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Investment Commentary 1st Quarter 2012

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

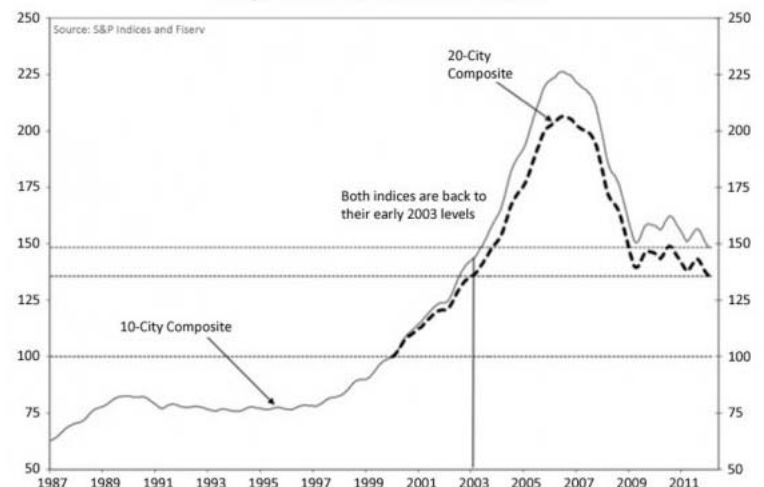
After four consecutive increases in GDP last year, Q1 appears to be coming in a bit below the 2.8% we saw in Q4. Current forecasts are only calling for 2.0% for Q1. Economists attribute this deceleration to the lag effect of the Japanese tsunami, which negatively impacted GDP in the first half of 2011, but provided a boost to the second half of last year as inventories were replenished. With the tsunami effect now subsiding; GDP will likely take a step back in Q1, yet forecasters remain optimistic and are expecting reacceleration throughout 2012. For the year, economists are predicting GDP growth of 2.4% and even higher rates of growth in 2013 and 2014.

Economists are all over the map when it comes to forecasts for 2012. The bullish economists point to the unemployment rate, which has steadily declined and is now at the lowest level of the recovery. Homebuilder confidence is at the highest level since the credit crisis began and everyone knows housing has been a huge drag on the economic recovery. If these positive trends continue, it could result in a significant boost to GDP growth. Corporate balance sheets are by most accounts stronger than ever. Businesses have been stockpiling cash versus upgrading equipment over the past couple of years as uncertainty surrounding the sustainability of the economic recovery has been questioned. The net cash flow to capital spending ratio (near 120%) is at levels not seen in more than 60 years. Should these sustainability fears begin to subside, an increase in capital spending will give GDP another shot in the arm. Households have also significantly repaired their balance sheets by lowering their debt service liabilities. The personal financial obligations ratio is near a record low of 16%, versus the record high of 19% in 2007. Need more good news? The stock market just completed its best start to the year since 1998. What's not to like?

The bears will counter these arguments by pointing out economic reports released over the last four weeks of the quarter saw more than two downside surprises for every upside surprise. Consumer spending in real, inflation adjusted terms, is stagnating despite a surprising rise in nominal retail sales. Both orders and shipments by manufacturing companies have trended lower over the past couple of weeks. Core capital expenditures are currently running at an annualized -5.2% and core shipments are not much better at -3.3%. Even the aforementioned confidence by the homebuilders can be called into question, as home prices have declined nine months in a row, dropping almost 5% annualized over the past 3 months. In fact, mortgage applications dropped 2.7% the last week of the quarter, the seventh weekly decline in a row. Refinancing activity also looks similar, having declined six weeks in a row to close out the quarter. The S&P/Case-Shiller Home Price Index is at a nine year low (see chart). All this and we haven't even mentioned the credit problems in the Eurozone or an impending slowdown in China. Not exactly a robust recovery!!

The balmy conditions during the winter also need to be factored into the 2012 forecast. This past winter was one of the warmest on record, producing the least amount of snowfall in 65 years. This reduced heating bills across America by upwards of \$30 billion. Combine this with the payroll tax cut extension and it becomes clear consumers had noticeably more money in their pocketbooks to start the year. Unfortunately, this tailwind may turn into a headwind this summer as the price of gasoline has the potential to take a toll on consumer spending. This appears to have contributed to the lackluster consumer confidence measures released at the end of the quarter. In March, the Conference Board's consumer confidence index declined 1.4 points, led by the "expectations" component which fell to 83.0 from 88.4. Consumers are clearly reacting to higher anticipated energy prices in the spring/summer months. This calls into question the consensus economic forecast that GDP will rise sequentially throughout 2012. Accordingly, we remain a bit cautious and it appears Federal Reserve Board Chairman, Ben Bernanke, agrees. He recently suggested further loosening of monetary policy was possible. Whether this occurs in the form of QE3 or some new Fed initiative remains to be seen, but monetary intervention seems plausible in the months ahead.

