Tarheel Advisors Newsletter

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2012 Investment Outlook

A tale full of sound and fury, signifying nothing - this may be the best way to describe the stock market performance in 2011 (and the last decade for that matter). Of the 252 market days this past year, we saw the DOW swing 100 points or more in 104 of those days. Despite all this volatility we ended up closing out the year with the broad market index, represented by the S&P 500, completely unchanged (+2.1% if you include dividends).

Year in Review—The core of our market thesis from the prior year ended up coming to fruition. Last January we targeted a 10% return for the year based on the prediction that "global liquidity and low interest rates will continue to drive up most asset prices." In the first half of the year , we saw Markets move close to our yearly target of 10% before losing all those gains to a 20% Summer sell-off inspired by the circus that was the U.S debt ceiling debate. From a big picture standpoint, our prediction that "there is a significant chance of markets overheating in the first half of the year setting us up for a 10 to 20% correction," was fairly spot-on. However, the selection of our favorite asset classes for 2011 was a bit hit or miss. Ironically, In the flight to safety that occurred during the Summer, U.S. bonds and the dollar strongly appreciated in value. As a result, emerging markets ended up suffering along with everything else that was not dollar denominated. Although most of these Markets outperformed their developed European peers, the absolute performance was sub-par. Commodities, on the other hand, did end up outperforming the broad markets for the bulk of the year.

2011 Score Card

10% Market Return	B
20% Correction in 2nd Half of the Year	A+
Emerging Markets Outperformance	C-
Commodities Outperformance	A
Avoid Long Term Bonds	C

We'll be looking for one of our predictions from 2011 to continue into the new year. Previously, we said that there would be a reversal in certain "investment grade" bonds that would be shunned by investors, thus increasing the risk of holding long-term bonds. Long-term U.S. Treasuries strongly bucked this prediction in 2011 and ended up being one of the best performing assets of 2011, returning 23%. Long-term bonds in Europe were a different story however, and saw large losses in value due to huge fear inspired spikes in borrowing rates bringing yields up to 7%. We are expecting to see further contagion of this effect in 2012 and beyond with it possibly even spreading to the U.S. or Japan. While long-term bonds in these countries may appreciate in a short term flight to quality, their risk should not be underestimated. Should investors begin to exit U.S. or Japanese bonds in a similar fashion to what occurred in Europe, don't be surprised to see long-term Treasuries lose 25% or more.

2012 Outlook & The Great Monetization- The budget satire in Greece this past year has made it clear to us that after the Lehman bankruptcy in 2008 and ensuing financial crisis, world leaders will avoid letting significant amounts of sovereign debt default at all costs. The issue of massive debt levels has not been resolved and will only continue to climb higher. If countries refuse to accept default as an answer, then the only other viable resolution is monetizing debt (printing money to pay off bonds).

Unfortunately, under this backdrop, a slow economy, and a presidential election year, we expect most asset classes to flounder in 2012. We expect both stocks and bonds to give returns of 5% or less and top out before the end of March. That being said, if investors like the results of the November elections then we could close out the year with a strong Santa Claus rally.

Another continuation of our 2011 thesis is we expect central banks around the world to continue to fire up the printing presses and thus

2011 Market Wrap

S&P 500	**+2.1%**
DOW	**+8.38%**
NASDAQ	**-1.8%**
MSCI World	**-12.21%**
BONDS	**+7.82%**
GOLD	**+11.12%**

Mortgage Rates

15-Year	**3.27%**
30-Year	**3.94%**
5/1 ARM	**2.88%**

Did You Know?

If you are ineligible to make a Roth IRA contribution for 2012 because of your income, there still is a way to potentially fund your Roth. Most wage earning investors are able to make a non-deductible IRA contribution. Currently, there are no income limits on converting IRA assets into a Roth. So, one is currently able to fund a non-deductible IRA and then the next day convert the assets into a Roth IRA with potentially no tax implications. Of course, don't expect this loophole to last for long, it could potentially sunset with the rest of the 2001 Bush Tax Cuts at the end of the year.

predict continued outperformance of the commodities asset class. We look for Gold to reverse its recent sell-off and to finish 2012 over $2,000/ounce. Also, don't be surprised to be paying over $4/gallon for gas nationwide come summer time.

