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Investment Commentary 4th Quarter 2011

Below you will find our investment commentary for the most recent quarter. I hope you find it informative and will consider our investment services in the future. If you have any questions or concerns about the market or your investment portfolio, please call Patty or Susan in our office to schedule a meeting or conference call.

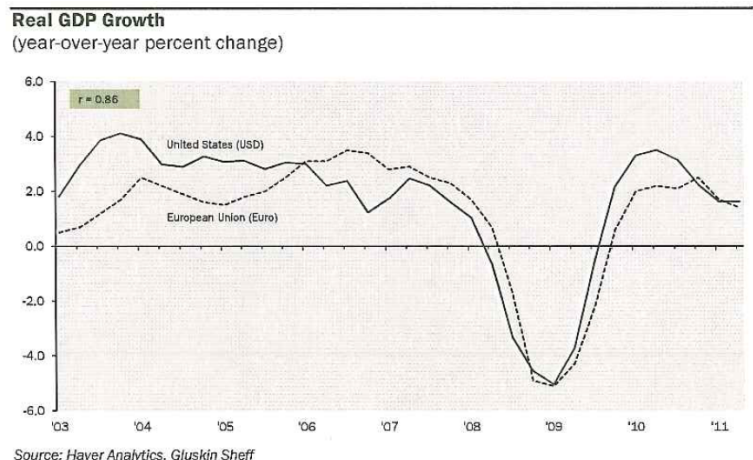
Economic Review & Outlook

As we close the books on 2011, most investors probably assume it was a bad year for the economy. Reflecting back on 2011 shows us that both fiscal and monetary policy remained extremely accommodative throughout the year. Interest rates finished near record lows in December, the unemployment rate is still well above average, housing prices continue to fall and the European economic situation shows no signs of abating. Had you forecast all of these accurately, you would have been hard pressed to predict GDP in the US would have improved all four quarters of 2011, but that is exactly what happened. Assuming Q4 GDP forecasts are accurate at 2.8%, this will mark the fourth consecutive quarterly increase in GDP. This sequential growth in GDP is hardly the hallmark of an economy many are characterizing as “doomed” or even “fragile”. Instead the resilience of the American consumer continues to surprise, evident by retail sales climbing 3.8% in November and December, versus year ago figures.

While the economic data has been improving as of late, it would be irresponsible not to mention some of the contributing factors outside of a resilient consumer that are also supporting economic growth, namely government intervention. Short term fiscal and monetary policy initiatives such as the payroll tax cut, extension of the Bush tax cuts, increased expensing elections, extended unemployment benefits, Quantitative Easing (1 and 2), Operation Twist, etc. have all gone a long way to aid the economy over the past three years. Unfortunately, every time the government has tried to end or reduce one of the aforementioned stimulus programs the economy has showed signs of slowing. In both 2010 and 2011, the economy experienced what some referred to as the summer doldrums, both of which were preceded by the ending of Quantitative Easing. We see little on the horizon to suggest this trend will reverse in 2012 and the longer the economy remains dependent upon government support, the harder it will be to ultimately remove that support.

The chart to the right shows the year-over-year percent change in GDP of the European Union and the United States.

As you can see, the two economies are joined at the hip, which is to say as goes Europe, so goes the United States. Statisticians have many ways to calculate how strong a relationship is between two sets of data. The most commonly used statistic is referred to as the R-Squared. In this case, R equals the correlation coefficient which you can see from the chart is 0.86. If you square this number, it creates a statistic used to determine how much the movement of one set of variables can be explained by the other. The R-Squared between the US and Euro economies is 74%, which is to say the change in GDP of either of these economies will determine 74% of the change in the other economy. So keeping an eye on Europe will be extremely important in 2012, because if a recession takes place on the continent, it almost certainly will drag the US down with it.



As we enter 2012, our forecast for the economy is below that of the consensus economic forecast which is predicting GDP to accelerate from 1.7% in 2011 to 2.3% in 2012. The risks to the consensus estimate are to the downside, due to our forecast of contracting profit margins contributing to slower profit growth, escalating political rhetoric leading to negative changes in tax policies and renewed European economic problems. Accordingly, organic economic growth will remain elusive throughout 2012. With “Operation Twist” scheduled to end in June (the same time the Presidential election will be heating up), both fiscal and monetary policy will likely be rendered impotent. Few politicians are going to support dramatic fiscal policy changes in the middle of an election and historically, the Federal Reserve has remained mute as elections approach. Those both may occur at a time when the economy loses much of the stimulus we previously discussed. If it results in pushing stock prices lower during the summer months for the third consecutive year, recession fears are likely to once again be hot topic throughout 2012.



