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Quarterly Newsletter to Clients Q1 2012

March 30, 2012

"You can avoid reality, but you cannot avoid the consequences of avoiding reality."
Ayn Rand, author of The Fountainhead and Atlas Shrugged

Executive Summary

So far this year the jobs data has improved and markets have rallied. We continue to question the authenticity of the recovery and believe a market correction is likely.

- Despite reducing risk in Q4 for all portfolios, both our Long-Term and Retirement Spending Portfolios continue to appreciate.
- Some important data supports our research firm's (ECRI) recession call. ECRI coincident growth indicators are in recessionary territory. We also believe there is a problem with the seasonal adjustment of reported data that skews data positively in Q4 and Q1 but negatively in Q2 and Q3. Finally, our own analysis of real economic activity confirms a decline in important measures of economic activity to recessionary levels.
- ECRI's recession calls have historically resulted in a drop in the stock market sometime after the recession is recognized by the rest of the world. While this call has not yet worked to our advantage, we continue to believe the call remains valid and may work to our advantage over time. However, should the call be proven incorrect, i.e. that we face an extended slowdown instead of a recession; we believe the process is sound and will benefit clients over coming years.
- Unprecedented monetary stimulus has resulted in an increase in asset prices. Based on a historical analysis of the long-term impacts of quantitative easing in the US and Japan, we believe this effect is only temporary.
- Seasonal adjustment serves a useful purpose but may have been distorted by the worst two quarters in economic history since the 1930s (Q4 2008 and Q1 2009). We believe this seasonal adjustment issue may cause economic activity to be overstated in the Fall and Winter and understated in the Spring and Summer. If our belief is true, and economic growth is weaker than expected, seasonal adjustments will overstate this weakness and exacerbate negative news.

Portfolio Allocation and Risk

Our portfolios are allocated with substantially lower risk than the S&P 500. Our Long-Term Risk Tolerant Portfolio remains allocated 50% to the Long-Term Less Volatile managers (primarily equity managers) like IVA Worldwide and First Eagle Global. These Long-Term Less Volatile managers have consistently shown better returns than market indexes including the S&P 500 over full market cycles. We compared the current allocation of our Long-Term Risk Tolerant portfolio to Ibbotson asset allocation models and found it is positioned squarely between a Moderate Conservative and Moderate portfolio in terms of its expected risk. While new clients are positioned more conservatively, the bulk of our clients are participating in the rally.

Similarly, while we reduced the risk of our Retirement Spending Portfolio by selling some of the more volatile bond funds, our current managers are, in aggregate, also experiencing positive returns. We believe both portfolios will experience substantially less risk than broad market indexes in coming months.

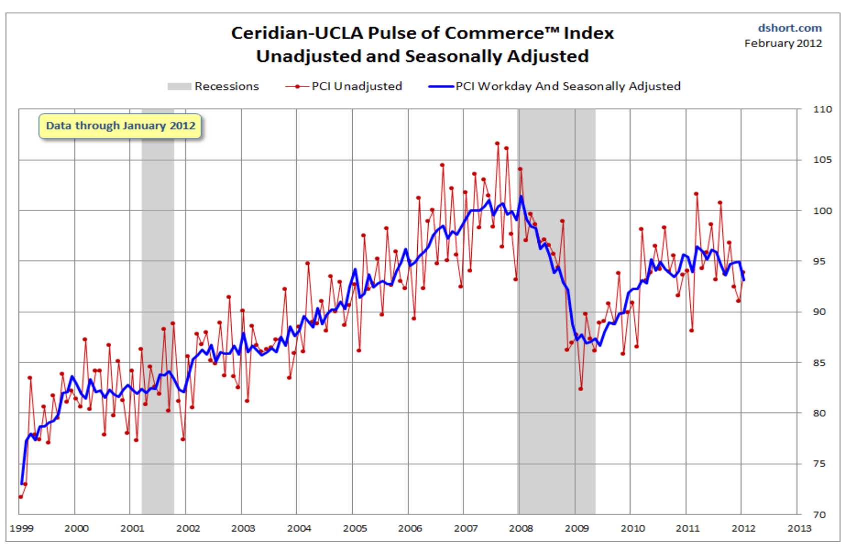
Data Continue to Suggest a Recession Remains Likely

As quoted above, "*you can avoid reality, but you cannot avoid the consequences of reality*." While we cannot say with certainty that a recession will take place we can say that currently the economy is at stall speed, at best. ECRI analyzes a myriad of indicators including leading (where the economy is going), coincident (where the economy is now), and lagging (where the economy has been). While it is easy to dispute leading indicators, looking at what is happening right now or what has happened in the past is less ambiguous. Let's look at this in some detail.

