WealthHealth
Personal Wealth Management

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5 Becker Farm Road
Roseland, NJ 07068

Tel: 973.535.9577
Fax: 866.734.4227

www.wealthhealthllc.com
info@wealthhealthllc.com

Our expectation of slow economic growth has largely been right on over the past four years.

A key risk going forward is how our politicians deal with the problem of growing public sector debt.

The developed world continues to face significant debt-related challenges.

We recognize that there are a variety of bullish factors that could drive stocks to strong returns over the next five years.

Given continued risks and unsatisfactory return expectations for most asset classes, our portfolios are positioned in a moderate but not excessively cautious way and we hold some niche assets that we believe offer the potential to add value relative to our benchmarks.

Market Review

Stocks shrugged off numerous worries to log a very good year in 2012. The riskiest areas were the most profitable. Europe gained over 21% in 2012. Emerging-markets stocks earned 18%. In the U.S., mid- and small-cap stocks slightly outpaced large-cap stocks.

The bond side also saw riskier asset classes out-earning traditionally safer fixed income market sectors. Emerging-markets local-currency bonds notably gained 17%. Domestically, high-yield bonds and leveraged loans returned 15% and nearly 10%, respectfully, while investment-grade bonds returned 4%.

Index Returns *Through 12/31/2012*

			Annualized Returns		
Index	QTD	YTD	1-Year	3-Year	5-Year
S&P 500	-0.38%	16.00%	16.00%	10.87%	1.66%
Russell 2000	1.85%	16.35%	16.35%	12.25%	3.56%
MSCI EAFE	6.57%	17.32%	17.32%	3.56%	-3.69%
MSCI All Country World Index	2.88%	16.13%	16.13%	6.63%	-1.16%
MSCI Emerging Markets Index	5.58%	18.22%	18.22%	4.66%	-0.92%
Barclay Capital US Aggregate Bond	0.21%	4.22%	4.22%	6.19%	5.95%
Barclay Capital Municipals	0.67%	6.78%	6.78%	6.57%	5.91%
Dow Jones UBS Commodity	-6.33%	-1.06%	-1.06%	0.07%	-5.18%
HFRI Fund of Funds Composite Index	1.34%	4.81%	4.81%	1.46%	-1.75%

Slow Growth As Expected—Now What?

For several years we have said the most likely outcome for the developed world economy would be years of slow growth. This view was based on our assessment that excessive debt levels in the United States and around the developed world had to be reduced, and that this lengthy period of deleveraging would suppress spending and be a major drag on economic growth. We have also believed that stocks were not fully pricing in the slow growth environment we expected and most definitely were not pricing in the most pessimistic of our scenarios, in which we experience another financial shock. Our expectation has largely been right over the past four years. While clear progress has been made, the deleveraging process is not nearly complete. The risk of another crisis has declined, but it remains possible and is not easily dismissed. Reducing the growth of debt at the right pace and in the right way is necessary, but not easily achieved. The risk is that this goal is not achieved, or that it is only achieved after political dysfunction triggers a crisis. 2013 will be an important year as politicians are charged with putting in place a viable longer-term plan. If this is not done in 2013, the risk is that it won't be done until after the next presidential election, unless a crisis comes first. The lost time will mean we will face a bigger problem with tougher choices and likely even greater consequences. The markets will be watching and may not behave well if the wait lasts until 2017.

Europe also made some progress in 2012—but most of that progress has been in the form of buying time by reducing borrowing costs and thereby lessening the "tail risk" of an imminent Eurozone breakup. There has been some improvement in the peripheral countries as most seem likely to have current account surpluses in 2013; capital flight appears to have stopped, and there are signs that the push for austerity may soften a bit.

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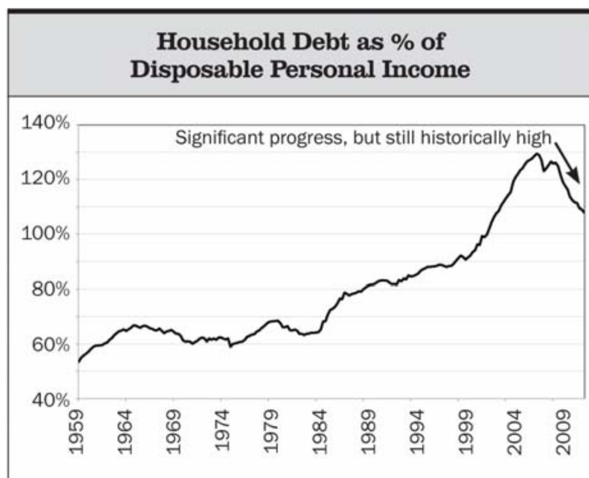

Source: Board of Governors of the Federal Reserve System/Bureau of Economic Analysis. (Data as of 9/30/12.)

It remains an open question whether European governments will be able to make the right decisions with respect to: growth policies, pursuing competitive balance, debt relief, and the fiscal and banking integration that is needed to hold together the single currency over the long run. As challenging as the politics are in the United States, the challenges are even greater in Europe where countries with different cultures and economic characteristics are being asked to give up some of their economic sovereignty. Solving these problems will take a long time and along the way they could trigger more serious social unrest.

As in the United States, Europe's problems are all about debt-related economic headwinds and the threat of political mishandling of a fragile economy. One important distinction between the investment prospects for the United States and Europe is that European stocks are cheaper. However, we recognize that the economy is slowly healing and more optimistic factors have come to light in 2012 which we believe will continue throughout 2013 and thereafter, offsetting some of the pessimism that exists as noted above.

