WealthHealth
Personal Wealth Management

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After huge volatility, the S&P 500 index ended 2011 where it started, with its 2% return coming from dividends. Smaller and mid-cap stocks closed the year down 4.2% and 1.7%, respectively, despite also posting double-digit fourth-quarter gains. Fear over Europe and slowing growth in China dragged foreign stocks down 12%, with China concerns and a flight from risk hitting emerging-markets stocks even harder; they fell 18.42%.

High-quality bonds were on the other side of the volatility, with sharp flight-to-safety rallies that helped net the Barclays Aggregate Bond Index a 7.84% full-year gain. Our allocations to flexible bond and absolute-return-oriented funds hurt performance in our balanced portfolios because they provided less short-term protection than high-quality bonds, but we remain confident that our bond allocations will provide better longer-term returns at still-acceptable risk levels. Over shorter periods in which investors' decisions about getting in and out of stocks are driven by macro headlines (often referred to as "risk-on, risk-off") there is less consideration for fundamentals of individual stocks. This creates long-term opportunities, but can be frustrating over shorter periods.

Index Returns *Through 12/31/2011*

Index	QTD	YTD	Annualized Returns 1-Year	3-Year	5-Year
S&P 500	11.82%	2.11%	2.11%	14.11%	-0.25%
Russell 2000	15.47%	-4.18%	-4.18%	15.63%	0.15%
MSCI EAFE	3.33%	-12.14%	-12.14%	7.65%	-4.72%
MSCI All Country World Index	7.18%	-7.35%	-7.35%	12.01%	-1.93%
MSCI Emerging Markets Index	-1.21%	-18.42%	-18.42%	20.07%	2.40%
Barclay Capital US Aggregate Bond	1.12%	7.84%	7.84%	6.77%	6.50%
Barclay Capital Municipals	2.12%	10.70%	10.70%	8.57%	5.22%
Dow Jones AIG Commodity	0.35%	-13.32%	-13.32%	6.39%	-2.07%
HFRI Fund of Funds Composite Index	-0.26%	-5.51%	-5.51%	3.64%	-0.71%

As most of the developed world struggles to dig out from under a mountain of debt, all options involve economic pain that is compounded by political uncertainty. Having hit debt levels that are unsustainable, deleveraging (debt reduction relative to GDP) is necessary. Ideally this comes from economic growth—increasing the denominator in the debt/GDP ratio. But when debt is so high, it becomes a headwind to growth. Governments try to use fiscal stimulus to counterbalance the private sector's retrenchment, but this can only continue for so long, as increased government spending/stimulus adds to the growing burden of public debt. So, 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, or (2) creating inflation by "printing" money so that money is devalued. Both of these options create other problems.

Governments can also attempt to force "financial repression," where they use all possible tools to keep interest rates low. This serves several purposes including keeping their borrowing rates low so that the debt-service burden does not explode to impossible levels. For investors, this means low returns from fixed-income investments.

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The huge amount of debt in the developed world continues to drive our expectations about the years ahead.

Although unlikely, we believe the risk of our most negative scenario, in which a financial crisis in Europe leads to a global recession, increased in the fourth quarter.

In our base-case scenario there is no major financial crisis, but growth remains slow in the years ahead due to ongoing headwinds from deleveraging and we continue to see elevated volatility.

Intended to reduce risk, our equity underweight means we would not participate as fully in the shorter term if stocks rally.

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The lesson from economic history is that, without exception, a debt-induced financial and banking crisis results in a lengthy period of subpar economic growth. This is exactly what has been happening throughout the developed world economies since the 2008 financial crisis. Weak economic growth leads to periodic recession fears and unacceptably high unemployment. Moreover, high debt levels mean that we will likely be living with huge macro-level risks for a few more years at least. If we are right, it is probable that we will experience (1) continued high financial market volatility and (2) reduced investor risk appetites, meaning lower prices for risk assets like stocks and high-yield bonds than would otherwise be the case.

The European Crisis

There are many debt-related risks in the world today. Europe is an obvious big risk in the near term and, as the sovereign debt situation has worsened, it has increased the chances of our most negative deflation scenario playing out—though we still view this outcome as unlikely. What we're seeing in Europe is that investors are afraid that the region lacks the political unity and possibly even the financial capacity required to provide a sufficient financial backstop for the Eurozone. That increases the risk of weaker governments defaulting on their debt, which makes investors demand higher yields for taking on that risk. Those higher yields contribute to an adverse feedback loop that makes a default even more likely, because governments can't sustain interest payments above a certain level, so only some type of unified policy action and intervention can allow governments to roll over all the debt that is coming due.