The definitive, hard data has been consistently worse, not better. GDP growth, year over year, peaked in Q3 of 2010, fell to 1.5% by Q2 of 2011 and has essentially flat lined (since last year annual growth was 1.6%). Personal income growth and broad sales growth have the same pattern. Industrial production growth as of January is at a 21 month low. These metrics are the same metrics the National Bureau of Economic Research (NBER) tracks when they call a recession. They are also the metrics used to build the ECRI Coincident Index for the US economy. Rolling all these up, the coincident index is at a 21 month low. The chart (left)right shows there has not been a drop to this level (red line) without a recession ensuing since 1950.

Shaded areas represent U.S. business cycle recessions.

While the press has been focused on improving jobs, we believe there are two reasons to be wary of this focus. First, jobs are a lagging indicator. Second, we believe there may be a problem with the seasonal adjustment program (more later). Personal income growth has been negative for five months. Historically, this has NEVER happened without a recession ensuing. While ECRI continues to suggest a recession is imminent, it is possible the seasonal adjustment issue (below) may have caused them to call recession prematurely.



Other real metrics that we follow indicate levels of current economic activity are at levels that are clearly inconsistent with increasing economic activity. The chart above illustrates for instance, that the gallons of diesel fuel consumed is has been declining over the last year. At best this suggests very slow growth.

ECRI Recession Call Track Revisited

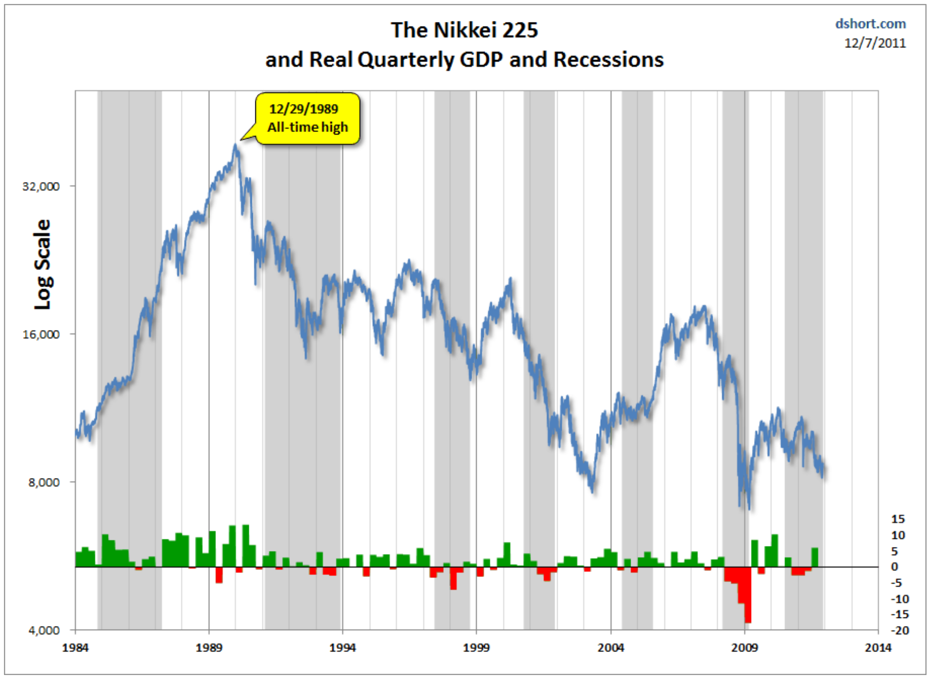
Should the Economic Cycle Research Institute (ECRI) call prove correct, we cannot know how long this will take or how deep the recession will be. Our rationale for reducing risk in Q4 was simple: we wanted to reduce the incredible downside potential that our clients face should a deep recession occur. Moreover, an examination of ECRI's historical recession calls suggest the risk of lost opportunity pales against the risk of downside. In other words we felt we could substantially reduce portfolio risk while exposing ourselves to only low opportunity cost. Even should ECRI's recession call prove to have been incorrect, we believe the process to reduce risk with their recession call is sound. Moreover, we anticipate making multiple allocation decisions over the next several years that will add to total return and reduce volatility.

What has been surprising is the extent of the market rally following the ECRI recession call. We ran an analysis to illustrate the potential downside against the opportunity cost between ECRI recession calls and Growth Rate Cycle Upturns (which historically coincide about 1:1 with market rallies). The table below illustrates that using this information would have been valuable in 2 out of the last 3 recessions called. Specifically, the S&P 500 fell by 42.5% between March 2008 when ECRI called recession to March 2009 when ECRI called a Growth Rate Cycle Upturn.[i] The benefit of using the call during the mild recession of 2001 was substantially less, only 4.7% from March 2001 to November 2001. Moreover, investors reducing their risk at recession call would have suffered substantially less volatility. During this period the stock market fell over 22% at one point. Historically, only during the 1990-1991 recession did stock prices rise between the ECRI recession call and Growth Rate Cycle Upturn. For this reason, we believe recognition of even a mild recession will result in a substantial market correction.

