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MERITAS ADVISORS
Comprehensive Wealth Management

2011- The YEAR IN REVIEW

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Strength and Stability in Volatile Times

Our mission is to generate stable real returns, regardless of the direction of the economy, while providing the highest level of service and exceeding expectations in performance, planning and communication.

We seek to generate returns from market movement, rather than being dependent on a particular market direction. We utilize the strongest performing investments across a wide range of sectors and strategies that when combined seek to optimize opportunity, while minimizing downturns.

Dear Clients and Friends: As we say goodbye to 2011, I think the one thing everyone can agree upon after this year of considerable angst and strife, is that it was one wild ride! Up, down, impending doom, no we're saved, genius, no bumbling fool and so it went as many headed for the hills holding onto their wallets and their stomachs, exhausted from the vicissitudes, "Just get me off this ride!" It was a year in which many sages of the investment world got it wrong, or at least appear to have for the time being. The U.S. government became the focus of much frustration and even rage, rivaled only by the disgust directed at Wall Street. It was a year of seemingly endless contradictory moves in the market, a year in which those who didn't keep their eye on the big picture paid dearly.

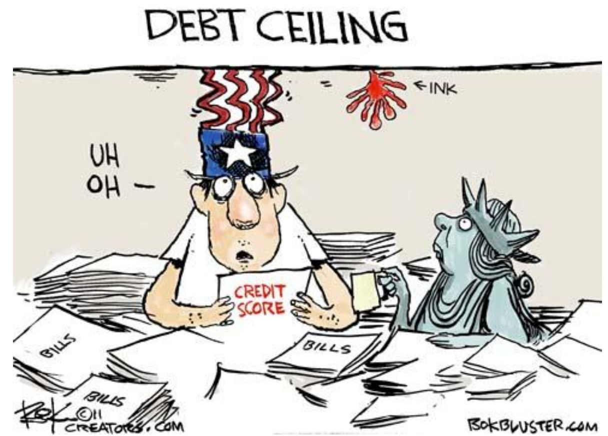
In honor of the season we present to you *The Top Ten Head Fakes of 2011* sung to the tune of the *Twelve days of Christmas*. I confess that my dog Dublin wasn't terribly enthused with this type of creativity as he whimpered and skulked out of the room when I sang a rousing rendition to him to check the rhythm. Hopefully your family will benefit from Dublin's sacrifice!
Lenore Hawkins, MBA, Principal

On the first day of Christmas my true love gave to me, a PIMCO without a Treasury.

Long-time market sage Bill Gross of PIMCO fame was vehemently opposed to Treasuries for most of 2011. In his March Investment Outlook for shareholders Mr. Gross said he was worried about demand for Treasuries once QE2 ended in June, so he removed all exposure to Treasuries in his flagship Total Return Fund. The iShares 20+ Year Treasury Bond ETF (Ticker TLT) was up 33.19% YTD as of 12/15/2011 and the iShares 3-7 Year Treasury Bond ETF (Ticker IEI) was up 8.37%. Oops! While his concern was absolutely justified, unfortunately for his shareholders he didn't see how big the fear trade would become with the European debt crisis and significant slowing in emerging markets. He has since brought exposure to Treasury bonds back into the fund. ***Bottom Line***: *While his concerns were quite valid, even the wisest investor can get the timing wrong on occasion, but I wouldn't be placing bets against Bill for the long run!*

On the second day of Christmas my true love gave to me an S&P downgrade and a PIMCO without a Treasury.

As regular readers know, I'm no fan of our current debt situation, but the events around S&P's downgrade of U.S. debt are ironic to say the least. In early August S&P downgraded U.S. debt one notch to AA from AAA, while Moody's and Fitch affirmed their existing AAA rating.



In the private sector, a rating downgrade usually results in bond yields going up. A downgrade means the bond is riskier. A riskier loan requires a higher interest rate. The company's stock price often drops as well, since the downgrade means that the company's financial position has weakened and investors understand that its borrowing costs are likely to rise, reducing profit margins.

