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January 2012

Portfolio Commentary

Remarkably, after all of the volatility witnessed throughout 2011, the S&P 500 index ended the year exactly where it started, with its 2% return coming from dividends. Smaller- and mid-cap stocks closed the year down 4.2% and 1.7%, respectively, despite also posting double-digit fourth-quarter gains.

The turmoil in Europe dragged foreign stocks down 11.8%, based on the MSCI World ex USA Index. Continued concern over global growth along with periodic flights to quality drove emerging-markets equities sharply lower; they ended 2011 down 18.8%.

High-quality bonds were on the other side of the risk-on/risk-off volatility, with sharp flight-to-safety rallies that helped net the Vanguard Total Bond Market Index a 7.6% full-year gain. International bonds returned 6.3% in 2011, while emerging-markets bonds, which are perceived as riskier, lost 1.7%. Floating-rate loans finished the year up 1.5%.

December Benchmark Returns (Preliminary)

Large-Cap Benchmarks	**Dec**	**4Q**	**YTD**
Vanguard 500 Index	1.0%	11.8%	2.0%
Russell 1000 (iShares)	0.8%	11.8%	1.4%
Russell 1000 Growth (iShares)	-0.3%	10.5%	2.5%
Russell 1000 Value (iShares)	2.0%	13.0%	0.2%
Mid-Cap Benchmarks			
Russell Midcap (iShares)	-0.1%	12.3%	-1.7%
Russell Midcap Growth (iShares)	-1.5%	11.2%	-1.8%
Russell Midcap Value (iShares)	1.2%	13.3%	-1.6%
Small-Cap Benchmarks			
Russell 2000 (iShares)	0.7%	15.4%	-4.2%
Russell 2000 Growth (iShares)	-0.2%	15.0%	-2.9%
Russell 2000 Value (iShares)	1.5%	15.9%	-5.6%
Other Benchmarks			
Vanguard Total Int'l Stock Index	-2.6%	4.2%	-14.6%
MSCI World ex USA Index	-1.1%	3.6%	-11.8%
Vanguard Emerging Mkt Stock Index	-3.3%	6.0%	-18.8%
Vanguard REIT Index	4.6%	15.2%	8.4%
Vanguard Total Bond Mkt Index	1.1%	0.9%	7.6%
Merrill U.S. High Yield Cash Pay	2.5%	6.2%	4.5%
Barclays 7 Yr Muni Bond Index	2.1%	2.8%	10.2%
S&P/LSTA Leverage Loan Index	0.5%	2.9%	1.5%
Citigroup World Govt. Bond Index	0.9%	-0.1%	6.3%
JPMorgan GBI-EM Global Div. Index	-1.5%	0.5%	-1.7%
DJ-UBSCI (Commodity Futures)	-3.7%	0.3%	-13.3%

As the media saturates us with political coverage that will only grow over the coming year, we can relate to the grind a politician faces in staying on message for an extended duration. Our message is not positive enough to get us elected to any office, but we hope it will earn us respect for intellectual honesty and well-reasoned decision making amidst an environment that we expect to be a far longer grind than that of a presidential election year.

The grind we are dealing with—and the same message we've been delivering since 2008—is that the developed world took on massive and unsustainable levels of debt that in all likelihood will take a decade or more to fully unwind. This will reduce economic growth below the levels we had come to think of as normal; levels which themselves became distorted upward based on the spending of all this borrowed money. As that debt is reduced going forward, there will be less money available to spend.

Another way that debt is reduced is through defaults, and this leads us to the reiteration of another very important point, which is that the risk of defaults—such as in Europe—poses a significant threat to the financial system, and in turn to the global economy. Very briefly, investors are afraid that Europe lacks the political unity and possibly even the financial capacity required to provide a sufficient financial backstop for the euro zone. That increases the risk of weaker governments defaulting on their debt, which makes investors demand higher yields for taking on that risk. Those higher yields contribute to a feedback loop that makes a default even more likely, because governments can't sustain interest payments above a certain level, so only some type of unified policy action and intervention can allow governments to roll over all the debt that is coming due.

It is possible that EU policymakers will fail to address the crisis before major economic damage occurs. The biggest concern is that the euro zone itself unravels, with impending government defaults triggering a financial crisis as banks that hold huge amounts of now-devalued debt no longer have sufficient capital to remain solvent. This would lead to a significant reduction in lending and economic activity and impact the rest of the globe as well—making a global recession likely and in a very bad outcome a depression in Europe or even globally can't be ruled out.