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, a 2008-type banking crisis, and possible European or even global depression. There are other outcomes in between these two extremes. Most economists now view recession in Europe in 2012 as almost certain. European authorities have so far been ineffective in containing the crisis through incremental steps. The worsening of the crisis actually increases the likelihood that the European Central Bank will finally step in more decisively and provide major support for the sovereign debt market and the banking system, e.g., by buying Italian and Spanish government debt via "quantitative easing" (much as the Federal Reserve has done with Treasuries) to bring down interest rates, restore confidence, and break the debt-contagion adverse feedback loop. But, this is not certain and the question of whether they will do it in time to avoid a serious and potentially devastating economic downturn is one we can't confidently answer. The costs of a European Union break-up are high so there should be strong motivation to avoid it, but the political and practical realities are highly complex.

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 as funding has dried up and assets on their balance sheets have become riskier and less valuable. Their actions are being felt around the world. In short, there is already a European banking crisis though not yet as severe as what we saw in 2008 in the United States.

The global ramifications of a disorderly EU breakup would likely be severe. The banking system would be a primary way to transmit the crisis globally and trade would be a secondary transmission mechanism. Though most of the direct exposure to default is with

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European banks (and they also operate in the U.S. and around the world), U.S. banks have exposure through derivatives (a financial instrument whose price is derived from the value of another asset or group of assets). Unfortunately, there is a lack of transparency that makes it impossible to fully understand the nature and amount of the derivatives risk to U.S. banks. (We have seen estimates that exposure through counterparty risk—the risk that the other party to a derivatives contract does not live up to its obligations—is as high as $4 trillion.) The likely result of this scenario would be at the very least a developed world recession, as credit could temporarily freeze and trade levels would drop. This would also result in a slowdown in some emerging economies and outright recession in others. Heightened risk triggered by concerns about sovereign risk could also trigger a funding crisis. According to the Organization for Economic Cooperation 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 (though capital has to go somewhere and U.S. Treasuries remain the asset of choice in times of heightened risk aversion).

Policy tools would likely be more limited than in 2008 and 2009 because we've already used up some of our "bullets," contributing to government debt levels that are very high and that could reduce the political will to allow them to expand further. We view this overall scenario as improbable because the ramifications are so extremely negative that authorities will want to avoid it at all costs. However, we have learned not to dismiss the unthinkable and we are not able to have complete confidence in policymakers taking effective actions at the right time.

While Europe is the imminent risk there are other worries. The U.S. economy, though still weak, has performed somewhat better recently and appears to have moved back above stall speed. But, 2012 will be a year of fiscal contraction with the amount still uncertain as we write this. If a European meltdown can be avoided it is expected that the United States will continue its slow expansion, but our own maddening political dysfunction, severe debt problems, and continued housing weakness makes the United States susceptible to economic shocks and policy errors.

Japan is one of the most indebted developed countries and highly susceptible to rising interest rates. China's economy is slowing and the authorities are now moving to stimulate growth. But, the impact of its previously booming real estate sector, which according to some reports is now contracting at disturbing levels in some regions, and slowing export growth to the developed world, remain serious risk factors. We can't confidently predict whether China will be able to avoid a sizable slowdown in growth (a "hard landing"). But, we are concerned because of the importance of China's impact on global growth, which has been disproportionate to their portion of the global economy. (Based on World Bank data, in 2010 China accounted for almost 20% of global growth.) A hard landing for China would be a significant blow to the developed world economies. And, yet another risk to the global economy as we move into 2012 is the possibility of rising Middle East tensions (with Iran specifically) driving up the price of oil.

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So Where Are We? Our Portfolio Strategy

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 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. That could happen because a second bullish factor is that companies 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.

Overall, our decision to reduce risk across our balanced strategies means that we could—perhaps for several years—underperform our benchmarks in some scenarios. In these outcomes we wouldn't look as good for a period of time as we would have by maintaining a more neutral investment position. We accept the risk of trailing under some scenarios for a number of reasons. First, while the odds of a very negative scenario playing out are relatively low, its effects would be highly damaging, and we think our optimistic scenario is even less likely. Second, our most-likely scenario involves no crisis but slow growth for many years, with mediocre returns for stocks (in the mid-single-digits), and periods of high volatility that create opportunities to add back stocks at more attractive prices. Third, our process and the decisions that result reflect our commitment to thorough research, intellectual honesty, and discipline, and we believe this kind of process has the best long-term likelihood of success. Finally, although some might conclude we are wrong if these risks don't happen (and we think this is the greater likelihood) it is our job is to make decisions that we believe best serve our clients, not our business.