa?

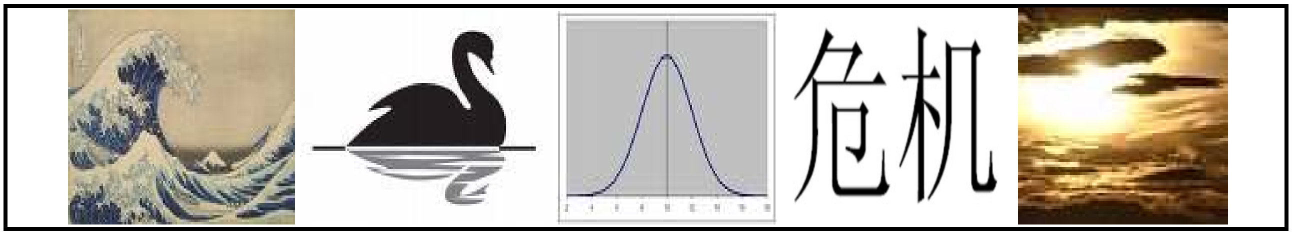
All well and good for this side of the "pond", but what about Europe? The story that won't go away is not likely to disappear any time soon. At the same time that US data points have generally firmed up, those in Europe are inching closer to an outright downturn for the Continent. Among a universe of fund managers surveyed by the Financial Times at the end of 2011 there was a 72% consensus that the Eurozone will slip back into recession, and about an even split between those who think the single currency area will fall apart and those who think it can be kept stitched together. Standard & Poor's helped keep the prevailing mood sour with a series of downgrades to ring in the New Year, hitting France, Spain, Italy and Austria among others. Market reaction to the downgrades has been somewhat tempered – the MSCI Eurozone index is up 1.9% for the (albeit brief) year to date, but Europe remains the major wild card in this year's overall outlook. Weakening demand in Europe was a significant contributor to the higher than expected US trade deficit of 10.4% in November last year as US exports to Europe fell victim to the ongoing crisis.

Most investors would no doubt love to wake up one morning without having to digest headlines about Greek debt renegotiations or how close Portugal is to outright default, or whether rumors about an IMF infusion of new spending are actually true. This steady trickle of sometimes meaningful, often irrelevant news flashes contributed in large part to the "risk on / risk off" trading paradigm of last year, when the magnitude and direction of market moves on any given day seemed to be driven mostly by how the algorithms driving massive trading programs digested and responded to the headlines (today is a case in point: "Stock futures up on report IMF may boost European funding" goes one of the lead stories on Reuters).

But there is a bright side to the protracted nature of this crisis – it is a result of policymakers largely figuring out how to patch together at least some quasi-solution to kick the urgency of the problem further down the road. That happened time and again over the course of the second half of last year. Amazingly enough even Greece, the basket case that most observers fully expect to lose the battle, has still not gone into technical default. Bond auctions among the peripheral sovereigns have had varying levels of success, but have not collapsed outright. And borrowing rates in Italy and Spain, which were the cause of so much concern in November and December last year, have eased considerably.

The barely hidden secret of the Eurozone crisis is that policymakers largely know what they could do to pull the governments and banks back from the edge of the abyss. If the US financial system were to show signs of seizing up again like it did in 2008 we have a pretty clear idea of what would happen – Ben Bernanke would flood the markets with money to stave off any liquidity crisis and enable short-term money markets to keep rolling over credit lines and printing payroll checks, and worry about the long term consequences some time down the road.

In theory those same monetary tools are available to European policymakers, but only by changing the charter of the European Central Bank and granting it decision making latitude it lacks today. And that can



only come about with the blessing of Europe's largest and strongest economy, Germany. The posture of German financial policymakers has been consistent throughout the crisis – wholesale bailouts of weaker European nations will lead to even worse consequences down the road, and must be avoided in favor of immediate austerity measures that rein in the spending problems in the troubled sovereigns. The question on the minds of many is what it will take to change this stance. Will Germany stand resolute as the currency falls apart, or will it ultimately agree to avoid this outcome at whatever cost?

We cannot emphasize enough how important the answer to that question is – it will not only determine how the Eurozone crisis plays out this year but whether economic upturns in the US and the global growth markets are able to avoid getting dragged along down the rabbit hole, or whether all bets are off.

Emerging Markets: Regaining the Momentum?

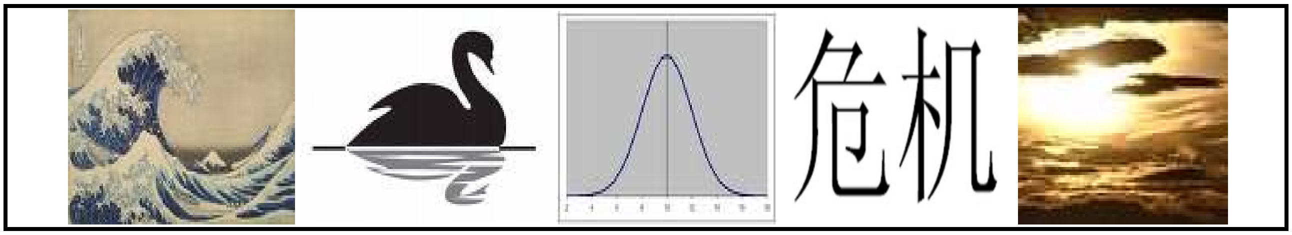
2011 necessitated a rethinking of one of the main pillars of our long term strategic outlook – that the world's growth engine economies led by China, India and Brazil would continue moving ever more solidly into the driver's seat. Market performance for those three giants ranged from very bad – losses of 18.2% and 21.6% for the MSCI China and Brazil indexes respectively – to disastrous in the case of India's 37.2% freefall. In the first couple weeks of 2012 these markets have rebounded with a generally higher prevailing risk appetite among investors – but there is a long road to go yet before the calendar closes out on this year.

