ROOF ADVISORY GROUP, INC.®
INVESTMENT ADVISORY & FINANCIAL PLANNING SERVICES

INVESTMENT UPDATE

December 2012

Economic Conditions & Market Outlook

Most Investment Updates begin with a broad review of overall economic conditions impacting the investment markets, as well as highlighting key metrics and critical benchmarks that are currently influencing our firm's portfolio management decision-making. However, at present, such fundamental economic concerns and important market influencers are, unfortunately, rather inconsequential when compared to the day-to-day market impact exerted by the political negotiations connected with the looming deadlines of the near-term federal tax and revenue issues collectively known as the 'fiscal cliff'.

To recap, the 'fiscal cliff' refers to major fiscal events that would be triggered nearly simultaneously at year end 2012 and early January 2013 unless the U.S. Congress and President come to some agreement on critical federal spending and taxation policies. Numerous individual components comprise the fiscal cliff including: 1) the end of many tax relief provisions, such as Bush-era tax cuts, temporary payroll tax holiday, AMT inflation indexing, etc., 2) the first installment of the $1.2 trillion across-the-board cuts in domestic/defense program spending mandated by summer 2011's bipartisan deficit reduction agreement, 3) the likely need for D.C.'s policymakers to again raise the federal debt ceiling limit to accommodate our country's growing red ink.

Unpleasant memories still linger for many investors of the last time raising the federal debt ceiling was debated by lawmakers because August 2011 earned infamy as one of the most volatile months in recent market history. Even more important is the fact that the ugly prolonged political standoff over whether and how to raise the U.S.'s borrowing limit to avoid default ultimately resulted in the first-ever downgrade of the nation's formerly unblemished credit rating as investors and ratings agencies alike called into question the U.S.'s ability and political willpower to effectively address it's ever-expanding Federal deficit.

In fact, the mandated spending cuts referenced above are a direct result of the Budget Control Act of 2011 which requires equal reductions in defense and nondefense programs via a process known as 'sequestration.' This legislation was signed in August 2011 to end that summer's debt-ceiling crisis and contained spending and taxation provisions presumed to be so distasteful to both political parties that policymakers on all sides would eagerly want to forge a compromise to seriously address the country's unsustainable budget deficit long before the Act's measures would be triggered in early 2013. Yet, here we sit.

The potentially onerous results associated with disregarding fiscal cliff deadlines should come as no surprise, certainly least of all the elected officials who approved the very legislation that was intentionally designed to hold their feet to the fire. Little substantive progress has been made by opposing politicians who choose posturing and rhetoric over substance and compromise and this impasse will continue to fuel uncertainty and periodically disrupt the investment markets until some clear resolution on these critical issues is reached.

The gap in current negotiations remains wide, with focus mainly on who pays what in taxes and how. At present, the White House proposes $1.6 trillion in tax increases over the next 10 years, including increases in tax rates for the top 2% of earners; with Republicans countering with $2.2 trillion in deficit reductions that include $800 billion in revenue increases achieved through phased out exemptions and capped deductions but leaving tax rates where they currently stand. Most observers have given up hope that any so-called 'grand bargain' comprehensively providing long term solutions for the government's revenue shortfall and spending addiction can be reached before year end; instead settling for an agreement that at least diffuses the immediate fiscal cliff ticking time bomb and provides a starting point for sincere reform discussions later in 2013.

Cynics are quick to point out the long odds of Congress and the newly re-elected President reaching an agreement on any singular issue, much less one as complex, convoluted and politically distasteful as fiscal policy reform and deficit reduction, citing the glaring example of August's 2011 debt ceiling debacle. Hopefully, elected officials recognize the likely consequences of plummeting off the fiscal cliff could be dire.

Without providing exhaustive detail of all the specifics involved, observers agree that the most damaging result of going over the cliff would be the resulting nearly $500 billion jump in federal taxes that would occur in 2013. When combined with the deliberately painful sequestration spending rollbacks that would also be triggered during the year, economist consensus is that the U.S. would very likely again find itself having to dig out of an economic recession whose cause would be directly linked to the double barrel shock to the financial system of huge tax increases combined with deep spending cuts. Federal Reserve Chairman Ben Bernanke warned the Senate Finance Committee of this potential fallout on September 13, 2012 stating, "If the fiscal cliff isn't addressed, I don't think our tools are strong enough to offset the effects."

Some foolish extremists on both sides of the argument have suggested just catapulting ourselves off that cliff and then picking up the broken pieces as a fresh start to serious budget and/or deficit reduction discussions. Not a good plan. So it came as a bit of a surprise when last week normally clear-headed Treasury Secretary Timothy Geithner, who is key negotiator for the Obama administration, said the White House is indeed ready to go over the fiscal cliff unless House Republicans give in to demands for higher marginal income tax rates. Hopefully he had only temporarily succumbed to a bout of post-election public bravado and is now instead working hard behind the scenes to avoid that inevitability.