After the rating downgrade, the U.S. stock market continued the downward trend that started in May and dropped another 5.43% in August, followed by a whopping 7.03% drop in September, leaving the index down 8.7% for the year. The head fake came with Treasury yields dropping from 3.20% for the Ten Year Treasury bond on July 1st to 1.81% on September 23rd. That is a 43% drop in yield after a downgrade! So much for rating agencies in the face of a flight to safety! Just what is safe these days when the risk-free rate is based on U.S. Treasury rates, but they are deemed riskier than many corporate bonds? Talk about flipping decades of finance theory on its head! ***Bottom Line****: Investors are wise to keep the bigger picture in mind. We are in a macro-driven climate with headlines largely dictating market direction.*

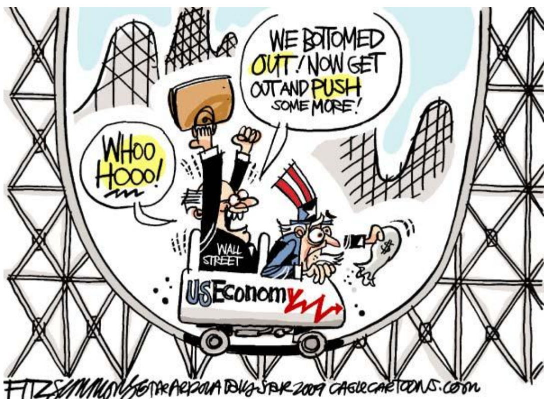
On the third day of Christmas my true love gave to me a Presidential Cycle, *an S&P downgrade, and a PIMCO without a Treasury.*

The third year of a President's term typically sees the S&P 500 gain on average 15.9% since 1945, compared to average gains of around 5% to 6% for the first two and fourth year. Towards the end of last year and early this year many investment firms published predictions that 2011 was going to be a strong year, due in large part to the phenomenon of the Presidential third year in which returns are typically high.

If the S&P ends 2011 in negative territory, it will only be the third time in over 80 years that the index declined in the third year of the Presidential cycle. The other two times occurred during the Great Depression in 1939 and 1931. The S&P 500 closed at 1,258 on December 31st, 2010. On December 16th, it closed at 1,219.66. ***Bottom Line****: Be wary of historical "norms" during such unprecedented global conditions.*

On the fourth day of Christmas my true love gave to me Quantitative Easing, *a Presidential Cycle, an S&P downgrade, and a PIMCO without a Treasury.*

The federal government injected around $814 billion dollars into the U.S. economy through the American Recovery and Reinvestment Act in 2009 and another $104 billion in 2010, not to mention the euphemistic quantitative easing programs nicknamed QE1, QE2 and Operation Twist. Government spending in excess of tax receipts, (meaning spending that adds to the national debt) jumped from 3% of GDP in 2006 to 8% in 2011. Earlier this year the Fed projected that in 2011 GDP would grow 4%. We will be lucky to get half that. The San Francisco Federal Reserve issued a report in November stating that odds are greater than 50% that the U.S. economy will experience a recession sometime in early 2012.



Bottom Line*: The recent recession was very different than prior ones because it was driven by a credit crisis due to an over-leveraged global economy. Debt levels need to contract for quite some time to get back to anywhere near historical norms. No amount of government spending can prevent this much needed process, nor fight the inevitable impact of it.*

On the fifth day of Christmas my true love gave to me John Corzine, *Quantitative Easing, a Presidential Cycle, an S&P downgrade, and a PIMCO without a Treasury.*

2011 was a year that provided a cornucopia of scandals to inspire endless evenings of laughter or angry debate. The season of scandal launched with Anthony Weiner's unfortunate Twitter choices, (step away from the mirror when undressed with a cell phone) and evolved into the ATF's Fast and Furious debacle that saw the federal government giving guns to murderers across the border and revealed the DEA had been laundering money for Mexican drug cartels.