The question about the growth markets – and about China, as the world's number-two economy, in particular – has been one of timing. China lacks a domestic market of consumers deep and rich enough for it to meaningfully lessen its dependence on export markets. Its long term economic strategy has been to increase national wealth through rapid growth in export-led manufacturing, to the point where more of its industrial output can be sold to domestic buyers. The percentage of China's GDP accounted for by personal consumption is around 35%, which is half the level of the US, and that would probably need to at least surpass 45% before China can start to enjoy a more self-sufficient economy. So for the time being China and other leading emerging markets are very much subject to the global forces at play: a Europe possibly headed back into recession, a US economy that is still not out of the woods and that is characterized by generally more modest levels of household spending than had been the case before the 2008 crisis, and various pockets of instability elsewhere.

Recently the World Bank issued a rather dour-sounding message to developing economies in conjunction with its own global growth forecast: take steps now to prepare for a Eurozone-led meltdown. The Bank expects global growth of 2.5% in 2012 and 3.1% in 2013 (compared to 3.6% in its forecast for both years issued six months ago); however it believes the level of uncertainty remains high enough that countries with less developed infrastructures and systems for absorbing the impact of a global freefall need to take precautions. As strong as the transition has been for the likes of China and Brazil from frontier market to global growth engine, the absence of economic strength in the more historically developed markets would make it less likely that these markets would have ready access to needed sources of capital and liquidity in the event of a significant economic contraction.

Volatility: Is There an End in Sight?

If there was one story in 2011 bigger than any other from the standpoint of investment market performance it was volatility. Market indexes set records for the number of days closed at 1% or more above or below the open, and for the number of days closed at 2% or more above or below the open, and for the number of days closed at 4% or more above or below…you get the picture. All across the country



families are tired of the whiplash experienced watching their 401(k) portfolios bounce back and forth, and the somewhat predictable result has been the withdrawal of retail money from equity and other risk asset funds. In normal times one might be inclined to attribute this to the tail-end of unsophisticated money moving to safer havens, which would be a classic buy signal. But this may very well be something else – not a cyclical move of "stupid money" at all, but rather a reasoned belief that markets are dominated by high-volume reactions to short term global macro events that have less and less to do with any notional valuation of the actual companies and cash flow outlooks that make up stock market indexes. If a person comes to the conclusion that he or she cannot make heads or tails of why markets trade the way they do, then that person is less likely to continue investing in them. The whole notion of what a stock market is changes from some general belief in the "growth of America" (or the world, or whatever) to a casino that is no less rigged than the Vegas or Atlantic City houses.

It may be that the unprecedented levels of volatility seen in 2011 will abate somewhat, especially if the Eurozone crisis avoids heading into worst-case territory. In the past couple weeks the lurches have been less pronounced – market sentiment has been generally upwards but cautiously so – we have seen gains of 0.2% or 0.5% in the S&P 500 on any given day as opposed to 4% or 5%. But we very much doubt that this is a harbinger of a general return to calm. In no small part the volatility is driven by high-frequency trading platforms whose sole reason for existence is to capitalize on short term arbitrage opportunities by executing trades just a few nanoseconds faster than competing platforms. A nanosecond – that is a thousandth of a microsecond, which in turn is a thousandth of a second.

That is the basis on which these funds compete, and it is their hair-trigger bulk trades that contribute to the wild daily price swings. In the last two weeks there have not been too many global macro X-factors percolating up to the surface – Europe has been mostly old news, the Straits of Hormuz are not (yet) being blocked and riots do not appear to be creating new havoc in public squares. Rest assured, something in this mix will change over the coming weeks and months, and it would be naïve to think that the outcome will be different in terms of volatility. This is what markets look like in a global economy that is as tightly wound and interconnected as this. The risks in this world are binary – for example either the Euro collapses or it doesn't, and the markets will react accordingly. It changes the calculations – and we have not yet come up with the tools to make sensible valuations out of these realities.

What Else Can Go Wrong?

With all that has contributed to the negative side of the ledger in the news recently, it may seem like piling on to even ask this question. Isn't there enough bad stuff to contend with already? But of course we have to ask the question, because there are other vulnerabilities in the market that have not been actualized yet. Here are some of the key issues keeping us paying attention to the news well into the night and in the early hours of the morning:

China asset prices: We still remember December 1989. That was when Japan's Nikkei 225 index hit its all-time high of just under 40,000 before settling into a long-term decline. Now, we don't want to make too big a deal of the comparison shown here below between the Nikkei's performance from its 1989 high point to the present and that of China's Shanghai Composite Index, which peaked in 2008 and is currently languishing at a bit more than one-third of that peak value. Three years do not a long term decline make, nor do we believe that 2012 China shares much in the way of economic and business fundamentals with Japan of the late 1980s.

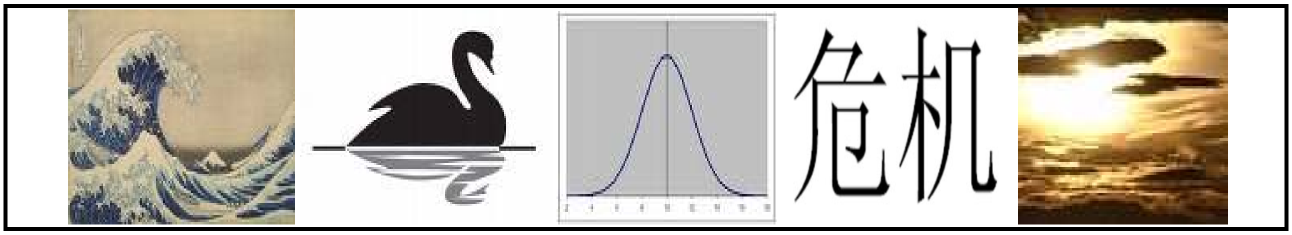
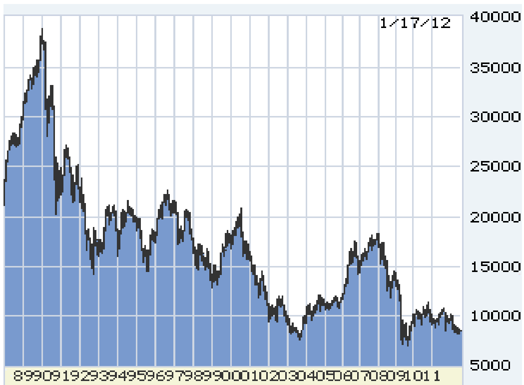