The fact of the matter is there are many more ways to effectively extract revenue from those taxpayers the administration deems as wealthy than simply raising marginal rates. These include eliminating special credits, deductions and exclusions primarily benefiting the well-to-do, as well as curtailing unique income categories, such as the 'carried interest' classification, which Warren Buffett has trumpeted allows him and other uber-investor types, hedge managers, etc. to pay income taxes at a lower rate than their hired help. Increasing revenue is part of the equation in addressing the long-term deficit, but the one-dimensional preoccupation on raising the highest marginal income tax rate is driven more by political ideology than basic math.

Another mathematical misnomer propagated by a few hardliners is that rolling over the fiscal cliff will bring federal spending in line with revenue, at least for 2013. Not so. If we unfortunately do roll over the cliff and all of the sequestration cuts occur as a result, the non-partisan Congressional Budget Office projects that federal spending will still go up for the year, just not as fast. Why? As draconian as these specific cuts may be, there will still be no net reduction in government spending because the ever-increasing annual cost of federal entitlement programs will continue to balloon out of control as more and more Baby Boomers qualify for Social Security and Medicare. The mathematical reality is that there can never be any effective deficit reduction reform without specifically addressing these entitlement spending behemoths.

One of the least publicized fiscal cliff issues was again brought to the fore last week when acting IRS Commissioner Steven Miller repeated his warnings that tens of millions of unsuspecting taxpayers would find themselves immediately subject to burdensome alternative minimum tax provisions starting January 1, 2013, unless Congress renewed annual inflation indexing relief. Mr. Miller noted, "The fact that alternative minimum tax [relief] actually expired at the end of 2011 has been overshadowed by other, higher-profile fiscal cliff issues." According to a letter the IRS sent to Congress a few weeks ago exhorting them to take action, "the number of households owing AMT would soar from approximately 4 million to about 33 million, with average tax increases that could run into the tens of thousands of dollars for many upper-income households."

Uncertainty regarding future federal tax policy and concerns as to the possible recessionary outcome of falling over the fiscal cliff has also influenced the current mindset of corporate entities as well. Many companies have accelerated dividend payments planned for 2013 into the last quarter of 2012 knowing this year's dividend tax rate is set at 15% while next year's taxation rate remains an unknown. A recent Wall Street Journal examination of the nation's 40 largest publicly traded corporations noted that half of those firms have announced plans to reduce capital spending either this year or next. Likewise, business expenditure for equipment and software stalled during the third quarter of 2012 for the first time since early 2009, with companies choosing to take more of a 'wait and see' approach as to the economy's continuing trajectory.

So with all the palpable trepidation and anxiety associated with unresolved fiscal cliff concerns coupled with the notably negative market gyrations and volatility that immediately followed November's election results, why have the markets remained relatively well-behaved of late? We suspect there are several reasons.

First, the currently overlooked economic fundamentals alluded to at the beginning of this Investment Update, while certainly not robust, provide positive confirmation that the recovery is indeed creeping forward. Noting the many caveats rightfully connected to the employment numbers just released on December 7th, the fact remains that companies did indeed add 146,000 new jobs in November and the published unemployment rate dropped to 7.7%, the lowest in nearly four years. Yes, this specific unemployment measure will fall as people stop looking for work and are no longer counted 'unemployed'. But the plus side is that this continuing uptick in aggregate new jobs creation occurred despite hurricane Sandy's hugely disruptive effect on significant portions of the U.S. economy and the general corporate buzz kill created by fiscal cliff unknowns.

Second, consumers seem to be much less maudlin about their near-term prospects than some of their corporate counterparts and were willing to put their money behind their attitude. The National Retail Federation's measure of Thanksgiving weekend sales surpassed 2011's number by 12.1%, exceeding $59 billion spent. Online shopping during the period also excelled; with ComScore tracking data showing Black Friday online sales topping $1 billion followed by Cyber Monday's $1.5 billion number, the largest online sales day ever.

Increased consumer confidence is not only being reflected in solid holiday sales numbers. October's pending home sales data beat consensus estimates and grew 18% year-over-year to reach the highest level since April 2010, a time when sales were boosted by a temporary tax credit. Case Shiller and FHFA data also show aggregate home prices continue to rise, signaling positively trending consumer demand. U.S. auto sales for November also grew at the strongest pace in over four years, jumping 15% above the prior year's number and logging the highest annualized growth rate since January 2008. All of these results validate the Conference Board's most recent consumer confidence index, which in November hit its highest level since February 2008.

Finally, while equities at first glance may not appear to be particularly alluring for investors right now, the reality is there are not many alternatives that look better. Yields on both corporate and sovereign debt remain historically low as bond prices continue to be propped up by both fear-driven demand and central bank actions. Cash positions offer temporary respite from near-term market dislocations but, as noted in this week's issue of Barron's, holding cash indefinitely is currently 'even more wealth destructive than it was during the hyper-inflation of the 1970s.' The article's author correctly observes that the, 'three-year return from the U.S. dollar, *after inflation*, now stands near -6.3%, worse than the -6% level seen near 1976.' Add this practical reality to some of the underlying positive economic fundamentals and the recently tempered action of the stock market becomes a bit more understandable, despite ongoing fiscal cliff angst and noteworthy geo-political stressors in the Middle East and Europe. Simply put, if the fiscal cliff concerns that are weighing down the market are soon successfully resolved, we suspect a very positive market response could result.

