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"Individuals who cannot master their emotions are ill-suited to profit from the investment process."*—Benjamin Graham*

To our clients and friends:

These famous words from the father of value investing seemed to ring true more than ever in 2012. We'll revisit this later in more detail, but first, a summary of what transpired in the financial markets last year and then some thoughts on the year ahead.

Fourth Quarter 2012: An Unexpected Finish

Markets rallied strongly into January of the New Year with the biggest year-end jump in equities since the 1970s (this strength continued right on into 2013 with another gap higher following the announcement of a fiscal cliff deal).

Global financial markets in 2012 saw a continuation of the volatility that has been characteristic since the 2008 crisis. In the end, however, the U.S., Europe and emerging markets all showed strong gains for the year. This surprising performance was achieved in spite of concerns about Europe's finances and worries that the U.S. would fall off the "fiscal cliff" and go back into recession.

The volatility of 2012 was driven by the ebb and flow of alternating bad news and good news about Europe. Markets rallied in the second half of the year when the European Central Bank announced that it would provide liquidity to governments and financial institutions. This worked. In 2012, Europe's stock market outperformed the U.S.

Here is a summary of global market performance in 2012. This chart also includes performance for years 2008 through 2011 and for the last 5 and 10 year periods.

Annual Returns	U.S.	Canada	Europe	Emerging Markets	World Markets
2012	**+16.2%**	**+7.5%**	**+16.4%**	**+17.2%**	**+16.6%**
2011	+2.0%	-10.0%	-8.8%	-12.6%	-6.1%
2010	+15.5%	+14.9%	+7.5%	+14.7%	+11.1%
2009	+27.1%	+33.6%	+28.6%	+60.6%	+30.1%
2008	-37.1%	-31.4%	-38.5%	-45.7%	-39.2%
5 yr. avg. return*	+1.8%	+0.4%	-2.0%	+0.3%	-0.8%
10 yr. avg. return*	+7.3%	+9.2%	+7.0%	+14.9%	+7.2%

Source: MSCI returns **including price gains plus dividends,** all returns in local currency

<u>The Outlook for 2013</u>

Despite difficulties and problems globally, analysts enter the New Year cautiously optimistic about equity markets. The reason for such optimism is not readily apparent.

Certainly, there is no expectation of an easy resolution to the world's debt loads, high unemployment or slowing economic growth. On the contrary, there is near-universal agreement that it will take years to resolve these long-term issues.

Instead, the reason for optimism arises from the fact that around the world corporate balance sheets and operating margins are generally in very good condition.

An October interview in <u>Barron's</u> magazine provides a clear example of potential reasons to be positive on stocks. In the interview, 45-year industry veteran and former Morgan Stanley strategist Byron Wien explains his bullishness. Wien argues (*and this is his forecast, not ours*) as follows:

- The U.S. housing market has hit bottom and will be a positive force in 2013
- Growth of the middle class in emerging markets will continue to provide opportunities for investors and for companies selling their products into those markets (Wien is especially positive about agricultural commodities.)
- Dramatic new discoveries of petroleum reserves will put a cap on the price of oil and thereby help buoy the U.S. economy
- Large multi-national stocks continue to offer predictable growth, solid balance sheets, and attractive yields at reasonable valuations
- Even in the face of challenges on budget deficits and debt levels, Wien points to the resilience of the U.S. economy and its history of repeatedly working through what he refers to as "disasters"

The full interview with Byron Wien can be found in the October 13, 2012 issue of <u>Barron's</u> website should you wish to read more: <u>Wall Street Sage Sees Reasons for Cheer</u> by Lawrence C. Strauss. We also hope to post a link to the article on our website.

<u>Is There Danger in Treasury Bonds?</u>

In past newsletters published during 2010 and 2011, we touched on another controversial topic—the direction of interest rates and bond prices, particularly U.S Treasuries. For several years now, there has been growing concern among leading strategists about the prospect for Treasury bonds. This is based on the current record low interest rates and their "flight to safety" appeal on the part of conservative investors.

A recent <u>New York Times</u> article titled "*Bond Craze Could Run Its Course in New Year"* cites research from Morningstar showing that bonds now comprise 26% of a typical U.S. investor's portfolio as opposed to14% five years ago. Interestingly, this is at a time when Warren Buffett—in his annual letter to investors last spring—said that due to today's low rates and inflation "*bonds are among the most dangerous of assets.*"

The lower Treasury yields go, and the more debt the U.S. Treasury accumulates (through Fed buybacks and the like), the more forecasts we will hear about the imminent demise of Treasury bonds. Eventually, Treasuries will decline and *it isn't a matter of if, but when.* But we don't know when, and obviously the economists don't know either.