Table 3
Peak to Trough Comparison: Nikkei 225 & Shanghai Composite



Nikkei 225 1988-2012

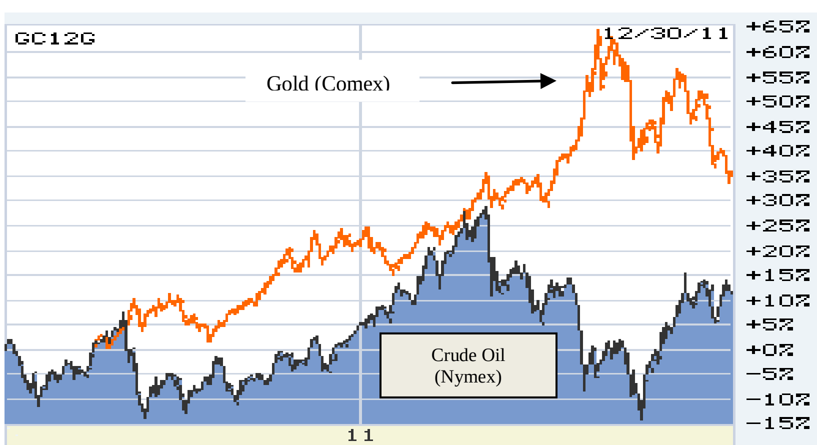
Shanghai Composite 1993-2012

Source: Wall Street Journal Online

But asset bubbles have a way of being alike even if the underlying causes are different. What the world economy does not need right now is a "hard landing" in China caused by a large pop in real estate and share prices. China is navigating its way to a comfort zone in managing to keep national wealth growing at sub-8% annual growth rates. Anything that disrupts the pace of change for the world's second-largest economy will be likely to reverberate around the world.

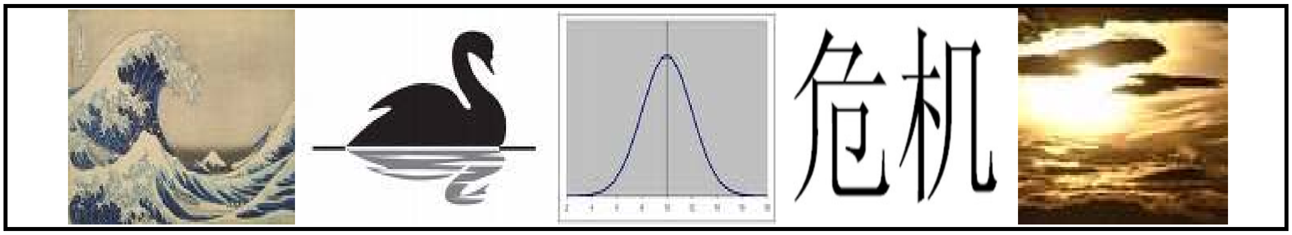
Commodities Tug of War: For pure thrills and spills you can't beat the commodities markets. There are multiple stories going on in this diverse polyglot, the Habsburg Empire of asset classes.

Table 4
Two Year Performance: Gold (Comex) versus Crude Oil (Nymex)



Source: Wall Street Journal Online

Oil prices are currently a bit more than halfway up between the low point reached in October last year and the previous high point in May. That earlier high point, you may recall, was beginning to put visible strains

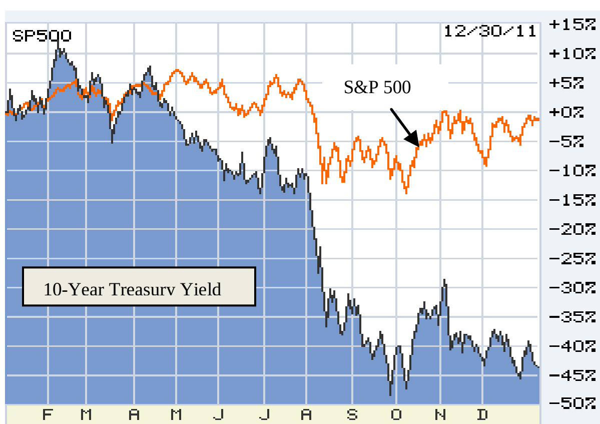


on the pace of recovery in the US, as households once again had to contend with gas prices over $4 and figure out where to cut elsewhere in the family finances. With tensions building in the Straits of Hormuz and the attendant fears of an oil blockade, the concerns on the supply side are that contractions could lead to higher prices and choke off the ability of the US economy to establish its currently firmer footing. On the demand side the picture is quite different though – demand actually dropped at the end of 2011 by 300,000 bbl/day, the first time that has happened since the depths of the 2008-09 crisis. Lower demand is due in part to a milder than usual winter, but also to Europe's economic weakness.

Gold was one of the marquee stories of 2011. As the chart above shows, gold prices sharply decoupled from oil and other commodities prices as markets headed into the turbulent second half of the year, becoming a pointed "risk off" asset. For awhile it was pretty clear-cut: if risk assets like emerging markets stocks were rallying then gold was languishing and vice versa. As the year headed to a close, that relationship seemed to break down and gold fell back to trading more like a commodity than like anything special (which it is not in an age of no gold standards).

Bond Market Conundrum Lives On: US Treasuries were the go-go securities of 2011, posting solid double-digit gains all along the intermediate to long term parts of the yield curve. At their lowest point at the end of September, yields on the 10-year Treasury note had fallen to levels last seen in the late 1940s.