S&P/Case-Shiller Home Price Indices



Bond Market Review & Outlook

Gains in the stock market and renewed confidence in a global economic recovery, at least put a short term end to the seemingly endless decline of interest rates in Q1. The 10 Year U.S. Treasury was trading at 1.87% to start the year and closed Q1 at 2.22%. This resulted in high quality bonds taking a back seat to the stellar gains in the stock market and credit sectors. Bonds as measured by the Barclays Aggregate Index delivered a total return of 0.3% during the quarter. However, as we routinely stress to our clients, all bonds are not created equal, evident by the strong 5-7% total returns posted by high yield and emerging market bonds during the quarter. These strong gains should serve as a reminder to investors that rising yields are not bad for all bonds. In fact, both high yield and emerging market bonds are currently exhibiting characteristics that suggest their performance is inversely correlated to that of interest rates. Accordingly, we remain comfortable with nearly every segment of the bond market, with the exception of U.S. Treasuries which we maintain minimal exposure. Most of our bond funds allocate only a small portion of their assets to U.S. Treasuries as a hedge against renewed deflation fears, political turmoil or economic uncertainty. Investors are once again becoming very quick to declare the bond market rally over and predict a perpetual rise in interest rates. While we believe caution is certainly warranted, this is the same rhetoric disseminated at the beginning of both 2010 and 2011, yet in both years yields ultimately fell. Can the bond market make it three years in a row? Only time will tell.

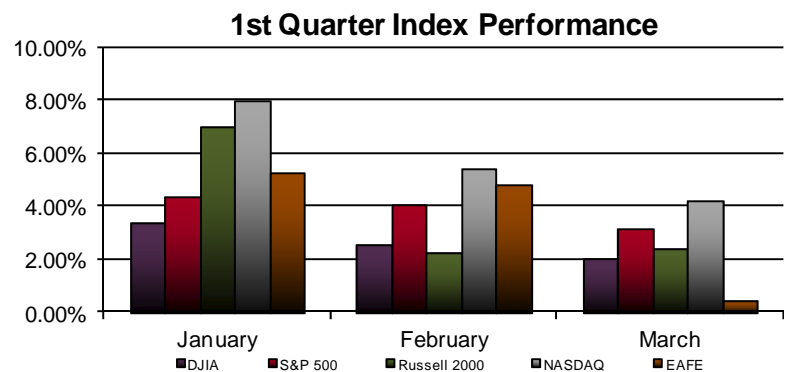
Our current bond allocation is primarily focused on corporate bonds, non-agency backed mortgages, high yield bonds and emerging market debt. We also have above average exposure to Treasury Inflation Protected Securities (TIPS). While we are certainly not forecasting hyper inflation, the policies being taken by our Federal Reserve have the potential to induce elevated inflationary pressures in the years to come. In our view, TIPS offer a couple of benefits to investors. First, they tend to be highly correlated to U.S. Treasuries in the short term, so if fears of a double dip occur this summer or the election puts pressure on the stock market, TIPS will provide investors with a hedge against falling stock prices. They likely won't perform as well as nominal Treasuries, but they should outperform most other credit sectors. Secondly, long term the inflation fears are very real and if/when these begin to manifest themselves into the Consumer Price Index (CPI) data, investors in TIPS will realize an automatic increase in the value of their bond via the principal reset feature. Thus, despite the strong performance of TIPS over the past decade, we still feel they deserve a meaningful allocation in an investor's portfolio.

Stock Market Review & Outlook

Stocks are off to their best start in more than 14 years, as investors' appetite for risk has come back with a vengeance. Fears of a Eurozone implosion were largely removed when the ECB launched LTRO1 and LTRO2. We've discussed these two policies at length in our monthly e-mails, so we won't bore you with the details. Suffice it to say they have worked like a charm. Geopolitical tensions have also subsided in recent weeks, as fears over an imminent Israel/Iran conflict have diminished. Although the debt and deficit problems in the United States remain concerning, the ramifications of these looming problems are too far into the future for the stock market to react negatively at the present time. In fact, it was during the final week of the quarter when Ben Bernanke commented at the National Association for Business Economics spring conference about the fragility of the recovery, insinuating that additional monetary policy stimulus was possible. Instead of ringing in a cautious tone, investors took this news cheerfully, sending the S&P 500 up 1.4%. That is correct; news that the Fed Chairman is worried about the economy and additional stimulus may be necessary sent a stock market already up more than 25% in just over 4 months even higher. Two words, simply amazing!!