It seems that everyone has forecast Treasury yields to rise and prices to fall. We should understand that eventually they will all be correct. And it could be this year, next year—or it could take another five years. We don't know and no one else does either.

The Downside of Emotional Investing

At the opening of this quarter's newsletter is a quote from Benjamin Graham. In it, he warns us of the danger in investing based on following your emotions as opposed to being objective. The past year once again tested the mettle of investors in this respect.

The media hysteria over the fiscal cliff was something that smart investors largely ignored. Those who remained bullish through the countdown to the cliff prospered. A number of market pundits expected a Black Monday scenario. But if everyone is openly talking about a market crash, then it is often very likely that the exact opposite occurs.

When market conditions change abruptly, people react in a fairly predictable way. When there's a fire, people will run out of a room. And when there are investment losses, people will sell their positions and seek safer ground.

This type of emotional and reactionary behavior is almost always a mistake. And in 2012, it once again turned out to be true. Inexperienced and novice investors who remained hunkered down in money market accounts and certificates of deposit—along with those who sold out of stocks based on the unfolding Greek tragedy and fiscal cliff fears—missed out on significant portfolio gains. Emotions controlled their decisions.

If you look at the chart on page 1, you'll see that "staying with the program" over the past 10 years has yielded solid gains for investors who were disciplined enough to remain invested. During 2008 in particular, the cries of "this time is different" rang out over and over—just as had been the case in prior (and equally vicious) bear markets.

Managing Risk

I'd like to turn briefly to the topic of managing risk in a portfolio. As an investor, there are two very important questions to ask yourself: *First,* how much risk am I willing to take? And *second*, what kind of portfolio swings can I withstand? In order to manage your portfolio more realistically, it requires more work now than ever before. It's hard.

The first thing you surely want to avoid is to become any sort of day trader. Instead, you may want to learn more about the investments you do own and how they've performed over time. What kind of risk profile does this investment have over the past 3, 5 or 10 years? It may look much differently now than it did in 2008. In other words, you want to ask questions about how stable the risk is in each of the funds you own.

The second thing to ask about is liquidity. By definition, mutual funds should be fully liquid. But we have seen that some funds suffer from the lack of liquidity when redemptions all occur at the same time. These types of investments are to be avoided.

Third, there are a variety of financial instruments available to investors today, including ETF's and other types of "alternative" securities. Before getting too fancy, investors really need to spend the time to try and fully understand the various different kinds of circumstances those products will either help or hurt their investment portfolios. It's a scary thought knowing that people often buy an investment they don't understand.

Risk Allocation vs. Asset Allocation

Investors need to manage their ***risk*** allocation as much as their ***asset*** allocation.

In truth, many investors are willing to take risk—what they *aren't* willing to do is to be *uncertain* about their risks. If you take a particular kind of risk in which you expect 10% swings in your portfolio over the course of a year, you're not going to want to see 30% swings.

The idea behind risk allocation is to reduce the surprises in risk—if you think you signed up for 10% swings, you need to be given 10% swings. There are ways to manage your portfolios to make sure that's more likely than less likely. This is where a dedicated and focused professional can provide added value to your portfolio.

Conclusion

Throughout 2012, the negative headlines over the demise of the Euro, the danger of the impending fiscal cliff, and the Mayan end-of- the-world scenario were widespread. They were also very convincing. The market, however, never did confirm this negativity.

In fact, the biggest surprise of 2012 was the band of market commentators and so-called experts who simply got it wrong by predicting a collapse in the world economy and a repeat of 2008. Indeed, the year was a classic case of "climbing the wall of worry".

In closing, it bears noting that there is now some certainty provided by passage of the American Taxpayer Relief Act of 2012. Advisors are now in a position to help their clients think about and prepare for the full array of estate tax, income tax, and gift tax planning opportunities available to them. Investors should also conduct a full review of their retirement account assets and any beneficiary form revisions that may be warranted.

Sincerely,

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Fama Fiduciary Wealth LLC
Registered Investment Advisor/
Registered Fiduciary

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Nothing contained in this quarterly newsletter should be construed as investment advice