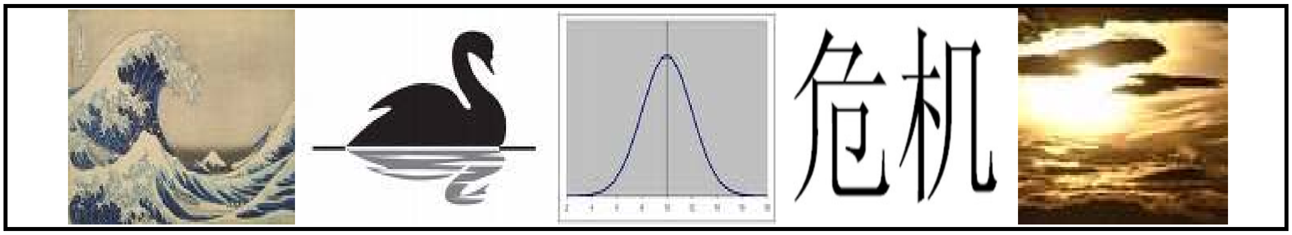
Table 5
One Year Performance: S&P 500 versus 10-year Treasury Yield



Source: Wall Street Journal Online

In hindsight the decisive factor for bond market performance in 2011 was that yields on the 10-year stood at over 3% as the year began. 3% is a low level for the 10-year on the basis of historical comparison, but it proved to be plenty high to provide a windfall to those bond investors who chose to not see the market as overvalued at the beginning of the year. The market defied the predictions of some of the most well-known bond professionals, most notably PIMCO's Bill Gross, in delivering up those racy 2011 gains.

What is interesting though, if you look at the chart above comparing the S&P 500 and the 10-year Treasury yield, is that while the S&P started a general upward trend in the middle of the 4th quarter and has continued this trend into early 2012, the 10-year yield has not risen commensurately. In other words, based on the relationship between these two assets over the course of most of last year we would expect to see rates (i.e. yields) rising as the stock market rises. Instead we see yields remaining below 2% and not too far above their September-October lows from last year. This puts a big question mark around the dynamics of the recent risk asset recovery and the extent to which investors are still hedging their bets.

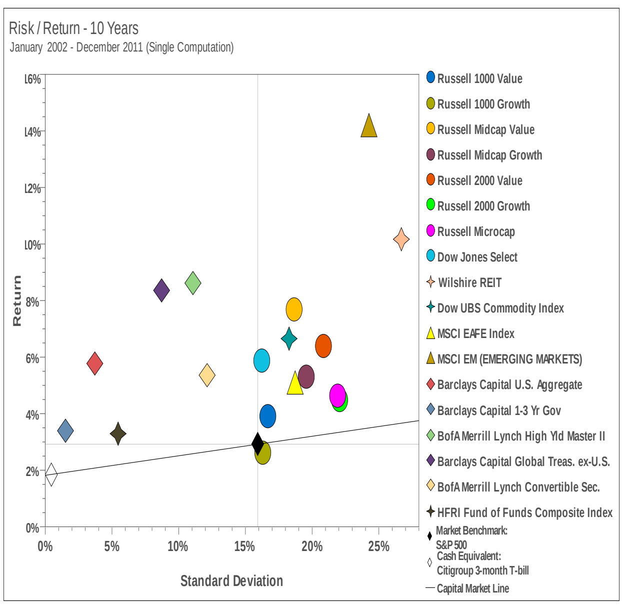


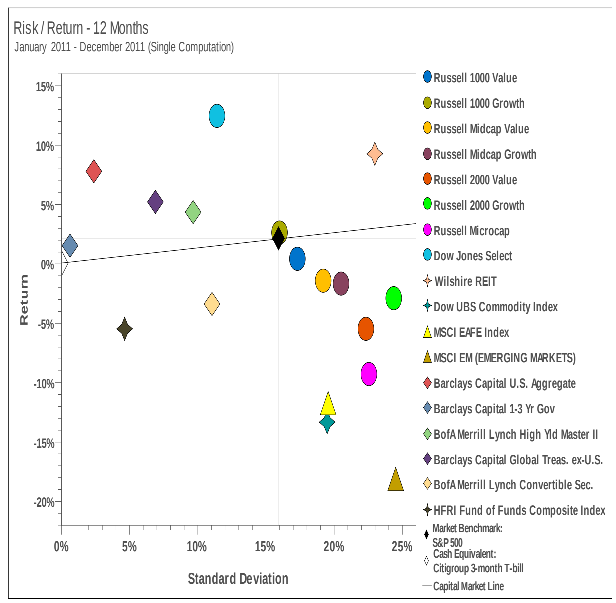
ASSET CLASS REVIEW AND OUTLOOK

The Big Picture

The theme of 2011, as we have mentioned elsewhere in this report, is that “diversification hurt”. Please refer to the two charts profiled next to each other below. The chart on the left shows the dispersion of major equities, fixed income and alternative asset classes around the anchor broad-market benchmarks of the S&P 500 for equities and the Barclays US Aggregate for fixed income over the last ten years (average annual basis). This illustrates well the advantages of diversifying a portfolio along the lines of style differentials like market capitalization and value versus growth, as well as geographic segmentation among US and non-US developed and emerging markets. On the fixed income side diversification lends itself well to classes like global bonds and high-yield corporates alongside the typically lower-volatility US investment grade corporates and government issues.

Table 6
Comparative Asset Class Performance: 10-year Average (left) and Last Twelve Months (Right)