Basically, we expect 2012 to be a year full of uncertainty much like the second half of 2011. Likely this will lead to more volatility and wild swings in the markets . Do not be afraid to take gains where you can find them. As we have been saying for the past two years, in this environment you need to be a "renter" of investments, not an owner. In fact, the majority of mutual fund and hedge fund managers ended up underperforming the indexes and their benchmarks, thus showing that even the professional money managers have not been able to take advantage of the volatility. Unfortunately, overweighting cash has been the best way to avoid volatility this past year and likely will be the case again in 2012.

The silver lining to our 2012 outlook is that we expect corporate profits to continue improving even if the lack-luster economy and high unemployment continue. During 2012, we hope that many of the economic issues facing the world will begin to be addressed. It will be impossible for the debt problems plaguing nations to be eliminated overnight, but if a game plan can be enacted to begin the deleveraging process, it could be extremely bullish for the world stock markets moving forward.

For the time being put a premium on protection. We expect 2012 to be a year where a strong defense will provide a strong offense for making profits 12 months from now. After all, imagine how excited investors will be when December 22nd rolls around without the world ending. Lets all hope the Tarheel Advisors' market predictions are more accurate than the Mayans and Nostradamus.

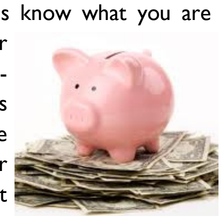
-Ryan Glover, CFP®

A Penny Saved is a Penny Earned

Ben Franklin popularized the saying "a penny saved is a penny earned". In today's low yield environment, his message of frugality is literally spot-on to what investors can expect to earn on their cash and "cash-equivalents". In fact, the average money-market fund currently pays .02%, with 1/3rd of them paying nothing at all. So, you may ask what then is the difference between a money-market fund and a piggy bank? Sadly, the answer is not much. Neither are insured, and both essentially yield nothing.

Why then did investors pile $90 Billion into these funds in November and December swelling the domestic total to roughly $2.7 trillion? The simple answer is safety. The problem with that answer however is that the safety sought is not necessarily as strong as you would think. Let's start with the basics -- what exactly is a money-market fund? The fund is essentially a basket of very short-term, "high quality", fixed-income securities typically with maturities of 60 days or less. Much like a mutual fund in nature, this "cash-equivalent" instrument can be redeemed by investors on a daily basis. However, unlike a mutual fund which has a floating net asset value (NAV) that is determined daily by dividing the funds total assets by the number of shares, a money-market fund is allowed to assume its NAV is always $1. Herein lies the problem. Take a quick trip back down memory lane and one can see as recently as 2008 that many money-market funds "broke the buck" because of investments in "high quality" securities such as those issued by Lehman Bros. All sarcasm aside, this was a really big problem in 2008 because of the panic it created, and the rush for the doors by spooked investors. Had the Federal Reserve not stepped in to provide assistance and unlimited protection in September 2008 (which expired in September 2009) things could have gotten uglier.

One might think that managers of money-market funds would have learned their lesson from this previous crisis, but a recent look inside the nuts and bolts of such funds led me to gasp - literally. Naturally, in a low-yield environment where the fed funds rate is .25% and the overnight LIBOR is .15% it is going to be difficult to find short-term investments that provide a significant return. However, what I saw from one of the top five money-market asset holders was the same old story with different characters. The supposed "high quality" investments weren't in failing US financial firms, but instead in a plethora of European banking institutions no doubt saddled with their own set of problems. One might ask these managers why they are taking on so much additional risk to scrape out a few pennies more of return. Unfortunately, I'd bet the answer lies in the mechanics of how these managers and their fund companies generate revenue to cover their own expenses. Think of it this way, if the average money-market fund charges expenses of .5%, then naturally they will need to invest in securities that average that yield or higher or face a negative real return for their parent company. In a world where overnight rates are lower than that, these managers must choose to add risk to the portfolio via investments in securities issued by European banks. So, if they invest in a basket of bank bonds that yield .52%, collect a fee of .5% for their work, you as the investor get the remaining .02% return and are often never the wiser to the unnecessary risk taking since the NAV is fixed at $1. Any guesses as to what these assets would be worth if Europe implodes and these managers have to sell these assets to meet customer redemptions? Hopefully, it doesn't come to that, but the moral of the story is know what you are investing in and seek an adequate return for the risk you are taking. If the "cash-equivalent" that is supposedly risk free turns out not to be, then find a suitable alternative like actual cash in a savings account, CD, or even a non-interest bearing checking account which currently carries unlimited protection via FDIC Insurance. -**Walter Hinson, CFP**®



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