ECRI Calls Recession	ECRI Calls Growth Rate Cycle Upturn	Change in Average Monthly Price	Worst Return since Beginning of Call Month	Best Return Since Beginning of Call Month
September 2011	none yet	?	-8.6%	17.1%
March 2008	March 2009	-42.5%	-47.8%	7.7%
March 2001	November 2001	-4.7%	-21.6%	6.1%
February 1990	February 1991	9.9%	-7.8%	16.8%

We have had extensive dialogue with ECRI. The primary variables that appear to be different in this case are the unprecedented monetary stimulus and the seasonal adjustment issue, both which have proven historically to be only fleeting in nature. However, the risk of further monetary easing goosing asset prices higher remains.

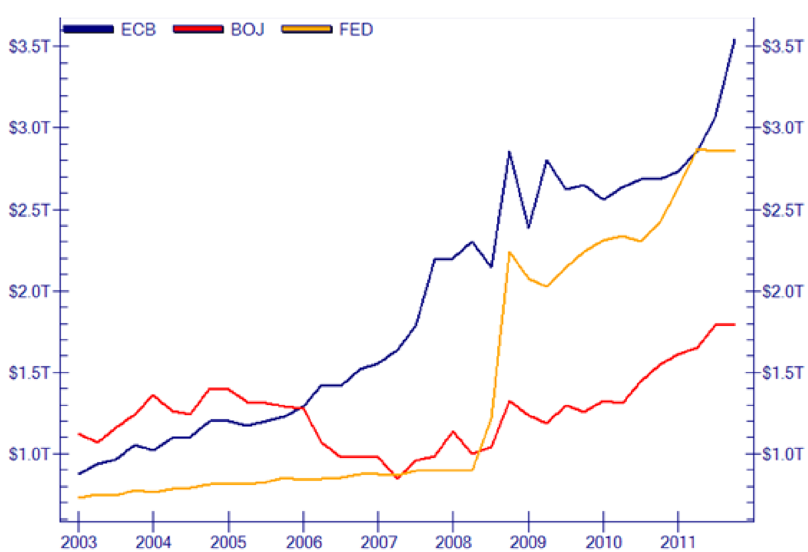
There is also compelling evidence showing we are headed for a cycle of more frequent recessions. During this period of lower trend (slow) economic growth combined with higher volatility due to increased government involvement in economic policy, we expect recessions to occur more frequently.



Japan experienced an asset price bubble from 1986 to 1991. Nomura research shows that Japan would have fallen into an extended depression had they not chosen to print money and spend trillions of Yen to prop up their economy. This created an environment where the Japanese experienced slow but positive economic growth. However, the Japanese stock market (Nikkei) did not fare well. When adjusted for inflation, the Nikkei remains nearly 75% below its high at the end of 1989 and has been incredibly volatile since the bubble burst. We are not convinced the problem in the US is the same magnitude. Nonetheless this is our only example in recent history of an country printing money to "solve" its problem. During this sole example, risk assets (stock prices) did not fare well.

Unprecedented Monetary Stimulus

The world's central banks have been printing money on an unprecedented scale. We all know about QE1 and QE2 in the US, but largely neglected is the even larger effect of the Long-Term Refinancing Operations of the European Central Bank. The chart (below) shows total assets on three key central bank balance sheets: Blue for the European Central Bank, Yellow for the US Federal Reserve, and Red for the Bank of Japan. Not shown, but significant include the UK and China.



Sources: Bloomberg, BOJ

Monetarists (economists who believe economic growth is a result of Money times Velocity) believe more money entering the economy can cause economic growth as long as the money continues to move. Unfortunately, the velocity of money has fallen to a record low in the United States and is near a record low in Europe and China. Money introduced into low velocity environments finds its way into asset prices and can give them a substantial short-term boost, especially commodities and risk assets like stocks and high yield bonds. Due to the European crisis and fears over China, global investors have recently considered the US stock market to be the least worst. This has likely resulted in a run up in stock prices, particularly in the US. However, as demonstrated earlier, such runs have historically been fleeting in nature.

The Seasonal Adjustment Issue

After several revisions real GDP was found to have fallen by 8.9% in Q4 2008 and 6.7% in Q1 2009. This was substantially worse than the 1974 recession and worse than any period since the 1930s. The nature of the Great Recession seems to have had an unexpected impact on the program the Bureau of Economic Analysis uses to make seasonal adjustments to economic data. We believe the Subject Matter Experts who compile GDP data are not sufficiently accounting for this anomalous period and that it is causing data to be OVER reported in Q4 and Q1 and UNDER reported in Q2 and Q3. Below is a chart from Nomura that illustrates this very well and suggests that GDP (and the underlying data used to compile GDP) for Q4 and Q1 may have been OVERreported by as much as 2%.