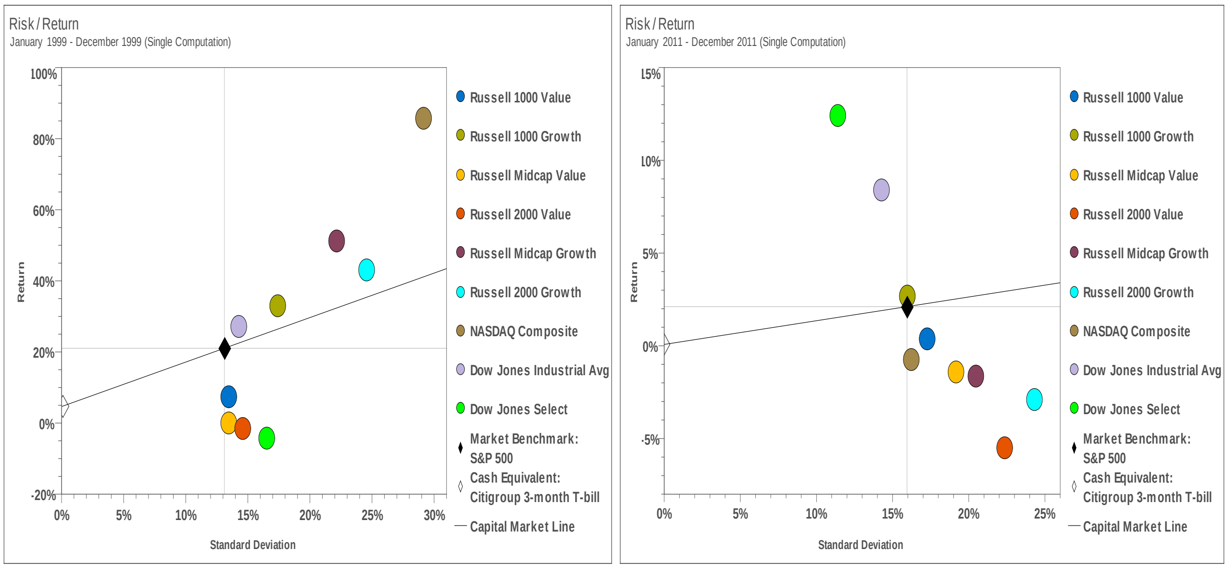
10 Years Jan 1 2002 – Dec 31 2011 **Last Twelve Months to Dec 31 2011**

Source: Zephyr & Associates LLC

The chart on the right shows the *same asset classes for the last twelve months to 12/31/11*. The anomaly of 2011 should be clear from looking at this chart. Essentially there was no diversification to be had outside two largely income-oriented risk asset classes – high dividend equities and REITs, while on the fixed income side you were either invested heavily in US Treasuries (which make up 60% of the Barclays Aggregate and account for the bulk of its performance gains) or you missed what was in fact a very narrowly constrained bull run in fixed income.

To emphasize how absent diversification benefits were from capital markets last year consider the following comparison of major equities asset classes. This time we compare the calendar year 2011 with another famous anomaly year – that of 1999. Recall that 1999 was the giddy, pre-millennial high point of the late-90s tech bubble, when the S&P 500 hit its all-time high P/E ratio and online pet stores with sock-puppet mascots commanded valuations in the hundreds of millions of dollars.

Table 7
Bookend Anomalies: Asset Class Dispersions in 1999 and 2011



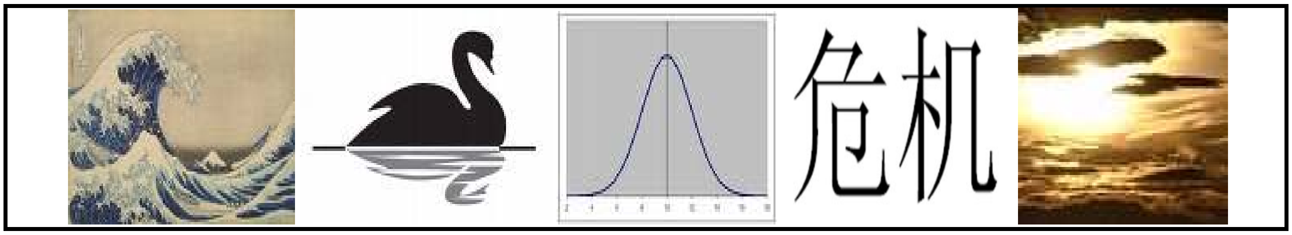
Twelve Months Jan 1 – Dec 31 1999 **Twelve Months Jan 1 – Dec 31 2011**

Source: Zephyr & Associates LLC

1999 was a bookend to 2011. Back then if you were looking for anything income-related you were fresh out of luck: all the performance at the time was in a fairly narrow segment of growth stocks – mainly technology and telecom, and most of all stocks that had listed on NASDAQ within the past several years (you can see by how much the NASDAQ index outperformed even the other growth-style indexes). Last year we saw the tables turn completely. Last year was all about income – performance gains from capital appreciation were simply not to be had anywhere. Hence the gravitation on the equities side to high-income securities like REITs and utilities stocks, while on the fixed income side even investment-grade corporate bonds with cash-rich balance sheets and virtually no default risk underperformed the can-do-no-wrong Treasuries with their safest of havens imprimatur.

Here's the thing, though. In between those two anomaly years of 1999 and 2011, diversification provided its customary benefits. In other words the normal course of action for prudent portfolio management – which is to maintain core exposures over a broad range of both appreciation-and income-oriented asset classes and to vary a percentage of the total portfolio on a more tactical basis to take advantage of more immediate capital markets opportunities – is still the right course of action.

You hear a lot of talk in the financial media these days about the "new world" of investing – how it is now a short termer's market dominated by frenetic risk on / risk off signals. We would respond to that with two observations. First, if we truly *are* in a world where the hyper-frazzled paradigm of 2011 persists for the foreseeable future then we will simply see most long-term capital move out of the market entirely, leaving the stock market to be some kind of glorified casino for insiders (which itself will not be a sustainable paradigm even for the high-frequency trading crowd parked next to the servers).



