

*Fourth Quarter, 2011
Investment Briefing*

During the fourth quarter, investor confidence in Europe eroded further while confidence in the U.S. strengthened. Europe saw several summits that produced “comprehensive solutions” to their debt crisis that fizzled within days (sometimes hours) of their announcements. The U.S., on the other hand, saw rising retail sales, lower unemployment, and rising stock markets. Here’s how the numbers fared:

Asset Class	4th Quarter	All of 2011	5 Years (annualized)	10 Years (annualized)
Large Cap US Equities (S&P 500)	11.8	2.1	-0.3	2.9
Small Cap US Equities (Russell 2000)	15.5	-4.2	0.2	5.6
Foreign Developed (MSCI EAFE)	3.3	-11.7	-4.7	4.7
Emerging Markets (MSCI Emerging)	4.4	-18.4	2.4	13.9
Bonds (Barclays Aggregate)	1.1	7.8	6.5	5.8

As the table shows, U.S. small-company stocks were the best performer for the quarter, while bonds fared the worst. For 2011 as a whole, bonds were the best performers and emerging markets the worst. Bonds also performed best over a five-year period, with foreign developed equities faring worst and domestic stocks mostly flat.

United States: Occupied

If there’s a theme we could associate with Q4 (and apparently only with Q4), it would have to be the Occupy Wall Street crowd. Who would have thought that a rag-tag group with no clear message would become such a strong phenomena, grabbing headlines almost daily for months? The electorate is unhappy about a lot of things and we’ll see how that pans out in November. In the meantime, gridlock in Washington will most likely continue. Investors, on the other hand, were optimistic in Q4, and for good reasons:

- Leading indicators continued their upward trend;
- Consumer confidence was back up;
- Consumer spending was up; and
- Personal savings were down.

But let’s not get too carried away. While all of these are positive signs, the rates of increase haven’t been as strong as in prior recoveries. Recovering from a debt binge takes time, and we’re only a few years into deleveraging from a long period of massive borrowing. As we look ahead, the trends will probably continue: Mostly-anemic growth that is occasionally punctuated by a scary moment brought on by some unfavorable data. Hopefully the Q4 rally will continue (market multiples and the above points support this) which may make 2012 a good year for stocks. A good year for stocks could also signal an eventual increase in interest rates, which would be anticipated by the bond market -- meaning that longer-maturity bonds may suffer this year. We will stick with our short-duration bond portfolios for now.

Europe: Unoccupied

With the exception of some noisy participants on the steps of St. Paul’s in London, Europeans were surprisingly absent while their leaders debated their financial future. The markets didn’t

like it (as reflected in the returns above), but the populace, other than a few limited outbreaks, remained glumly silent. Perhaps Europeans really are more detached, or perhaps they're used to a lot of hoopla for no real reason. The story unfolded mostly in the same cycle many times: *Disaster is Imminent! Major Summit Scheduled! Complete Agreement on Comprehensive Solution! Handshakes! Smiles! The Market Loves it!...* Time passes, then... *Is That All They Agreed To? The Market Hates It! Disaster is Imminent!...*

It was enough to deaden even the most sensitive market participant. The euro declined in value, but not as significantly as one would have thought given the impending danger trumpeted by the media. At some point, we need to temper what we hear from the media.

- Is there a danger? Yes.
- Is it imminent? Given the slow progress, probably not.
- Is the danger of the euro downsizing or disintegrating higher than it was? Yes, many pundits have now increased the probability of this to about 25 percent.
- Has the market already discounted its prices to take this higher risk into account? Yes.

Franc€ and G€rmany

France and Germany continued their struggles with their southern neighbors, attempting to solve money problems without spending money. While the likelihood of some sort of breakup is higher than it was three months ago, it is still regarded by most as a low-probability event. Still, European officials are playing a game of chicken, and the outcome could be disastrous. The good news in all of this is that whenever they get close to something that smells disastrous, they quickly back off. Hopefully, they will continue to do that. In the meantime, what should we do to protect ourselves? The fact is that European markets, with 2011 returns generally in a range of -15 percent to -20 percent, have already priced in the risks of a recession and even the remote risk of a breakup. Also, Europe continues to need the euro to keep its economies working as smoothly as possible.

Let's speculate for a moment about what would happen if Germany gave up on the euro and went back to the Deutschemark (DM). Since Germany has a strong economy with high output and lots of savings, the relative value of the DM would soar. An expensive DM would mean that Germany's products would become extremely expensive, pricing them out of the highly competitive global market. A Lexus would suddenly look like an amazing bargain compared to a Mercedes.