Bond Market Review & Outlook

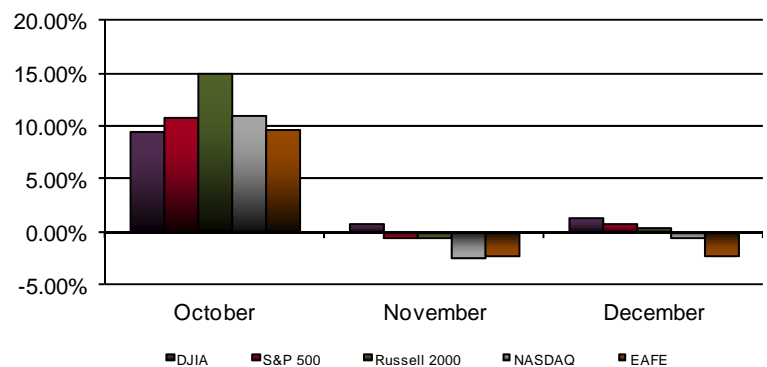
Despite a near universal prediction that interest rates would rise in 2011, markets found a way to make the majority of highly paid economic forecasters look incompetent. Not only did interest rates fall, but they fell so precipitously that long term U.S. Treasury bonds were the big winners in 2011 delivering a gain of 34% to investors. This pales in comparison to the more traditional bond indices, such as the Barclays Aggregate Index, which returned just under 8%. Obviously both exceeded returns of the stock market by a wide margin, but as you can see, which bond market sectors you invested in had a huge impact on your overall return. In fact, some of the most highly recommended bond fund sectors such as bank loans, short term bonds, emerging market debt all delivered gains, but none of them exceeded 2% in 2011. The outperformance by U.S. Treasuries caught nearly everyone off guard, evident by the difference in the category average for intermediate term bond funds lagging by more than 2% for the year. All together only 9% of intermediate term bond funds beat the Barclays Aggregate Index according to Morningstar. The broad based underperformance was a contributing factor to lackluster returns by many of our bond funds. Additionally, the interest rate hedge we initiated during much of 2011 was detrimental to individual account performance.

As we peer into the New Year to see what the crystal ball forecasts for 2012, not surprisingly estimates are for interest rates to rise once again. According to a Wall Street Journal survey of 54 economists, the interest rate on the benchmark 10 Year U.S Treasury Note will rise to 2.75% by the end of 2012. This will mark a near 1% rise from where it closed 2011 at 1.87%. If this were to happen, long term Treasuries would lose 12-18% of their value as the drop in price would be dramatic, relative to the coupon payment. It should be no surprise that given this forecast, most bond managers remain heavily underweight long term U.S. Treasuries. We too remain underweight these issues, but this is not to say we are completely avoiding them. As discussed in our economic outlook, real organic growth will likely remain difficult to achieve in 2012. Additionally, the European debt crisis has not been resolved by a long shot and undoubtedly will flare up again in the months ahead. These two factors should continue to support low long term interest rates. Although lower rates may be difficult to achieve, we don't anticipate as much of a move higher in rates as the average economist. The one caveat to this forecast is a possible change in the credit profile of the United States. We already received a debt downgrade from S&P last year, the first in our country's history. Ironically, despite the downgrade the European situation is actually boosting the demand for our debt, as investors look for anything they deem a safe haven to park money. However, if politicians continue to minimize the gravity of getting our fiscal house in order, or the Federal Reserve finally goes too far with its monetary policy tools, interest rates may begin to climb. If these events begin to unfold, we will reevaluate our fixed income investments and make changes accordingly. At the present time, we remain very comfortable purchasing all types of corporate bonds (especially high yield), mortgage backed securities, emerging market debt and TIPS. Should economic conditions closely track 2011, it is very likely that many segments of the bond market will outperform the stock market and with much less volatility.

Stock Market Review & Outlook

The stock market delivered a noticeable pop in the fourth quarter. Unfortunately, as you can see from the chart the champagne glass was almost completely empty by the time we ushered in the New Year, as the gains were nearly all realized in October. All indices rose during the quarter, led by the small cap Russell 2000 up 15.0%. Large caps held their own with the blue chip DJIA rising 12.0% and the broader based S&P 500 up 11.2%. Tech shares fared very well during the quarter as the NASDAQ tacked on 7.9%. Finally, international stocks closed the year on a winning note up 4.9% during the quarter, but as you can see they limped to the finish line in November and December. For the year, the S&P 500 actually had a point change that was undoubtedly the smallest in history. It opened the year at 1,257.64 and closed the year at 1,257.60. So in 2011, investors were treated to a whole lot of volatility and nothing more than a dividend payment to show for it. While at first glance this anemic investment performance may leave investors feeling as though 2011 was a bad year, however investors with fixed income securities in their portfolio likely managed to eke out a small gain. It is also very interesting to note that while U.S. investors may be a bit disappointed with the returns in 2011, investors in most other countries would gladly switch places. According to the Bespoke Group, the U.S. was the best performing developed country in the world in 2011. The average developed country stock market fell 13%, while emerging markets fell 18%. Fortunately, large cap U.S. equities represented the largest component of our client's equity investments, helping to minimize our client losses. As we enter 2012, we are keeping this overweight allocation to large cap U.S. stocks intact.