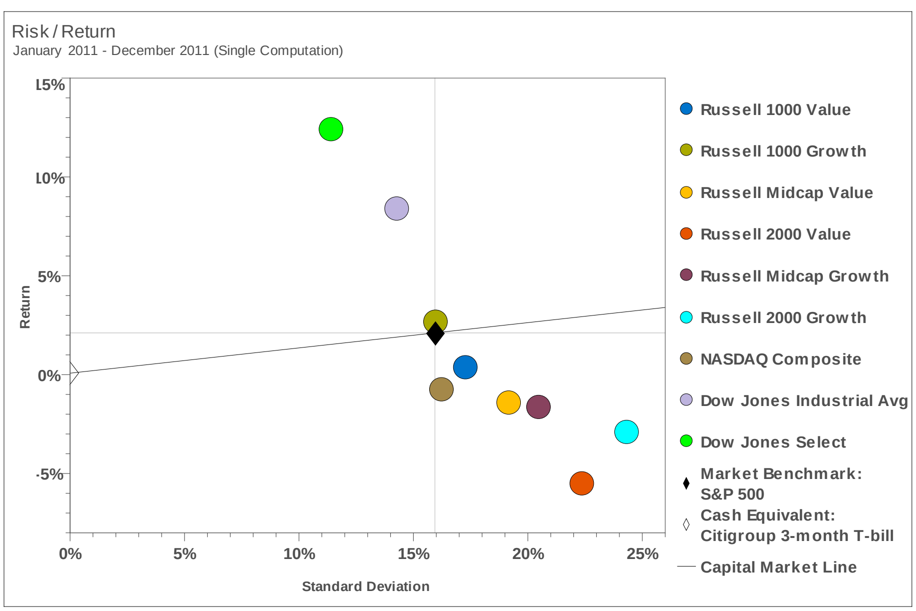
Second, remember what people were saying in early 2000. It's a new world governed by new rules, they were saying. Stratospheric sock-puppet valuations *do* make sense and income is dead. *This time it's different*, all the way from Dutch tulips to Pets.com to risk on / risk off. Except that it's not different. Maybe one day we will be wrong about this, but we do not believe that day is at hand. Look again at that 10-year average figure in Table 6 above. That – not the bookend anomalies – is what the benefits of diversification are all about.

US Equities

We at MVCM have long maintained that we hold a value bias, meaning that over the long term we believe that value stocks will demonstrate better performance than growth stocks. As sensible as we believe that to be for a long-term strategic position, we also need to address intermediate-term situations where broad value indexes like the Russell 1000 Value are challenged by capital markets conditions. The problem with value indexes, in particular large cap value indexes, in today's environment is that they typically have a heavy weighting towards financial institutions. Financial institutions have been the poster-child sector for those wild intraday mood swings, since investors basically use this sector as a proxy for how they feel about Europe and the other financial trouble spots around the world.

Over the past year we began to establish a more formalized, deliberate set of weightings around income-oriented equities classes. This includes general (mostly non-financial) high dividend stocks, master limited partnerships, and utilities as well as the REITs that we traditionally allocate to our alternative investment category. Income-oriented equities will tend to provide something of a hedge position during high-volatility periods. In strong bull rallies income stocks will tend to lag other classes like small caps or emerging markets, but they will still tend to participate at least somewhat in the upside. This is consistent with our intermediate term outlook: that sustained directional bull or bear trends are less likely than is the continuation of choppy volatility with shorter directional cycles.

Table 8
US Equities Asset Class Dispersion Last Twelve Months to Dec 31 2011



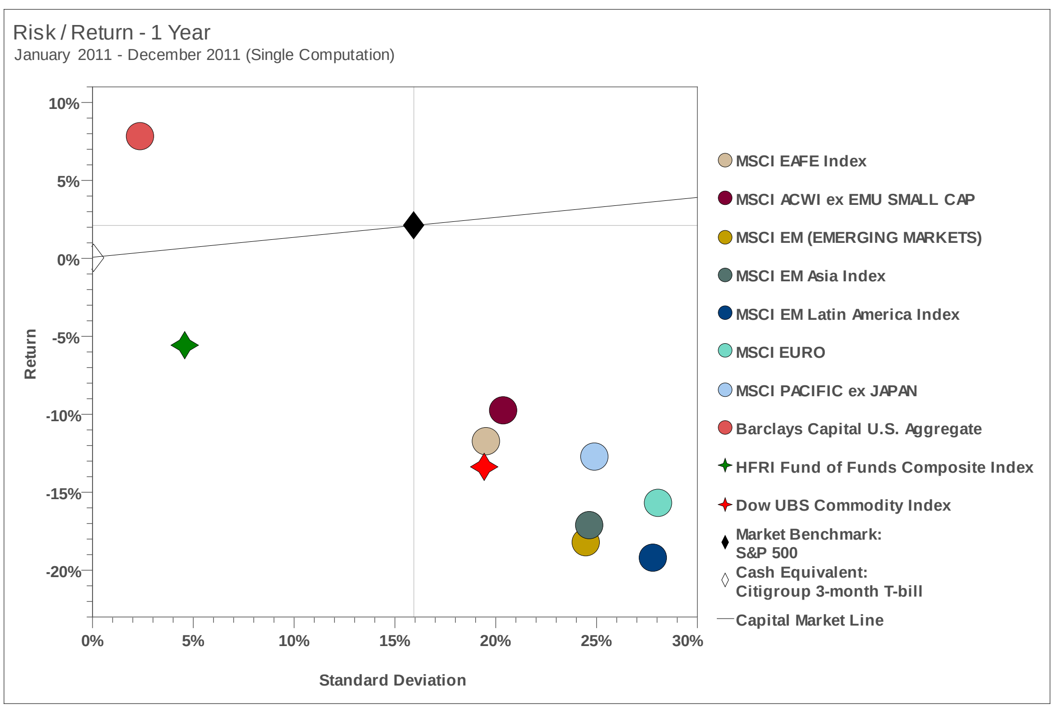
Source: Zephyr & Associates LLC

Again, note the absence of any kind of diversification benefit among US equities apart from the income sector (represented here by the DJ Select Dividends Index) and the highly concentrated Dow Jones Industrial Average. As we discuss in more detail above, we consider this to be a highly anomalous result and not one we believe has a high likelihood of playing out over a sustained intermediate period.

Non-US Equities

Non-US equities turned out to be the ultimate bane of diversified portfolios in 2011. The year started off well for European equities, with the peripheral problem cases of Greece, Spain, Portugal, *et al l*eading the way into mid-25% returns by the end of the first quarter. But the Eurozone crisis caught up with the stock market, and by year-end country indexes all across Europe were in the negative double digits. On the other hand, emerging markets started the year off on the wrong foot, with stalwarts like India and Chile leading the way down. They were in a somewhat tentative recovery before being engulfed by the European crisis and the volatility that kicked in for good by midsummer. No region was spared – the gulf between the S&P 500 and just about every regional index – and most country indexes – looked as it does for the selected exposures represented in the chart below.