These are the reasons our message remains a sober one as we ring in the New Year and explains our continued underweight to stocks. Staying true to our commitment to deliver a message that is apolitical in its honesty demands we make another important point. No matter how self-servingly confident anyone comes across about how things are going to play out, the truth is that no one (ourselves obviously included) can predict complex macro outcomes with any certainty, and this is especially true given the huge number of variables at play today. Confident predictions may make you more "electable" with your constituents, but honest investors base their decisions on realistic analysis that accepts that some aspects and time frames relating to the overall environment can be analyzed with confidence and some cannot. We build portfolios that take these many tradeoffs into account, and it is important that clients understand the limitations of the decisions we make and where their own decisions are required.

For clients who want (or need) to emphasize protecting capital in the event of a very negative scenario playing out, it is important to choose an appropriately conservative strategy. In fact we have reduced risk by a greater amount in our more conservative strategies because we believe that capital preservation is more important to clients in these strategies. That same client has to also understand how they will feel if a bad outcome doesn't happen. By choosing a more conservative strategy they will have missed a chance for greater returns and may feel regret. Toward the other end of the spectrum, clients with long time horizons can take some comfort in knowing that even if we see a sharp short-term decline, our analysis gives us confidence that over 10 years and beyond they will earn better returns in our more aggressive strategies, *provided they don't bail out if we do see a sharp decline*.

Overall, our decision to reduce risk across our balanced strategies means that we could —perhaps for several years—underperform our benchmarks in some scenarios. For example, if European authorities are able to coordinate on action that effectively takes away the perceived risk of larger countries' defaulting, we could see a strong rally in stocks, and if the U.S. economy surprises further on the upside the rally could be even stronger. It's even possible that there's enough positive feedback in the global economy that our optimistic scenario of a return to pre-debt-crisis levels of growth plays out. In these outcomes we wouldn't look as good for a period of time as we would have by maintaining a more aggressive investment position.

So Where Are We? Our Portfolio Strategy

In the 18 years since our firm was founded we have managed through many challenging environments. However, none has been more challenging than the recent financial crisis and the aftermath that continues. In order to assess opportunities and risks across asset classes, we consider many factors and analyze a wide range of possible outcomes and their odds of happening. Our investment approach has been to invest somewhat defensively but not overly so. A short-term market surge could lead us to reduce stock exposure. Conversely, a market dive could cause us to increase stock exposure.

Given our outlook it is fair to ask why we are not more defensive. It comes down to our lack of confidence in knowing exactly how things will play out, and our high level of confidence in the investment process and research we use to make decisions. Here are some of the important aspects of that process that influence our investment positioning.

First, our stress tests indicate that, as currently positioned, if we saw a 25% to 30% drop for stocks over a one-year period, we would violate our risk thresholds by only a small amount in our various balanced portfolios. Over less than a year, the losses could be much worse at the market trough before stocks snap back and fixed-income investments earn a full year of interest. Remember that our risk management is based on one year, not shorter periods. So, from a risk management standpoint we believe our balanced portfolios are in the ballpark of where they should be even in a very negative environment. We have to point out, though, that there is no guarantee that it could not be worse—we've given careful thought to this but our assumptions could prove not to be sufficiently negative.

Second, as positioned we believe that over five years our portfolios can do reasonably well in our base-case, slow-growth scenario. But, it would likely be a scary ride with some periods as bad as or worse than what we experienced at times in 2011, when risk assets suffered sharp short-term price declines. There would also probably be temporary market surges where our portfolios would lag.

The process of choosing the correct portfolio for each client must include the consideration of two questions. First, if the worst case occurs, is it tolerable—e.g., will investors be able to stay in the portfolio they are currently in? The worst thing would be to ride markets down and then get more defensive as we approach a bottom, because from that point forward the upside will be huge.

Second, if after remembering what past periods of extreme fear felt like, the investor concludes they cannot tolerate a worst-case scenario, then are they also able to live with the forgone return that a conservative portfolio would experience (opportunity cost) if a bad scenario does not occur? Ultimately, these are questions that clients must answer with assistance from their advisor—the answer will determine the appropriate strategy.

The specifics of our current positioning in terms of stocks, bonds, and alternatives are as follows:

Equity-Type Risk (Underweighted):

- We are building up emerging-markets equity exposure because we believe there is a strong case to be made that over five years this asset class will offer the highest returns regardless of which scenario plays out (but short-term risk can be high).
- We also hold positions in emerging-markets local-currency debt, funded from a reduction in equities, as an asset class we believe can generate high single-digit returns in a subpar growth

environment and would likely significantly outperform equities over five years in the deflation scenario.
- Developed market equities (domestic and foreign) are diversified across thousands of stocks with exposure to large, mid, and small caps.