Another point to keep in mind is that we've often referred to Germany as the powerhouse of Europe. Is it powerful enough to keep the entire continent humming? No. We tend to think of the rest of Europe as all too eager to accept handouts and take a vacation. France, for example, is frequently derided for its 35-hour workweek. The facts, however, reveal a country with much greater economic vitality. France has:

- A first class education system, one of the best in Europe;
- Productivity, or output per hour worked, that is second only to the U.S.;
- Good infrastructure (roads, power, etc.);
- Gross domestic product equal to about 79 percent of Germany's in 2010 (the next highest after Germany, and larger than the U.K.'s);
- A high standard of living; and
- Substantial foreign direct investment. According to the U.N., France is the fourth highest recipient of foreign direct investment after the U.S., China, and Hong Kong, meaning it's the fourth most popular place for companies and investors to send their money.

Actually, Europe contains six of the world's ten largest economies. Per the World Bank, those six countries had output of about \$10.2 trillion in 2010. (By comparison, U.S. output was about \$14.6 trillion.) With output of \$3.3 trillion, Germany is certainly a powerhouse, but it's important to keep it in perspective.

As we look ahead, we must make our investments based on the higher probabilities of cooler heads prevailing with the continuation of the euro. Volatility will be the norm for European and possibly world markets until this is resolved. As we mentioned, the fact that the euro has held its value this well so far shows that the market expects a positive outcome. The following chart shows that values have stayed mostly between \$1.20 and \$1.50 per euro for many years. The euro has dropped in value recently, but not alarmingly so.

Euro/Dollar Value 1/1/2000 to 12/31/2011



Source: Morningstar Direct

Emerging Markets: Unbound

When investors run for safety, emerging markets suffer, which is what happened in 2011, with losses in excess of 18 percent (higher than developed markets by almost seven percent). There are some real issues here, such as the fact that China, the premier emerging market, has been slowing down uncharacteristically. Also, India began to run head-long into its infrastructure impediments (30 percent of India's homes have no electricity). But every country experiences growing pains and we need to step back and consider the longer-term growth prospects. While developed economies are struggling for growth against massive debt loads, emerging economies have very little debt to hold them back. They generally have ample resources to stimulate their economies and build infrastructure. While these countries will most likely continue to struggle in the short term, the probability is good that their growth will continue at very high rates for the foreseeable future.

Bonds: Bound

Despite record-low interest rates at the beginning of 2011, the flight to safety continued and the year proved to be a good one for bonds. That said, the rate of increase in bond prices finally slowed down in Q4, to the point of being the major asset class with the lowest returns. Yields dropped overall, with long-term rates falling with the Federal Reserve's Operation Twist. With rates as low as 3.75 percent for a 30-year mortgage, it is very difficult to see how they could fall much further.

2012: Where Are We Headed?

Since it's the beginning of the year, the pundits are dripping with their usual highly-precise predictions of how this year will (or won't) progress. Rather than succumb to the temptation to join in, we'll summarize the biggest trends and speculate what direction they may take:

U.S. Elections: As we've mentioned in the past, markets don't like uncertainty in politics, and this could turn out to be an uncertain year. While many believe that the gridlock will continue, there could be some positive surprises, especially in an election year that has many expiring tax rules approaching in 2013.

U.S. Real Estate Values: Perhaps 2012 will be the year that buyers get used to tighter lending standards, record-low mortgage rates, and cheaper real estate, and then -- just maybe -- residential real estate values will bottom and resume modest increases. Surprises will probably be positive.

U.S. Debt Loads and Interest Rates: Given a continued soft real estate market, and still-high loads to begin with, consumers will probably continue their trend of paying down debt. This means less-than-normal consumption at this point in the business cycle, with a continuation of subdued spending. As with real estate, any surprises will probably be on the positive side. Interest rates are likely to remain low (because the Federal Reserve said earlier that they'd keep them low through the middle of 2013), although the bond market will start to anticipate increases at some point.

European Economy: Europe is most likely in a recession now that may turn out to be mild if talks of the euro staying together are at least a little productive. Any surprises will probably be negative here. The value of the euro compared to other currencies will probably continue to suffer.

Middle East Upheavals: This is always a wild card, even more so now that Iran is rattling its saber while the world keeps tightening economic sanctions. Add to that the ongoing aftermath of the Arab spring, and markets could get nervous if oil prices once again begin to spike. Surprises will probably be negative.

Japan: With output of about \$5.5 trillion in 2010, Japan ranked as the third largest economy (U.S. was \$14.6 trillion and China was \$5.9). As it continues to recover from domestic and nearby natural disasters, Japan could once again begin to deliver some nice surprises which, given our tight linkages, could also benefit the U.S.

Emerging Markets: As we stated above, most emerging countries have healthy reserves and the potential for vibrant economies. Expect positive surprises here.

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As always, we look forward to your comments, and we appreciate your trust. Here's to a great 2012!

Your Vista Wealth Management Team

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