Table 9
Risk and Return Metrics for Selected Non-US Regions, Last Twelve Months to 12/31/11



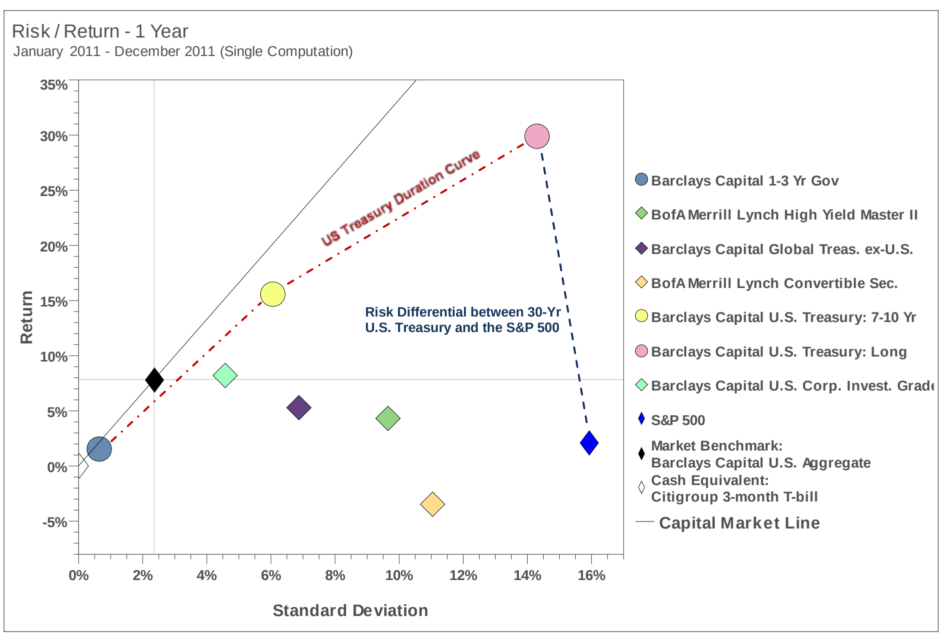
Source: Zephyr & Associates LLC

The emerging markets performance may prove to be more cyclical, and therefore less drawn out, than the more deep-rooted European situation. Whether or not the immediate dangers of the financial crisis are solved within the next twelve months, there are some long-term consequences that will most likely play out over years to come. In the long run there will be winners in the EU – it would not take too much clairvoyance to make the case for going long Germany – but the path to whatever new structure emerges may be long and twisted. Growth engine and frontier economies will be impacted by this – the EU is by some measures the most important trading partner with many of these nations – but the near-term performance of emerging markets equities probably depends more on whether the nascent US recovery can maintain itself with enough strength to keep global growth on a strong positive trajectory. Firmness in the US and particularly as reflected by US corporate earnings (much of which earnings are sourced from their activities in Bangalore, Beijing and the like) may provide a tailwind for a cyclical rebound for emerging markets this year.

Fixed Income

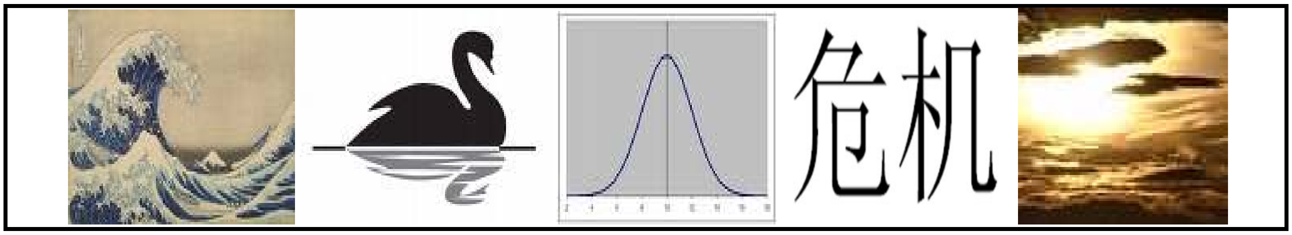
US Treasury securities were the Asset Class Gone Wild in 2011. The chart below shows the performance of the 1-3 year, 7-10 year and 30-year Treasury maturity bands (connected by the dotted crimson line). As was the case with equities, the fixed income category did not provide much opportunity for meaningful diversification – it was Treasuries or nothing. The interesting thing to note about this dynamic is that, when considered analytically, US corporate investment grade bonds could have been seen as a safer haven than Treasuries. The asset class showed less volatility, as seen in the chart below, and high-rated US companies currently have record low levels of debt, strong cash balances and extremely low chances of defaulting. Yet investors did not swarm in huddled masses to high-grade corporates when the seas raged – they went back to Old Faithful. This, in spite of the fact that 2011 was the Year of the Downgrade, when the full faith and credit of the US government was pronounced to be less than what it had been ever since the rating agencies began applying their imprimatur.

Table 10
Dispersion of Fixed Income Asset Classes Last Twelve Months to 12/31/11



Source: Zephyr & Associates LLC

We were decidedly unenthusiastic about fixed income in general and Treasuries in particular at the beginning of the year – and that certainly impacted the performance of our portfolios. At the outset of 2012 we continue to see no particularly good reason to view this asset class with favor. It is worth noting that while 2011 began with 10-year Treasury yields above 3% (which as our earlier chart in this report shows to be historically low in and of itself), this year they are ringing in the new with yields below 2% and