Regardless, continued vigilance remains imperative. As typical, specifics relating to our firm's recent tactical investment management moves are outlined in the last section of this Update. However, the unique nature, possible severity and long lead time associated with the fiscal cliff warrants some additional details regarding the firm's disciplined preparation process. Our evaluation of possible portfolio management responses to this potential crisis started in early 2012, with the first in a series of incremental steps to reduce client portfolio volatility initiated in late April. From then until the end of October, client target portfolio volatility was deliberately pared by approximately 33% in preparation for the uncertainty ahead. In addition to standard portfolio rebalancing strategies, the composition of individual portfolio holdings was notably modified and, where appropriate, significant long term capital gains were realized to assure taxation at the 15% rate. A further temporary reduction in volatility via a temporary move to our 'minimum equity' position was enacted in response to November's market spasms and we have since returned to 'mid-point' levels in our target portfolios. If a successful compromise to defuse the potential crisis is not reached before critical deadlines and extreme market volatility results, we are fully prepared to again quickly return to 'minimum equity' levels.

Winston Churchill is credited with making the tongue-in-cheek observation that, "Americans can be counted on to do the right thing…after they have exhausted all other possibilities." Let's hope our country's elected officials truly understand the necessity of taking action and can get there a little sooner this go around.

<u>Our Tactical Investment Stance</u>

Roof Advisory Group's disciplined investment approach emphasizes adding upside value to client portfolios while also controlling downside risk. Strategies include clearly defining investment policy ranges based on each client's specific investment objectives/risk tolerance, monitoring portfolio adherence to established benchmark parameters and ongoing evaluation of portfolio return relative to various risk measures.

Within this strategic investment management context, the firm makes tactical shifts to address changing market conditions and optimize client portfolio performance. Each client situation is unique but a few of the tactics presently being used across most portfolios managed are outlined below:

- The overall ***target allocation*** level for managed portfolios is currently at ***<u>mid-point</u>*** equity exposure based on each client's investment policy. As noted, this target allocation level was temporarily ***reduced two steps*** in range to minimum in November in response to the increased ***market volatility*** detailed throughout this *Investment Update*. While long-term fundamental ***risk/return*** potential in equities remains ***more attractive*** than either bonds or cash, we will remain ***extremely cautious*** until fiscal cliff uncertainty is resolved.

- The ***portfolio composition*** of all investment policies was ***notably modified*** during the second and third quarters in preparation for the ***uncertainty and changing risk factors*** associated with the fiscal cliff and November elections. The ***portfolio betas*** of all target portfolios had been ***pared*** an average of 30% from the end of April to the end of October in an attempt to ***lessen the impact of market volatility***. This was a reversal from the earlier months of 2012 when overall portfolio beta levels had been steadily increased in response to appreciating markets and an attractive potential reward relative to risk.

- Our ***large-cap equity bias*** remains and there is currently an overall ***value-style leaning***. The slight shift in higher equity level target portfolios towards more growth-style exposure earlier in the year continued to be moderated after May, with even ***greater reductions in growth-style*** concentrations made in ***balanced target portfolios*** to further dampen volatility. Most all international equity exposure at present comes primarily via select ***multi-national companies*** offering ***superior returns/less risk*** compared to pure foreign-based firms.

- Equity sector diversification remains a priority, as does regular portfolio rebalancing on a security by security basis to targeted portfolio levels. ***Profits were taken or losses capped*** throughout the period when risk/return potential deteriorated on several equity/fund holdings. Special focus was given to selectively ***realizing capital gains before year end*** and the likely increase in capital gains tax rates in 2013.

- In general, aggregate exposure in sectors classified as economically ***"Sensitive"*** remain at lower-than-normal levels, while ***"Defensive" and "Cyclical"*** sectors classifications are currently weighted higher-than-norm. Specific ***technology*** sector exposure remains near S&P 500 index ***benchmark level*** for ***growth-oriented*** target portfolios but has been ***markedly reduced*** in portfolios that are defined ***balanced or income***.

- The aggregate ***equity yields*** in all target portfolios have been ***above historic norms*** and are currently ***10% above*** April's already elevated levels. The return opportunity offered by high equity yields will be ***emphasized*** near term, as it provides both a ***tempering influence*** to ongoing market volatility and partially compensates for the much ***lower than normal interest rates*** currently available in ***fixed income*** investments.

- Ultra-short-term fixed income exposure continues to be ***significantly below target levels***, except during tactical portfolio repositioning or rebalancing. ***Interest rates*** in fixed income investments remain at ***historic lows*** and it is unlikely interest rates will rise significantly near term. Because of this, overall ***average duration*** of our bond portfolios has been slightly extended but remains ***short to intermediate*** because even longer term rates are comparatively low. ***High-quality preferred stocks*** continue to be used in ***moderation*** to enhance yield. Likewise, ***select fixed income exchange traded funds*** offering ***attractive yields*** along with ***notable diversity*** are being used in limited quantities. Overall fixed income ***diversification and credit quality*** remain critical considerations for all portfolios.

E. Jeffrey Roof