Altamont Wealth Management

Fourth Quarter 2012 Performance

Money ... those who don't have enough of it are only aware of what it can buy them. When you finally have enough of it you become aware--acutely aware--of all the things it can't buy ... the really important things ... like youth, health, love, peace of mind. F. PAUL WILSON

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Be your money's master, not its slave. PUBLILIUS SYRUS

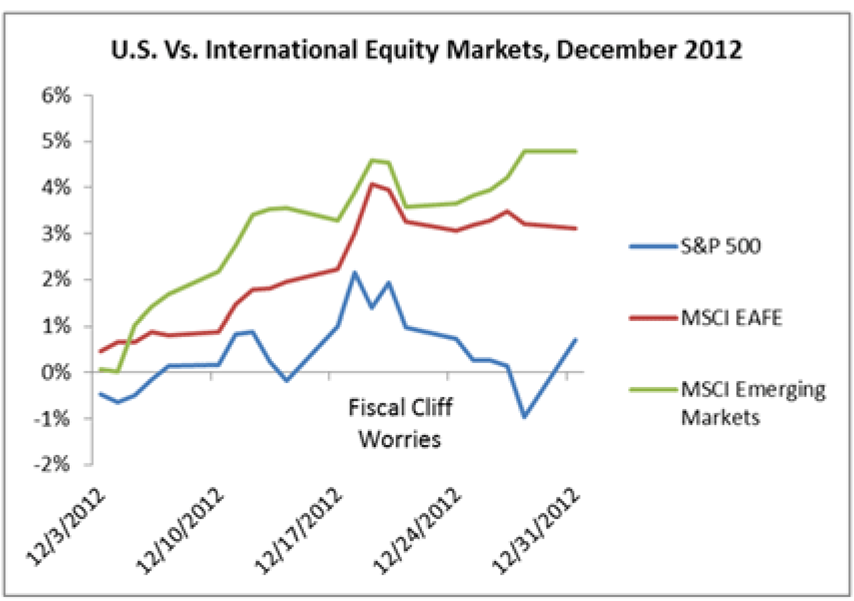
Despite the Fiscal cliff concerns, the U.S. stock market finished the fourth quarter flat, thereby locking in a strong 16% gain for the year.

During the past year, midsized companies outperformed large- and small-capitalization companies, and value beat growth. On a sector basis, financial and consumer discretionary stocks did best, while the utilities and energy sectors lagged. Stocks have stealthily pushed higher over the past four years, with the S&P 500 now just 9 percent below its 2007 peak.

Fourth Quarter 2012 Benchmark Index Returns

	Fourth Quarter	2012 Returns
Large-Cap Benchmarks		
S&P 500 iShares	-0.2%	16.1%
S&P 500 Growth iShares	-2.1%	14.4%
S&P 500 Value iShares	1.7%	17.6%
Mid-Cap Benchmarks		
S&P 400 Midcap iShares	3.7%	17.8%
S&P 400 Mid Growth iShares	2.6%	17.1%
S&P 400 Midcap Value iShares	4.4%	18.3%
Small-Cap Benchmarks		
S&P 600 iShares	2.1%	16.3%
S&P 600 Growth iShares	1.2%	14.5 %
S&P 600 Value iShares	3.2%	18.3%
Other Benchmarks		
MSCI EAFE Int'l iShares	8.4%	18.8%
MSCI EM Int'l iShares	8.0%	19.1%
Vanguard Total Bond ETF	0.0%	3.9%
DJ-UBS Commodities iPath ETF	-6.5%	-2.1%

The strong performance of international markets continued through the end of the year with the MSCI EAFE (developed countries) and MSCI Emerging Markets indices rising 8.4% and 8.0%, respectively. These returns generally reflected an improving economic climate in emerging markets and a stabilization of European markets. Fiscal cliff concerns weighed down the U.S. markets allowing the Developed and emerging markets to outperform the U.S. during the month of December (see chart).



Source: Bloomberg

Fixed income markets also performed well in 2012, with the Vanguard Total Bond ETF showing a return of 3.9% for the year. High-quality bonds held even to slightly negative in the fourth quarter, with the Vanguard Total Bond ETF
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declining 0.01%. Yields on Treasuries traded in a relatively narrow range throughout the year, reflecting the generally high degree of risk aversion in the markets.

Quick Recap of 2012

Declining Global Economic Growth Spurred Government Intervention

The influence of governments and central banks on financial markets and economies was apparent across most of the globe in 2012. The first quarter of the year saw markets rally as a result of the European Central Bank's (ECB) Long-Term Refinancing Operation, designed to inject capital into troubled European banks. Early in the second quarter the Federal Reserve took further action by extending its easing policies through Operation Twist. The Feds actions caused interest rates to fall further, forcing investors into riskier assets in order to earn a decent return.