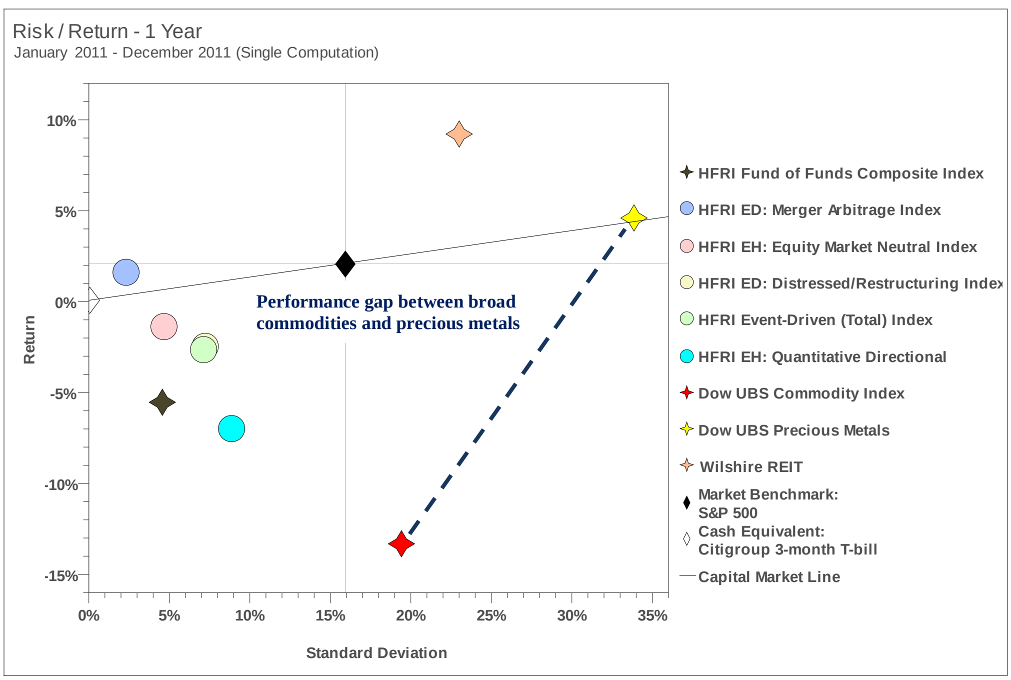


not too far away from those 1940s-era lows they hit back in the fall. If some form of a worst-case scenario plays out then this calculus changes, but as it stands we are looking for performance in US corporates, high yield and elsewhere as more likely contributors to our fixed income portfolio returns this year.

Alternatives

Wall Street Masters of the Universe were not in the pantheon of popularity in the Year of the 99%. All the more embarrassing for the 2/20 Crowd (i.e. those who charge 2% management fees and 20% "performance" fees) that the HFRI Fund of Funds Composite index, which reflects an average of actual fund-of-funds performance returns, was down by (5.5%) for the year. At least investors didn't have to pay for performance, because there was none to speak of…in any event, the low-volatility alternatives that have been useful in many market environments, either as a hedge against equities or as an alternative source of low volatility performance from fixed income, accomplished neither.

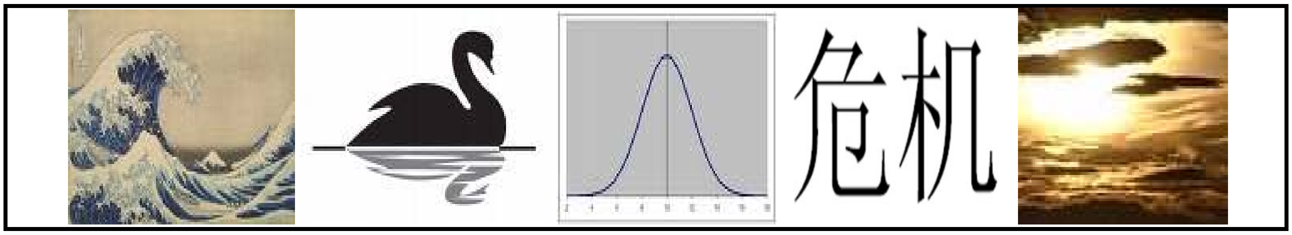
Table 11
Dispersion of Alternative Asset Classes Last Twelve Months to 12/31/11



Source: Zephyr & Associates LLC

We have seen a near-complete erosion of the traditional low-correlation benefits that commodities have provided. There are a number of reasons for this shift, but in our opinion the main one most likely has to do with trading habits. Commodities are a "risk on" asset (except when gold is taking on its *alter ego* guise as a safe haven). They trade risk-on when equities do and vice versa. Also, the rise of ETFs has made commodities more widely available as an asset class. It used to be that commodities futures were the province of large institutions. Now it takes no more than a fistful of dollars and an online trading account. That has driven correlations to converge to the levels we see here.

Alternative assets are a key component of our long term diversification approach – but we will intersperse use of alternatives with other equities and fixed income exposures for a more holistic exposure basis.



SUMMARY OF KEY POINTS

- 2011 was an anomaly year in which diversification hurt – you were better off being in the S&P 500 and the Barclays Aggregate than in any diverse mix of styles, geographies and themes. We believe it is unlikely this anomaly will become a permanent part of the landscape, any more than 1999 became any kind of permanent paradigm after the dot-com collapse.

- In equities we believe that the US will continue to offer more relative value as it is on much firmer footing than Europe. However downside risks remain present – the pace of growth is still below 3% and the US will suffer if a worst-case scenario unfolds in Europe. We continue to favor the income-oriented sectors that have done well lately but remain positioned for tactical shifts if we see stronger-than-expected upside taking shape.

- Europe's problems are structural and markets there will likely continue to keep world markets at higher levels of volatility. We tend to think that European policymakers will at least figure out how to prevent a meltdown of the single currency in 2012, though we are not optimistic for much more. Time may be an ally. For non-US equities we would see a higher likelihood for growth/emerging markets to outperform non-US developed markets on the basis of more cyclical rather than structural factors.

- With the 10-year Treasury note yielding under 2% at the year's outset we see value coming from other sectors of the fixed income market. US corporate investment grade and high yield bonds should benefit from a more rational re-assessment of relative quality, as US companies' balances sheets are cash-rich with low relative debt levels.

- Correlation convergence has impacted the traditional role of commodities and other alternative assets. While they remain a part of our long term asset arsenal we will use them more judiciously in conjunction with other equity and fixed income assets to refine risk positioning.

- Overall we retain a defensive stance in the face of continued large-scale challenges. Our base-case outlook is cautiously optimistic and depends largely on a non-worst case evolution in Europe. Given the overall tenor of fragility we remain poised with flexible tactics to move into either a still-more defensive position or a more aggressive long position should conditions materially change over the course of the year.

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