



FAI Advisors, Inc.

REVISED 2/3/12

Monthly Investment Commentary

January / February 2012

Remarkably, after all of the volatility witnessed throughout 2011, the S&P 500 index ended the year exactly where it started, with its 2% return coming from dividends. It was quite a frustrating journey to no rate of return. Also, smaller- and mid-cap stocks closed the year down 4.2% and 1.7%, respectively, despite also posting double-digit fourth-quarter gains. Foreign stocks were down 11.8%, based on the MSCI World ex USA Index. Continued concern over

global growth along with periodic flights to quality drove emerging-markets equities sharply lower; they ended 2011 down 18.8%.

High-quality bonds were on the other end of the return/risk scenario, the Vanguard Total Bond Market Index had a 7.6% full-year gain. International bonds returned 6.3% in 2011, while emerging-markets bonds, which are perceived as riskier, lost 1.7%.

Updated Market Data

“A Year in Review”*

	December	YTD		1/23/12	1/23/11	% Chg
Large Cap Benchmarks			Consumer Rates			
Vanguard SP 500	1.00%	2.00%	6 Month CD	0.59%	0.38%	55.26%
Russell 1000 Growth ishares	-0.30%	2.50%	30 Yr. Mortgage	4.06%	4.77%	-14.88%
Russell 1000 Value ishares	2.00%	0.20%	Prime Rate	3.25%	3.25%	0.00%
Small Cap Benchmarks			Commodities			
Russell 2000 Growth ishares	-0.20%	-2.90%	Gold	1653.00	1345.00	22.90%
Russell 2000 Value ishares	1.50%	-5.60%	Crude Oil	98.46	88.86	10.80%
Other Benchmarks			Gasoline	3.39	3.10	9.35%
Vanguard REIT Index	4.60%	8.40%				
Vanguard Total Intnl Stock Idx	-2.60%	-14.60%				
Vanguard Total Bond Mkt Idx	1.10%	7.60%				
Merrill Lynch High Yld Cash Pay	2.50%	4.50%				
Citigroup World Govt Bond Idx	0.90%	6.30%				
DJ-USBCI (Commodity Futures)	-3.70%	-13.30%				

* Source: JP Morgan Weekly market recap

January / February 2012

Our tactical positions in emerging-markets bonds hurt portfolios, due to the US Fixed income positive performance. With longer-term expected returns facing substantial headwinds, we believe our positioning will allow us to battle these headwinds at still-acceptable risk levels. We expect the volatility in equities to continue for at least the next 12 months.

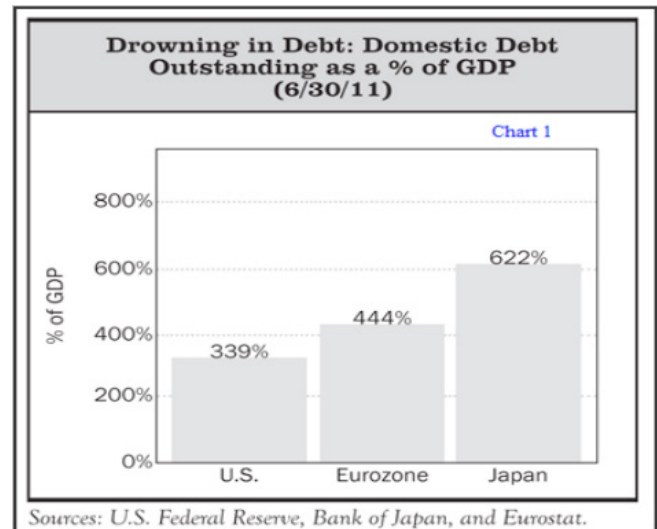
Coming Forward

Almost the entire developed world is struggling to dig out from under a mountain of debt. The problem is that there is no easy or quick solution, and all options involve economic pain that is compounded by political uncertainty. The focus is on Europe, but the U.S. and Japan also face debt-related challenges. Chart 1 quantifies all debt, public and private, in the majority of the developed world.

Having hit debt levels that are unsustainable, continued deleveraging is necessary. Ideally this comes from economic growth—but when debt is so high, it becomes a headwind to growth. Households spend less because they are already committed to high levels of debt service, are out of work, and/or need to rebuild their savings. This also includes the drop in housing prices and financial assets. Additionally, governments try to use fiscal stimulus to battle the private sector's retrenchment, but this can only continue for so long, as the increased government spending/stimulus adds to the

growing burden of public debt. Eventually, growth in government spending must pull back, adding to the headwind. So, growth as a near-term option for deleveraging is not realistic.

That leaves spending reductions and tax increases as solutions at the government level (austerity), or some degree of debt default. Default can happen in two ways: (1) not repaying debt (e.g., Greece and probably at least some other European governments will default on a portion of their debt, as many households are defaulting on their mortgages and credit card debts), or (2) creating inflation by "printing" money so that money is devalued. Both of these options create other problems.