After a market pullback in the second quarter, the ECB took further action by announcing its willingness to buy sovereign debt of distressed peripheral nations. Not to be outdone, the Fed promised to engage in a third round of quantitative easing, this time with an open-ended time horizon and targeting an unemployment rate of 6.5 percent. European and U.S. central banks were also joined by their peers in the developing markets, as both China and Brazil cut lending rates during the year.

The reason for this extraordinary intervention on the part of central banks was a soft global economy. The Eurozone fell into mild recession, the Japanese economy struggled, and global manufacturing stagnated. In the U.S., the economy continued to grow at a slow pace, largely as a result of an improving housing market and reasonable levels of consumer spending.

The willingness of the Fed and the ECB to serve as economic backstops thereby propping up their economies soothed investors by making it improbable that "really bad" scenarios, such as a disorderly dissolution of the Eurozone, would occur. As worries of a catastrophic economic events dissipated, investors entered the market, thus moving them higher although the global economy struggled.

U.S. housing and consumer spending recover, business lags

In 2012 the first signs of genuine economic recovery became apparent. Housing slowly improved throughout the year, with home values reportedly increasing year-over-year for the first time since 2006. Inventories remained below historical levels, which should help keep prices stabilized. In many regions, buying became cheaper than renting, which also lent stability to the housing market.

Another boon to the housing market was the nascent recovery of household formation which occurs when a person or persons come together or separate to establish a new residence. New households can be formed when children move out of their parents' homes, when couples separate or when unrelated individuals choose to live singly after previously sharing a residence. New home builders watch household formation closely as a leading indicator of market growth. For the past few years, however, household formation has been stagnant. The Census Bureau, not surprisingly, tracked many young adults and college grads moving back home to weather the storm of the job market. A side benefit of more households is job creation.

Employment also improved, with 2012 job gains seeming to be on a pace similar to that of 2011 and close to that of 2004 and 2006. Despite weakness in the second quarter, employment growth recovered in the third and fourth quarters, and the unemployment rate (U3) dropped from 8.5 percent at the start of the year to 7.7 percent near the end—a much larger improvement than had been expected. Unfortunately, part of this drop in the unemployment rate was caused by unemployed workers giving up and no longer looking for employment.

Consumer spending followed the recovery in housing values and employment, tracking previous recovery levels and moving back above the peak of the previous cycle. Consumer savings rates fell but remained at reasonable levels, and consumer debt and debt service levels declined to multiyear lows, suggesting that demand would be sustainable.

Business spending was much weaker, driven by policy uncertainty with respect to taxes and federal spending. This remained the weakest part of the economy, and whether this will improve in the coming year is still unclear.

One Cliff Avoided But …

Congress is trying its best to derail the economy. It barely managed to avert the Fiscal Cliff at year end. If Congress had not acted then a series of tax increases and spending cuts would have automatically kicked in. Approximately 90% of all Americans would have seen their taxes increase and the Federal budget would have been slashed. The resulting shock waves would have sunk the economy back into recession. In the end Congress dealt with the impending tax increase but did not address the spending cuts. Instead they kicked that can down the road.

Hence we face Sequestration…

Sequestration is a procedure adopted by Congress that forces cutbacks on government spending in order to pay down the deficit. Forced cutbacks will set in unless Congress reaches another agreement. Hopefully, the delay until March 1st will give Congress the time they need to agree on spending cuts.

After the sequester comes the threat of a government shutdown on March 27. And after that, probably sometime this summer, the threat of default will once again loom unless lawmakers can reach a consensus on long-term tax and spending policies.

The markets have been able to ignore Congress but their actions are disruptive. In this environment, it is difficult for business leaders to plan and feel confident committing capital to new projects and hiring new employees. I don't think Congress is going to get its act together anytime soon; the best we can hope for is modicum disruption to the economy.