Figure 1: Same seasonal pattern of economic surprises in 2010 and 2011

Note: Nomura USD Overall Surprise index, Bloomberg: NGISOUSD Index<GO>; see FX Quant Insights: Nomura growth surprise indices (GSI) for more details. Source: Nomura.

Compounding this issue, the US has experienced unseasonably warm weather. Abnormally warm temperatures and a record mild winter have likely pulled retail purchases forward into January and February and March from April and May. This, combined with the seasonal adjustment bias illustrated above, may set the environment for negative economic surprises. Finally we believe high gas prices will put a damper on consumer spending and in itself may be recessionary.

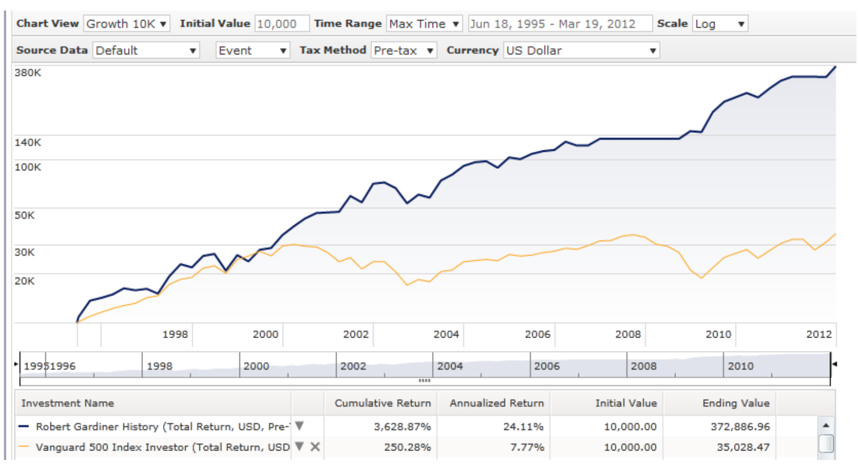
ERBAA and Coming Expansion

In our last newsletter, we wrote that we would get clear signal before a cyclical upswing in stock and risk asset prices begins anew. Following is the sequence of events that unfolds:

1. Long Leading indicators turn up. During recession, this typically happens 8 months before the economic expansion and one month before a cyclical upswing in stock prices
2. Short Leading indicators turn up (confirming the expansion). The Weekly Leading Index growth typically turns up about the same time or a month before stock prices turn up.
3. Finally, the economic growth cycle turns up and everyone realizes we are in recovery. This will likely be several months later and stocks will have already risen substantially.

There remains substantial risk. We are unwilling to increase our exposure to risk assets until we get a clear signal that an economic expansion is in place. At some point we will get a signal of an Economic Growth Rate Cycle Upturn indicating an opportunity to take additional risk. Historically markets have rallied during these upturns.

Our clients during 2009 remember when we introduced Wasatch Global Opportunities to portfolios. This fund substantially beat the market during the expansion period. In fact an investor following Robert Gardiner since March 1, 2009 would have experienced a cumulative return of nearly 80% above the S&P 500. Below is an example of Robert's track. We are itching to use his latest fund at Grandeur Peaks when we get an expansion call. Should ECRI's Growth Rate Cycle Upturn call be as good as last time, when they told clients to invest in March of 2009, we hope to improve on this going forward. However, we feel confident we will be able to do this at substantially lower prices.



As part of our manager due diligence, Joey, Adam, and Ken went on company visits with Robert's new company. We look forward to investing client's money in their new funds when appropriate at the next Growth Rate Cycle Upturn.

Concluding Remarks

We are, above all, pragmatists. Our overwhelming priority will always be to avoid permanent loss of capital. We believe we made the right decision to reduce risk. Because we believe we are likely to endure a period of more frequent and shorter economic cycles over coming years, we believe this opportunity will be afforded more frequently and will prove useful over time.

"*Volatility plus low trend equals more recessions*," Lakshman Achuthan.

Past performance is not a guarantee of future results. Any investment advice should be rendered in a one on one environment and customized for the client receiving the advice based on their goals and investment time horizon.

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[i] This analysis was run using the average price of the S&P 500 for the month ECRI called recession and the average price of the S&P 500 for the month the Growth Rate Cycle was called. This average price was used to minimize the effect of timing day to day volatility and we feel is a more accurate representation of how we would actually have implemented the call.