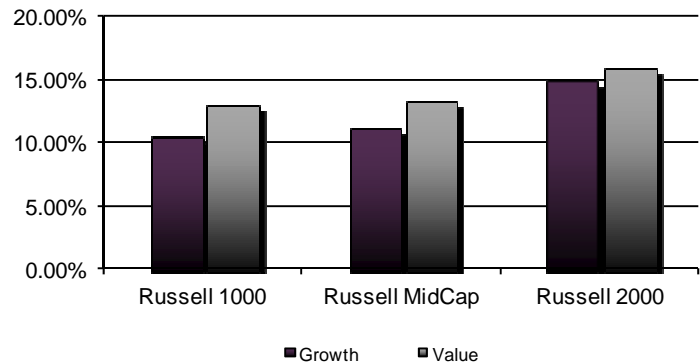
4th Quarter Index Performance



For the quarter, value trumped growth and small caps beat large caps, but for the year the exact opposite was the case. When we look back at our forecast for 2011 in our previous year end letter, we did in fact anticipate growth stocks would lead and large caps would outperform. Although the road may have been bumpy along the way, record earnings growth and profit margins helped growth stocks deliver solid gains, while troubling macroeconomic events throughout the world resulted in investors focusing on safer, more established names. While the prospects for stocks in 2012 doesn't appear to be materially different than 2011, we do have a slight change in our forecast. We still predict large cap strategies will outperform, as investors remain cautious throughout the year and valuations remain compelling relative to small caps. However when it comes to

investment style, value names are where we plan to concentrate our stock picks in 2012. Earnings forecasts are likely still too high in an environment heavily dependent upon government aid. Government transfer payments (food stamps, welfare, etc.) currently represent the highest percent of GDP in our country's history, so it's no wonder the political landscape is so polarized around entitlements versus taxes. Consider, the annual deficit in the U.S. now stands at \$1.3 trillion versus just under \$250 billion at the end of 2008. In 2009, nominal GDP fell to \$13.9 trillion as the credit crisis delivered the most devastating blow to our economy since the Great Depression. The reaction from our government was to spend more money, which we didn't have, by increasing our borrowing. This has resulted in an annual deficit now over \$1 trillion larger than before the crisis started. Over that same period of time, GDP has increased by less than \$700 million annually, illustrating just how poorly of a job the government does when it comes to growing the economy. Until real free market, capitalistic principals resume, it seems unlikely that organic growth in the economy will take on a firm foundation. Additional government stimulus programs and increased regulations in all industries continue to hold back the real economy from recovering. We are hopeful the election will begin to push our country in a more positive long term direction, but at the present time we remain skeptical either party truly understands the gravity of the situation.

**Russell Style Indexes
Q4 Performance**



Our investment strategy for 2012 will revolve around being more tactical than we have in the past, as we anticipate market conditions to be very similar to those in 2011. Strong cases can be made by both the bulls and bears, which will likely lead to both camps having their day in the sun at various points throughout the year. However, anemic organic growth in the economy will likely continue and it will become apparent throughout 2012 that the recovery remains highly dependent upon easy fiscal and monetary policy, capping any above average gains that may occur. The downside is also likely to be limited by factors such as below average valuations, predictions of record profits, and a feeling that as long as interest rates remain low, both fiscal and monetary policy can be loosened even further. These two counterbalancing forces will keep the market in a trading range throughout 2012, unless something material changes. Our primary focus on downside risk this year will be on interest rates. Should rates begin to climb as a result of confidence in the U.S. dollar weakening; real problems to our economy will begin to surface, negatively impacting both the stock and bonds markets. On the contrary, if confidence begins to take hold in the real economy and companies begin spending more of their idle cash on long term investments, stocks could post gains large enough to eclipse prior market highs. This volatile environment is making it difficult for active portfolio management to outperform. According to Morningstar, the Vanguard 500 Index ranked 17th versus the large blend category average, indicating 83% of actively managed large cap funds trailed the index last year. The investment climate will undoubtedly remain very fluid throughout 2012, so be sure to read our monthly e-mail updates for insight into how we have your accounts positioned.

Sincerely yours,

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