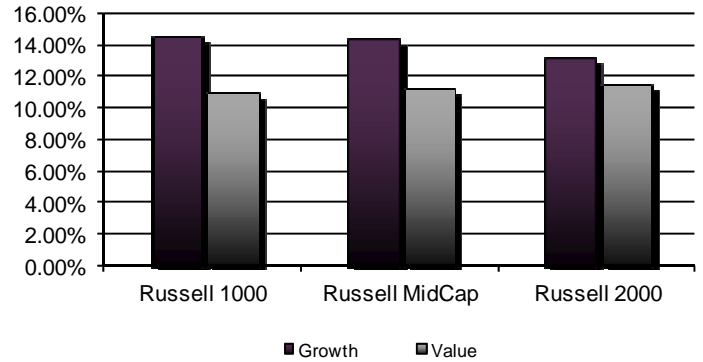
The chart of the Q1 index performance says it all, stocks are doing extremely well. Large caps as measured by the DJIA and S&P 500 were up 8.1% and 12.0%, respectively. Small caps as measured by the Russell 2000 delivered gains of 12.1%. Technology shares have really stood out to start the year with the NASDAQ up 18.7%. No doubt the 48% Q1 gain in shares of Apple Computer have been the driving force behind the NASDAQ's rise, as it accounts for close to 20% of the composite. Finally, international stocks rebounded nicely from the drubbing they took last year, up 10.8% as measured by the MSCI EAFE Index. Investors have unquestionably been pleasantly surprised when opening their brokerage statements every month this year.

With corporate profits projected to reach another record this year and stocks still trading below historical valuations, the trend higher seems very possible to persist throughout 2012. Although caution is certainly warranted given the huge gains we've already seen, the fundamentals of most stocks remain strong. Two big items to keep an eye on as we enter the precarious spring/summer months include the Supreme Court ruling on healthcare reform and the Presidential election. These outcomes will heavily influence the financial markets, but exactly how at this juncture is difficult to predict.



In terms of style, growth investors have enjoyed the upper hand to start 2012, irrespective of which market capitalization segment you are investing. As you can see from the Russell Style Indexes chart, growth outperformed value by an average of 2.8%. This is what you would expect, given the huge run to start the year as traditional growth sectors such as technology and consumer cyclicals are at the top of the performance list. What is interesting and surprising to many is the lack of outperformance by the small caps. Over the past decade, small caps have been market leaders when stocks are moving higher, yet this quarter they simply performed in line with large caps. This is something we have been calling for and we are optimistic it will continue. The small cap valuation premium is still more than 25% over large caps. We believe this is unjustified given that large caps typically have more stable business models, higher credit ratings, stronger balance sheets and better diversification. Small caps do tend to grow faster than large caps, which can justify a higher price. However, when you factor in the higher operating risks and the other aforementioned points, small caps have historically sold at a discount to large caps, not a premium. Large caps continue to represent better value than small caps and we have all of our managed accounts allocated accordingly.

Russell Style Indexes Q1 Performance



As the second quarter begins, it is extremely important to understand what is driving the stock market higher. By analyzing the final week of the quarter, it becomes evident that government intervention and monetary support sends the market higher. The markets were up sharply on Monday and Friday, yet down all three days in the middle of the week. The big news on Monday and Friday involved further monetary support from the U.S. Federal Reserve and the Euro-zone finance ministers. We already commented on the Bernanke comments that sent share prices up 1.4% that Monday, despite a weak home sales report released on the same day. Then on Friday the Euro-zone finance ministers agreed to expand the European Financial Stability Facility (EFSF) bailout capacity by over \$260 billion, sending shares up 0.4%. Again, this is viewed as a huge positive to remove what economists refer to as “tail risk” (in layman’s terms this simply means a very bad economic scenario) from an entire continent teetering on the verge of recession. The middle of the week had no mention of further monetary support, thus markets only traded on earnings and fundamentals, obviously less appealing.

At the present time, it appears global macro economic factors centered around easy monetary policy are the driving force behind higher stock prices. The fact that earnings estimates for 2012 have declined seven months in a row seems to be of little concern to the stock market. Gasoline prices having risen 21% since the beginning of the year (nearing \$4.00 nationally) doesn’t appear to have served as even a speed bump to the stock market. Nor any concerns about the tax code changing this year, when 41 tax provisions will expire in 2013 resulting in a tax hike for all Americans. Despite this renewed confidence being provided by easy monetary policy both here and abroad, we are recommending our clients take some defensive measures to hedge against a potential sudden shift in market sentiment. We plan to discuss these options with all of our clients during our upcoming quarterly meetings to make sure your portfolio allocation remains in line with our 2012 outlook and your individual risk tolerance.

Sincerely yours,

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