

SELECTOR[®] Money Management

2011 Year End Review

As 2011 is being put into the record books, both professional and civilian investors are washing their hands of a year that proved to be widely unsatisfying. The S&P 500 needed help from its dividends to end the year in positive territory, closing up +2.11%. The S&P MidCap 400 Index finished 2011 down -1.73%, while the Russell 2000 SmallCap Index closed down -4.18%. The broad international equities EAFE Index closed down -12.14%, with the S&P Europe 350 Index down -10.76%, the MSCI Emerging Markets Index down -18.42%, and the S&P Latin America 40 Index down -18.36%. All of these returns were accompanied by high volatility the second half of 2011 that featured dramatic declines in the third quarter, a surprising rally in October and choppy performance the final months of the year.

Bond markets, in spite of historically low interest rate yields, were far more stable in 2011. The Barclays Capital U.S. Aggregate Bond Index finished the year with a total return of +7.84%. The Barclays Capital U.S. 20+ Year Treasury Bond Index was up +33.84%, the Barclays Capital U.S. 7-10 Year Treasury Bond Index up +15.59%, and the Barclays Capital U.S. TIPS Index up 13.56%. High yield bonds were buffeted by the equity markets' volatility but still managed to finish in positive territory, with the iBoxx \$ Liquid High Yield Index up +5.94%. Municipal bonds also enjoyed a positive year, with the S&P National Municipal Bond Index ending up +11.22%. It should be noted that a significant contributor to bond market performance in 2011 may be attributed to the very high volatility seen in equity markets.

The best-performing sectors in the equity market complex were utilities and health care. The Dow Jones U.S. Utilities Index gained +19.15% in 2011, while the Dow Jones U.S. Select Pharmaceuticals Index rose +21.81% and the Dow Jones U.S. Health Care Index gained +11.75%. Real estate securities regained their footing in the fourth quarter, with the Dow Jones U.S. Real Estate Index finishing up +6.05%. The Dow Jones U.S. Oil & Gas Index closed out the year with a gain of +4.11%, although the Dow Jones U.S. Select Oil Equipment and Services Index lost -7.15%. Other industrial indexes which experienced difficulties in 2011 include the Dow Jones U.S. Select Insurance Index, down -7.33%, the Dow Jones U.S. Select Home Construction Index, down -8.50%, the Dow Jones U.S. Financials Index, down -12.84%, and the Dow Jones U.S. Basic Materials Index, down -14.72%.

Looking ahead, a wide cross section of investors are viewing 2012 with considerable suspicion. When one reviews what went wrong in 2011, and what actually got fixed, there are a lot of missing pieces to the puzzle. The excessive volatility that drove prices down in the third quarter was accentuated by high frequency algorithmic computer trading, also known as algo trading. No throttles nor controls have been introduced to regulate algo trading, so volatility risk is significant. The general consensus for the U.S. economy is for very gradual improvement, which doesn't translate to a sudden pick up in jobs or the housing market. The international economic outlook is even cloudier, and the European debt crisis an open wound.

At this time, SELECTOR[®] Money Management sees a great deal of sensibility in limiting our clients' exposure to equity markets. For most of 2011, domestic equity markets were trapped in trading ranges. Money can be made in trading ranges, but generally it is made in smaller slices and over precise time frames. We are prepared to take advantage of trading range opportunities in equity markets during the upcoming year. That being said, we also believe that the best opportunities profiting in equity markets occurs when positive up trends unfold. Should these conditions develop we relish the opportunity to participate.

In the meantime, we feel that it is prudent to be selective and cautious. This means larger allocations into bond markets, in spite of the low interest rate environment. All SELECTOR[®] model allocations are now over weighted in high quality bonds, and in some cases money markets. This provides us with a more stable platform from which to evaluate financial markets, while limiting exposure to algo trading. This is not a long-term investment strategy, but we believe it to be an efficient strategy as we enter 2012.

Edward D. Foy
Manager, SELECTOR[®] Money Management

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