In the investing world, the truly priceless moment came when former New Jersey Governor, former New Jersey Senator, former Goldman Sachs CEO, and until recently CEO of MF Global, Jon Corzine, was hauled in front of a Senate committee concerning the collapse of MF Global and the disappearance of $1.2 billion of client funds. As a Senator, Mr. Corzine had played a major role in writing and passing the much-vaunted Sarbanes-Oxley Act which was supposed to save investors from MF Global-like losses. He'd also been a harsh public critic of the level of risk taken on by the likes of Lehman and Bear Stearns, leading to their demise. He stated that, "We need to have regulators that are more active." In a later interview back in 2008 he argued that, "We need systematic oversight of derivative markets." You can't make this stuff up! As Jon Stewart put it so well during a November broadcast, Corzine took the leverage levels of Lehman and Bear Sterns not as a cautionary tale, but as a dare! ***Bottom Line****: I believe it was Lady Macbeth who first taught us, "The lady doth protest too much, methinks." I wonder if Jon Corzine has a poker game setup with family values champion, former Governor Mark Sanford?*

On the sixth day of Christmas my true love gave to me bigger, safer banks, *John Corzine, Quantitative Easing, a Presidential Cycle, an S&P downgrade, and a PIMCO without a Treasury.*

From September 30th, 2006 to today, the total assets of the six largest U.S. banks increased by 39% and they were too big to fail back then! We also learned recently, (and only through much court wrangling involving the Freedom of Information Act) that as of March 2009, the Federal Reserve had committed $7.77 trillion to rescuing the banks and even Congress didn't know about it. That is more than HALF of U.S. GDP! The six biggest banks, which received $160 billion of TARP funds, had also borrowed as much as $460 billion from the Fed during the crisis!

The crisis was far worse than Americans were led to believe and the heads of the major banks have shown themselves to be exceedingly competent frauds. On January 22nd, 2009, Bank of America CEO Kenneth Lewis said, "The diversity and strength of our company is allowing us to continue to invest in our businesses to drive future profit and growth." B of A received $45 billion in TARP money and as of February 26th, 2009, had borrowed $91.4 billion from the Fed. B of A's 2008 net income was $4 billion. (I highly recommend "What the Fed knew and didn't tell," in the January 2012 edition (current edition) of Bloomberg Markets for more stunning revelations on the condition of the banks and the level of risk placed on the American economy by the Federal Reserve without our knowledge, let alone consent.)
Bottom Line*: The taxpayer funded bank bailouts exacerbated the "too big to fail" problem so now, punishing the banks for their bad behavior is a bit like shooting ourselves in the foot...and they know it! I doubt we'll see any improvement in their behavior as long as their individual financial well being is so critical to our economy.*

On the seventh day of Christmas my true love gave to me Fairholme is tanking, *bigger, safer banks, John Corzine, Quantitative Easing, a Presidential Cycle, an S&P downgrade, and a PIMCO without a Treasury.*

From 2003 through 2010, Bruce Berkowitz generated double digit positive returns every year in the Fairholme mutual fund, ranging from a low of 13.74% in 2005 to a high of 39.01% in 2009, except for the one down year in 2008 in which the fund experienced a 29.7% loss, still better than the S&P 500 decline of 37% for the year. As of December 15th, the fund has lost 30.47% while the S&P 500 was only down 1.36%. Why? Berkowitz made an enormous bet on the financial sector, a bet which we at Meritas Advisors still cannot understand. Obviously this is an investment professional with judgment and skills that demand considerable respect, which makes his decision and ongoing commitment to the sector all the more puzzling. As of August 31st, 76% of the fund was invested in the financial sector.

Bottom Line*: Berkowitz is known as a contrarian and you have to respect his fortitude in the face of such pressure. He placed heavy bets awfully early in the game and is paying the price. With the mess in Europe and the state of banks over there, I think it is highly unlikely that this sector is going to strengthen significantly anytime soon. For the investor, be careful of putting too much of your portfolio in the hands of such contrarians, unless you are willing to be very patient and take significant losses along the way.*

On the eighth day of Christmas my true love gave to me a Summertime rally, *Fairholme is tanking, bigger, safer banks, John Corzine, Quantitative Easing, a Presidential Cycle, an S&P downgrade, and a PIMCO without a Treasury.*