Furthermore, most of the developed world will be forced to spend less and pay higher taxes in coming years. Some governments will default and others, as mentioned, will attempt to create

inflation to reduce the debt burden. Finally, governments can attempt to use all possible tools to keep interest rates low for an intended period of time. This serves several purposes including keeping their borrowing rates low so that the debt-service burden doesn't rise to impossible levels. But, for investors, this means continued low returns from fixed-income investments (bonds and money markets).

Negative Feedback Loop

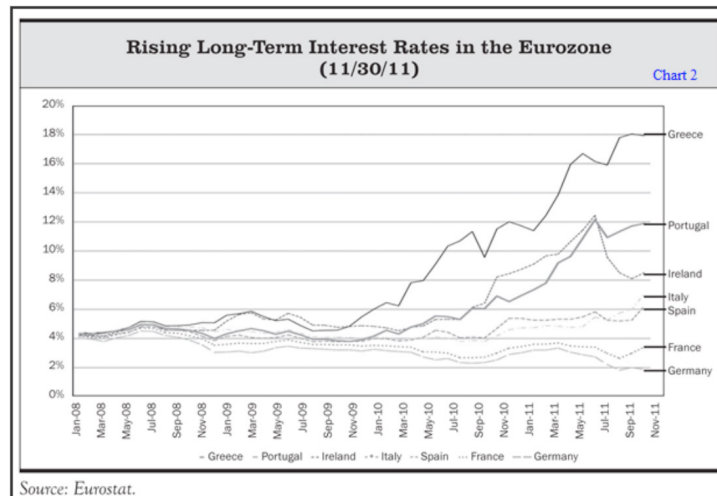
What we see in Europe is a negative feedback loop where high government debt levels and uncompetitive economies create the following problems:

- Investors in the government debt of many European countries fear that they won't be paid back in full. As a result, interest rates rise to account for this increased credit risk.
- Concerns about bank solvency grow because banks throughout Europe hold most of the government debt. This can cause a banking crisis because they have difficulty renewing maturing debt to fund their businesses. The bank's assets decline in value.
- A credit crunch ensues as banks cut back on their lending and sell assets to downsize in order to build capital to offset loan losses, and also because they no longer can raise enough capital to support all of their businesses.

- This constriction in lending and credit puts more strain on governments because private sector economic growth suffers, causing lower tax receipts and higher social spending. This transmits the crisis to the core of Europe because the bulk of the bailout costs would be paid by the strong economies (such as Germany).
- Economically weak countries that need assistance from the strong are expected to implement austerity measures—lower government spending and higher taxes—in order to reduce their debt and deficits. But, this risks further harm to their economies that could make deficits even larger, at least in the near term.
- All of this scares lenders and investors even more, which drives interest rates higher and makes things worse.

This has been a vicious and worsening cycle through the last couple of years.

Most economists now view recession in Europe in 2012 as almost certain. European authorities have been trying to contain the crisis through incremental steps, this strategy has failed miserably. Chart 2 graphically illustrates this failed attempt, as we see the breaking out of the yields in the European bond market, referred to as “exploding yield spreads”.



As this continues, it is likely that the European Central Bank will finally step in more decisively and provide major support for the sovereign debt market and the banking system. This is the “quantitative easing” our own Federal Reserve has done. European government leaders must snap the loss of confidence cycle, putting the brakes on the downward spiral.

It is very possible that we will find out during the next year whether Europe can keep the EU together and get through the crisis with a mild recession or, at the other extreme, whether we will see an EU collapse triggering defaults in the trillions of euros. This would be a 2008-type banking crisis, and possible European or even global depression. There are other outcomes in between these two extremes. As we enter 2012, stress on the banking system is intensifying and banks are downsizing by aggressively reducing lending, selling assets,

and pulling out of many markets. The assets on their balance sheets have become riskier and less valuable. Their actions are being felt around the world, in fact, there is already a European banking crisis though not yet as severe as what we saw in 2008 in the United States.

According to the Organization for Economic Co-operation and Development, developed countries will need almost \$11 trillion in funding in 2012—mostly maturing loans needing to be rolled over. Normally this would not be a problem, but a European meltdown could conceivably trigger market pressure on the heavily indebted U.S. and Japanese economies. Fortunately, U.S. Treasuries remain the asset of choice in times of heightened fear.

It makes sense that the policy tools governments want to use in times of crisis are likely to be more limited than in 2008 and 2009

January / February 2012

because we've already used up some of our "bullets". This has contributed to government debt levels that are very high and there is little political will to allow them to expand further.

Examining the Bullish Arguments

The weight of the evidence suggests to us that it is right to be cautious, but there are bullish arguments worth examining.

By far the strongest bullish argument, in the short run, is that authorities will do whatever it takes to avoid financial catastrophe, and therefore there will be much stronger steps taken in Europe. For example, if the ECB undertakes major quantitative easing as discussed above, global stock markets could experience a massive rally. If this coincides with continued improvement in the U.S. economy, 2012 could turn out to be a very good year for the stock market. Companies do have piles of cash and are ready to spend it if uncertainty declines or demand increases. So, if policies are pushed forward that reduce some of the scariest risks, we could see companies loosening up their purse strings. This could be a positive double play for the economy and markets—as we'd have both policies that reduce uncertainty and a business sector that is poised to expand. A 20% to 30% return for stocks from year-end levels is not out of the question.