Yield Hunger Games

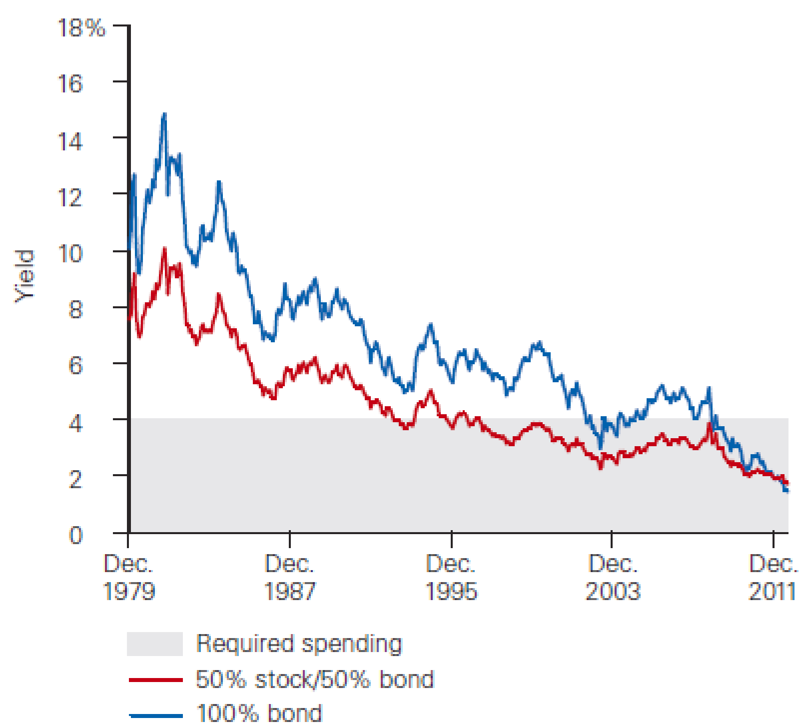
Investors hunger for yield but there is little to be had. Bond yields are incredible low due to the Federal Reserve's programs designed to keep interest rates low and stimulate the economy. At year-end, the yield on the 10-year Treasury was a pitiful 1.7%. The yield is so low that when inflation the cost of inflation is considered treasuries are actually a losing proposition. Of course money markets are no better, with some generating less than a 0.01% yield. In addition, dividend yields on U.S. stocks are near all-time lows with S&P500 yield below 2%.

The hunger for yield has grown investors as the Baby Boom generation retires. This glut of retirees is looking for yield. But the yields we have grown accustomed to over the last 30 years are nowhere in sight.

Today, the yield on a balanced portfolio (50% bonds and 50% stocks) is approximately 2%, which is not even the rate of inflation. In this veritable yield desert investors are doing precisely the wrong thing at the wrong time in the hunt for yield.

Money is pouring into traditional bond funds at an unprecedented rate while stock funds have seen net outflows. Insanity. The worth of a bond is inversely related to the movement in interest rates. When rates fall (like they have over the last 30 years) the value of bonds increases. The reverse is true when rates rise (bonds fall in value). So when rates begin to rise (some pundits' estimate that rates will begin to rise before year-end) bonds will fall in value.

December 1, 1979–September 30, 2012



Note: Based on the dividend yield of the Standard & Poor's 500 Index and the yield-to-maturity of the Barclays U.S. Aggregate Bond Index.

Sources: Vanguard calculations, using data from Thomson Reuters Datastream and Barclays.

Investors are also flocking to low-quality bonds that offer higher yields than high-quality Treasuries. The yields are higher to compensate investors for the higher risk, the risk that the issuer will default and not pay all the interest or the borrowed principal.

Judiciously investing in low-quality bonds can be a great investment. Unfortunately, yields are compressing so the additional yield paid by low-quality bonds is smaller than usual. So the yields on junk bonds have reached a record low and investors are really not getting paid for the additional risk assumed by investing in low-quality bonds.

A blind hunger for yield has lead investors astray. It is dangerous for investors to be invested in conventional fixed-income. Not only are yields meager but as inflation creeps up it will erode bond values further. The impact of rising interest rates will also cause bonds to fall in value and generate negative returns, erasing what little yield they paid.

Bond markets are more complicated and can change rapidly. Currently there are several strategies that will help protect your portfolio in this current market environment. Investing in floating rate securities are a good investment in a rising interest rate environment. These assets have yields that reset when interest rates change. So when interest rates rise the yield on the bonds is increased and the bonds retain their value.

Another way to insulate a bond portfolio from rising interest rates is to keep the maturities short. (Remember, a bond's price is adjusted down if interest rates rise so that the set interest payment reflects the higher rate - set bond payment divided by the bond's value equals the current interest rate). Bonds are issued with a set maturity date. The bond pays interest until maturity when the principal (amount loaned to the company or government entity) is returned to the investor. The closer a bond is to maturity there are only a few interest payments due until the principal is repaid. Therefore the impact of rising rates on bonds close to maturity is negligible compared with a bond with 10 years until maturity. So holding bonds close to maturity is another way to mitigate rising interest rate risk.

There are some good strategies and alternatives to offset these trends. First is to buy well-managed mutual funds that are flexible and take advantage of the rapidly changing bond markets. Traditional intermediate maturity bond funds are not going to perform as well in this market environment. So bond funds that are unconstrained and can go anywhere around the world are a good option. This is why I have added Pimco Unconstrained Bond Fund to your portfolios. It can adjust maturities and invest in any segment of the bond market, such as floating rate bonds. Holding unconstrained bond funds will help mitigate the risk of rising interest rates and greater volatility in the bond markets.