The markets have been exceptionally volatile this year, but August was a particularly wild one. On August 9th, after three days of market declines that dropped the S&P 500 11.5%, we woke to learn that all was well in the world. The Kardashians announced they were going to leave the public life in favor of a life of quiet contemplation, Democrats and Republicans sang a rousing rendition of "We Are the World," on the floor of the House and peace was achieved in the Middle East. Alright, I made most of that up, but the markets appeared to truly believe that the U.S. debt ceiling crisis was being adequately addressed and the European debt crisis just wasn't that important. The S&P rose 4.74%, the biggest one day rise for the year. But the market's relief was short-lived and fell 4.42% the following day only to rise 4.63% on the 11th! The month of August saw 10 days where the market either rose or dropped by more than 2%. Despite those big daily gains, August closed down 3.34% and September dropped another 6.45%. ***Bottom Line****: Investors have to be wary of volatile swings in the market that are not consistent with the underlying economic realities.*

On the ninth day of Christmas my true love gave to me Papandreou replaced, *a Summertime rally, Fairholme is tanking bigger, safer banks, John Corzine, Quantitative Easing, a Presidential Cycle, an S&P downgrade, and a PIMCO without a Treasury.*

Former European Central Bank Vice President Lucas Papademos became the new prime minister of Greece on Nov. 11, replacing George Papandreou, who led the government for the last two years. Papademos is to head a short-term coalition government supported by the outgoing Socialists and their rivals the Conservatives. This technocrat government was created to secure the approval of $117 billion in bailout funds from the IMF and other Eurozone countries. Over in Italy, Berlusconi was similarly replaced by another former banker, Mario Monti, who took over an

unelected government charged with imposing austerity measures to prevent the third largest economy in Europe from breaking under the weight of the debt crisis; two countries, two newly installed technocrats put in charge without any vote by the countries' own citizens.

Once again, the market was supposed to be happy with this situation. We've been saved. Hmmm, didn't work out quite that way as on November 23rd, even Germany's auction for 10-year bonds was poorly received, with the bids falling 35% shy of the maximum sales target. Holy cow! When the strongest economy in Europe can't get love for its bonds, you know faith is falling fast.

Bottom Line: *A change in leadership from elected representatives to installed technocrats is no guarantee that solutions will be effectively implemented to address a country's economic woes. The problems in Europe and here in the U.S. have developed over decades with no painless solutions possible. Be wary of market rallies based on faith in a political savior.*

On the tenth day of Christmas my true love gave to me unemployment falling, *Papandreou replaced, a Summertime rally, Fairholme is tanking, bigger, safer banks, John Corzine, Quantitative Easing, a Presidential Cycle, an S&P downgrade, and a PIMCO without a Treasury.*

The December labor report showed a growth of 120,000 jobs and the markets rallied on the belief that the U.S. economy is getting back on its feet. But.... and you knew this was coming, the 120,000 new jobs compares to a roughly 135,000 monthly average since mid-year, which is slower at the margin. Then look at where the new jobs are being created: retail, leisure, health and education, and waste management services. These are all lower paying jobs. Over the past four months, the annualized growth rate on average hourly earnings has slowed to 0.8%. A year ago it was 2% and two years ago it was 2.2%. In November of 2007, this measure stood at 1.9%, which means the pace of average weekly earnings, is now below where it was one month before the worst recession since WWII!

We are losing jobs in construction, (which pays 20% above average) and in the financial sector, (which pays 13% more than the average) and switching to retail, (20% below the average) and leisure, (30% below the average).

About 97.3 million Americans fall into a low-income category, which is typically defined as those earning between 1 times and 1.99 times the poverty level. Another 49.1 million are below the poverty line, which means 48% of the population are either low income or below the poverty line! Following the 2007 recession, the share of working families who are low income rose for three straight years and is at the level percentage of the population in at least a decade. The inflation-adjusted average earnings for the bottom 20% of families has fallen from $16,788 in 1979 to under $15,000 today. Adjusted for inflation, the median household income level is back to 1996 levels. Since December 2007, median household income in the U.S. has decline by 6.8%, when adjusted for inflation. In 1980 less than 30% of American jobs were considered low income. Today more than 40% fall into that category. As if all this wasn't painful enough, the total net worth of U.S. households dropped by 4.1% in the 3rd quarter of 2011, according to the Federal Reserve, which is the biggest drop since the height of the 2008 financial meltdown.