While this and other steps could significantly lessen the chance of another financial crisis, it would not solve the problem of too much debt.

There is no easy solution to the heavy debt loads of Europe, the United States, and Japan, so the growth outlook for the next several years is likely to remain challenged. So, while the global stock market could have a good few months or even a year if the imminent and extreme risks are taken off the table, we believe it is unlikely that markets will support a strong bull market over much of our five-year investment time horizon.

There are many other less convincing bullish arguments:

Stocks are cheap. This argument is one of relative value, as compared to interest rates (bonds). With this simple comparison, dividends on stocks are attractive compared to short term bond investments. However, could the argument be telling us more about bonds being rather unattractive going forward, and not necessarily that stocks are attractive?

Stocks are fairly valued so long-term returns should be okay. This conclusion is usually based on price/earnings ratios compared to long-term historical averages. Fair value is based on how close the current measure is to the average. Our research suggests that there is a good chance returns over the next five years will be below average (historically) because global deleveraging will result in below-average earnings growth. Also, we believe all-time-high profit margins are likely to decline, which could

January / February 2012

be a sizable headwind to earnings growth. Moreover, a deleveraging world is a higher-risk world, which leads to higher volatility, and using historical long term averages may not provide desirable outcomes in the next few years.

The economy is improving. Yes, the economy is slowly improving. This is a good sign, but it is still not on firm footing. Any additional crises must be avoided if the economy is to continue through the lengthy period of slow growth as the United States deleverages. Household deleveraging is progressing—aided by low interest rates, government transfer payments, and defaults—but it has further to go. Shrinkage at the state and local government level continues. Federal government deleveraging has not started yet but fiscal policy will tighten in 2012 and economists forecast this will result in a drag on U.S. GDP growth. Looking further out, some fiscal austerity is coming to the United States. While occasional good news could trigger temporary optimism and market surges, the weight of the evidence suggests that it is quite unlikely that the economy will be a bullish factor over most of our five-year investment time horizon.

Scenarios

1. Another financial crisis with deflation and a possible developed world depression. This scenario could be characterized by enormous

downside for equity assets, potentially 30% to 50% from current levels to a stock-market bottom. Most “risky” assets would also suffer. This would probably happen in the form of a huge bear market at some point, followed by strong returns following the market bottom. Clearly this is a very scary scenario and there is no way to confidently put odds on it playing out. Generally, we believe this “worst-case scenario” is improbable but not so improbable to justify dismissing the possibility.

2. No major financial crisis, but growth remains slow. This is our base case, as we believe it is the most probable outcome. It assumes the headwind to growth from deleveraging is unavoidable and that it will be a long, slow process. It is consistent with similar past periods in economic history. Volatility would remain. (This scenario is most likely in our opinion)
3. Policymakers hit the bull’s eye, emerging-markets lift all boats, and growth is higher than we expect. This scenario suggests stronger earnings growth and higher multiples as macro risks subside. U.S. equities could return in the low to mid-teens and emerging-markets equities could return in excess of 20% annualized. Bonds would perform poorly. We view this scenario as the least likely of the three.

Managing Through

The process of choosing the correct portfolio for each of our clients must include the consideration of two questions. First, if the worst case occurs, is it tolerable — and will investors be able to stay in the portfolio or range of portfolios they are currently in?

Second, if after remembering what past periods of extreme fear felt like, the investor concludes they cannot tolerate a worst-case scenario, then are they also able to live with the forgone return that a conservative portfolio would experience (opportunity cost) if a very bad scenario does not occur? In some cases, the success of an overall strategy hinges on the ability of the portfolio to avoid the worst-case scenario.

Ultimately, these are questions that our clients must answer with assistance from our team of advisors. Staying flexible is key. Finally, we have to base decisions on what we believe is best for each client. Over the long term, what we expect of ourselves in a world that is inherently uncertain is that a strong commitment to intellectual honesty, thorough research, and a disciplined process is the best predictor of long-term success.

FAI Advisors, Inc.

Portfolio Sterling Committee January 2012

Certain material in this work is proprietary to and copyrighted by Litman/Gregory Analytics and is used by FAI Advisors, Inc. with permission. Reproduction or distribution of this material is prohibited and all rights are reserved.

Advisory services offered through FAI Advisors, Inc. a registered investment advisor.

Securities offered by registered representatives through The O.N. Equity Sales Company, Member FINRA/SIPC (www.FINRA.org & www.SIPC.org). Investment Advisory services offered through O.N. Investment Management Company and FAI Advisors, Inc. Financial Architects, Inc and FAI Advisors, Inc. are not subsidiaries or affiliates of The O.N. Equity Sales Company or O.N. Investment Management Company. We have representatives currently registered in the following states: AL, AZ, CA, CO, DC, FL, GA, HI, ID, IL, IN, KS, LA, MD, ME, MI, MN, MS, MO, NE, NH, NV, NY, NC, OH, OK, OR, PA, SC, SD, TX, VA, WA, and WI.