The Optimistic View

An important part of our investment discipline is to challenge our own conclusions through lots of debate amongst ourselves and our investment managers and exposing ourselves to alternative points of view through our reading and working our extensive industry network. Most importantly, our approach forces us to think through a variety of possible outcomes. We recognize a variety of bullish factors that could drive stocks to strong returns over the next five years. These include:

- As we move further along in the deleveraging process, expected returns for stocks have improved as we anticipate a return to more normal earnings growth in the future. Optimistically, if we put deleveraging-related headwinds behind us, earnings can temporarily overshoot the long-term trend level. In such a case, US stocks may post returns in the high single digit to low double digits. Expected returns in this scenario for European stocks (which had large price declines until a market rebound starting in June) and emerging-markets stocks may be materially higher.

- The passage of time has also meant that an enormous amount of froth has been taken out of stock prices. The stock market, as measured by the S&P 500, is at a level first reached 13 years ago and multiples are much more reasonable than they were.

- The risk of another financial crisis that leads to deflation has declined. Time has allowed for some healing, some deleveraging has happened, and Europe has made some progress. Over time, this should have some impact on investor risk-taking, especially if this trend continues.

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- Relative valuations driven by the Fed's low interest-rate policies could continue to play a big role in stock returns going forward. Valuations are in a fair-value range on many absolute measures. If one assumes that macro forces will result in below-average earnings growth, stocks could be overvalued. However, if economic growth gradually improves, tail-risk fears subside, and as time further distances investors from the financial crisis, investors could find stocks far more appealing than bonds or cash.

- If politicians can agree upon a credible plan for long-term deficit reduction, that could go a long way toward mitigating concerns about future debt build-up and related policy errors. In the United States, the corporate sector is sitting on a lot of cash that could be used for capital investment and hiring as some of the uncertainty recedes. In Europe, while fear of policy errors is justified, it is also possible that 2013 could see progress toward banking and fiscal union and a return to growth later in the year.

- The global economy has experienced some encouraging macro developments. In the United States, housing is now a driver of growth rather than a drag on growth. Credit markets also continue to improve with easier lending standards. And the labor market is slowly healing, though it remains historically weak. Outside the United States, the growth slowdown in the emerging markets may have ended and there are numerous signs that China's economy is picking up (though not to previous growth levels). Even Europe, currently in recession, could start growing again in the second half of 2013.

The odds of the bullish case playing out may be increasing, but in our view they are still not high. There is no easy road out of our debt bind and there are consequences to that reality. The only easy road would be robust growth, but this is close to a mutually exclusive condition with a deleveraging global economy. So despite somewhat improved odds of the bullish scenario, it is more likely that we see a slow-growth environment with a continuation of some aversion to risk. In this environment, corporate earnings will be challenged as growth through cost cutting has largely played out. Revenue growth will need to be a driver and ultimately that will depend on demand.

How This Impacts Portfolio Positioning

As a result of our perceived balancing of the optimistic versus pessimistic considerations outlined above, our portfolio positioning remains the same as last quarter as it reflects several considerations:

1) Caution because of elevated risks and low expected returns in our view (continued subpar growth). This is why our portfolios are underweighted to stocks relative to our strategic allocations. However, it also reflects the real possibility of a better environment and the expectation that in all but the most pessimistic scenarios, stocks should significantly outperform bonds over five years. This is why, while underweighted, our portfolios continue to hold material allocations to stocks. We may increase the allocations to stocks as we see more signs of improvement.

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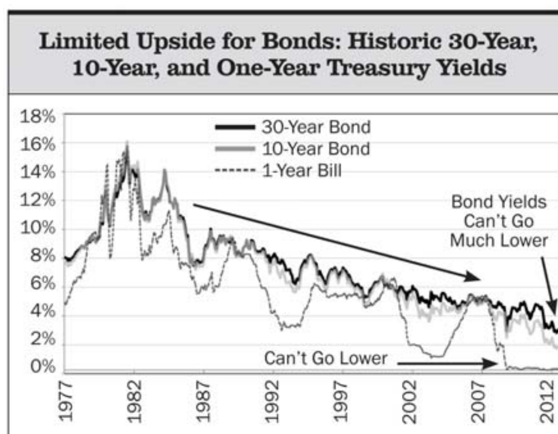
2) Higher return expectations for foreign stock markets.

3) Decent fixed-income opportunities outside the investment-grade bond market, including parts of the mortgage market, high-yield bonds, and emerging-markets local-currency bonds.

4) Opportunities to capture higher returns than bonds, and more stable returns than stocks in alternative strategies, such as hedged strategies, and also in flexible fixed-income strategies.



Source: Yahoo! Finance. (Data as of 12/3/12.)

During 2012, our fixed-income positions added enormous value to our portfolios and helped to offset the impact of our equity underweight. Our view is that there is still sizable potential for excess returns from our fixed-income positions in coming years, but the magnitude is likely to be less than what we captured in 2012. Most of the bond funds we hold pay much higher yields than the bond index and have less interest-rate risk. The lower-interest-rate risk is a function of lower duration and more credit exposure, which is likely to perform better in a rising interest-rate environment. However, yields have come down and this means lower potential returns than what we were able to capture in 2012 and over the past several years.

Looking Ahead

Although our commentaries have been less than optimistic lately, we do see some light ahead. This somewhat cheerier outlook laid out in the factors above could result in a more optimistic scenario playing out. However, the weight of the evidence still suggests global deleveraging will create an environment that will mute returns and carry outsized risks.

Our portfolios are positioned in a moderate but not excessively cautious way and we hold some niche assets that we believe offer the potential to add value relative to our benchmarks. This can be a frustrating strategy that requires the patience to wait for better opportunities. But this past year was an example of this strategy working.

We appreciate your continued confidence and trust and wish you all a happy and profitable 2013!

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