Bottom Line*: The unemployment situation is much more complicated that just a headline of new unemployment applications or an unemployment rate. With 71% of the U.S. economy coming from consumer spending, strong economic growth requires that people are not just employed, but that their income levels are growing and their household assets are at the minimum stable. While we are pleased to see some signs of improvement, we are far from out of the woods.*

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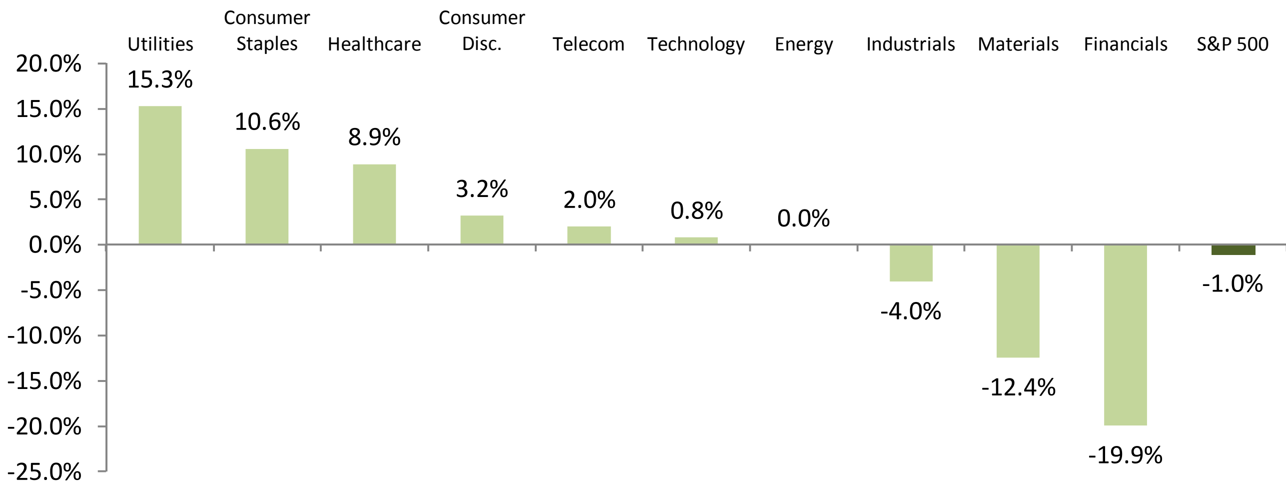
Market Recap

Index Levels	Close 12/16/11	Year End 12/31/10	Year Ago 12/16/10
Dow Jones 30	11,866	11,578	11,499
S&P 500	1,220	1,258	1,243
Nasdaq	2,555	2,653	2,637
Russell 2000	722	784	777
Bond Rates			
Fed Funds Target	0.25	0.25	0.25
2 Year Treasury	0.23	0.60	0.66
10 Year Treasury	1.85	3.30	3.47
10 Year Municipal	2.55	3.75	3.82
High Yield	8.61	7.51	7.70

Commodities	Close 12/16/11	Year End 12/31/10	Year Ago 12/16/10
Gold	1,594.00	1,405.50	1,363.00
Crude Oil	93.87	89.84	87.7
Gasoline	3.29	3.05	2.98
Currency			
$ per þ	1.30	1.34	1.32
$ per £	1.55	1.57	1.56
¥ per $	77.71	81.11	84.34



Wrap Up: 2011 provided plenty of opportunities for investors to get head faked by short-term trends and lose big. As investors we must always be aware of the underlying economic reality and never let emotions like hope or fear direct portfolio strategy. The coming year will likely see increased levels of frugality on the part of the global consumer. Nations will be forced to implement significant austerity measures as a global debt diet becomes the trend. Rising nationalism along with protectionist legislation and a tendency towards isolationism is likely to emerge. Significant geopolitical changes such as regime changes and wars will most likely dominate the headlines from time to time. During the coming year, traditional investing in which one finds a fantastic management team with a much needed product or service will be of little use in the face of macroeconomic forces. Tactical portfolio shifts that work with the market's increasingly headline driven swings are critical.

We wish you and your family a very merry holiday season and hope that Santa treats you to your heart's desire. The coming year is likely to be a difficult one, but such times often result in exceptionally productive changes. As the next chapter in the global saga unfolds, we will continue to be vigilant stewards, honored by our clients' trust.

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