Fixed-Income:

- The core holdings are intended to be conservative and provide diversification for our equity exposure.
- A portion of our portfolio is invested in funds that take credit risk (Loomis Sayles Bond, and floating-rate loan funds). These funds will almost surely underperform in a meltdown but we expect them to generate the highest returns over five years.
- We are not concerned about inflation risk over the near term (deflation is the greater risk) but it is a concern in the later years of our time horizon.

Alternative-Investment Exposure:

- We hold a dedicated hedge position via Gateway Fund. We believe this is likely to generate mid-single-digit returns over our investment time horizon with relatively low risk over one-year periods. This is an attractive way to have some dry powder that is not subject to fixed-income interest-rate risk and can provide better returns than what we expect to capture in core fixed-income funds (unless the worst case plays out).

What is Our Job?

This is an important question especially in times where economic and investment complexity is high with a wide range of possible outcomes. Our answer is that our job is to:

1. Understand each client's long-term investment goals and shorter-term risk tolerance
2. Understand each client's investor psychology and other factors that might impact their investment experience
3. Manage a portfolio that is consistent with the above, if possible; if we are not the right match for a potential client, help them find an alternative
4. Use our process and research discipline to deal with the high level of uncertainty that comes with investing, assess the possible outcomes and their odds, and make decisions that balance risk and return relative to the client's objectives
5. Educate the client so that they understand the thinking behind our decisions and the risks and rewards of various courses of action
6. Match our benchmarks over the long term when we can do so without compromising clients' objectives; sometimes these goals will be at odds, such as when lower-probability but highly damaging outcomes must be taken into account with our portfolios
7. Help provide context to assess how we should be evaluated

The last point is a tricky one because we obviously have a huge conflict of interest when it comes to how our work should be evaluated. But, the desire to want to focus a report card on one metric—such as how we did relative to an index—is overly simplistic and we believe this is especially true in today's environment where a wide range of outcomes is possible. We are making decisions with the expectation that we are in a long period of debt deleveraging during which we expect to be subject to high risk.

Whether we have done a good job may not be known for five years or more. For example, if we invest aggressively and the optimistic scenario plays out we would look very smart. But, would we really be smart to take that risk? And, if we are rewarded over the next year for such a gamble, does that mean we will be consistently rewarded longer term for taking those kinds of risks? We think not.

In the late 1990s we didn't look smart by underweighting technology stocks and we performed poorly relative to benchmarks for a while. But, eventually our decision was rewarded with performance that more than made up for the prior underperformance. When the bubble burst, our Equity portfolios held up much better than the market, declining 15% over the three years from 2000 to 2002 compared to a 38% loss for the S&P 500 (our Balanced and Equity-Tilted Balanced portfolios did much better, losing 2% and 8%, respectively). However, before the collapse, our limited tech exposure and subsequent underperformance versus the market benchmark caused us to lose more clients in an 18-month period than we'd lost in the entire preceding 10-year period.

We believe accountability based on relative performance is important and necessary, but more context is required. Absolute performance measurements are part of this context, as is the appropriate time horizon for evaluation and an understanding of the risks that are taken and avoided. Risks avoided are particularly important because though some risks may not come to pass, no investment manager can forecast the future with certainty. Meeting clients' needs is also an important part of assessing an investment manager's decisions and performance. Some clients invest in more conservative strategies because capital preservation is an important goal and, in our case, we give more weight to protecting capital in high-risk environments. This can cost us relative performance, or even clients, but our job is to base decisions on what we believe is best for clients. Over the long term, what we expect of any manager and of ourselves in a world that is inherently uncertain is that a strong commitment to intellectual honesty, thorough research, a disciplined process, and clients' interests is the best predictor of long-term success.

To summarize, we accept the risk of trailing under some scenarios for a number of reasons. First, while the odds of a very negative scenario playing out are relatively low, its effects would be highly damaging. Second, our most-likely scenario involves no crisis but slow growth for many years, and periods of high volatility that create opportunities to add back stocks at more attractive prices. Third, our process and the decisions that result reflect our commitment to thorough research, intellectual honesty, and discipline, and we believe this kind of process has the best *long-term* likelihood of success. Finally, although some might conclude we are wrong if these risks don't happen, is our job is to make decisions that we believe best serve our clients, not our business. One of our long term principles has been to manage money for the downside as much as for the upside. And, we're sticking to that.

We appreciate your continued confidence. If you have any questions, please don't hesitate to contact us.

Best regards,

Align Wealth Management