ALL STAR QUARTERLY

THIRD QUARTER 2012 VOLUME 18 ISSUE 3

2012 – 3RD QUARTER REVIEW AND PREVIEW

Bob's Corner

Election Year Uncertainty

As we look back at the first 3 quarters of 2012, we have experienced plenty of volatility in the markets as uncertainty reigns supreme. Up 8-12% the first quarter, down 5-6% the second quarter, then up 4-6% the 3rd quarter. All of this gets us to a 10-12% return YTD with on average 65% of market risk. This is a very good risk reward performance, but please be assured that the volatility will not go away until we have more certainty come out of our political system. We need to see how the powers to be will handle the U.S. debt situation and how we are going to create enough jobs to get the economy on track. In my 25 years of managing money with the same strategic and tactical asset allocation discipline that is centered on value money management principles; this has been the hardest 24 months to get a clear picture of what is going to happen. Again, based on the fact that the politicians have not done anything for about two years, the consumer and business (both big & small) are sitting still. Please go out and vote and after you vote keep them accountable to making decisions for the betterment of America, not arguing over what is right or wrong.

Thank you for your trust in the All Star Team!

As Global Economy Slows, Liquidity Is Unleashed. Will It Ignite Economic Growth?

MARKET OVERVIEW

Overview

Signs of a slower economy were evident across the globe in the 3rd quarter. Much of Europe is mired in a recession as its debt crisis continues to create challenges. The twin engines of economic growth, China and the U.S., experienced significant slowdowns in the past three months. In fact, most economies were on a similar track. Central banks recognized the risk that the trend could continue and took steps to provide additional support to faltering economies.

The European Central Bank (ECB) began by cutting interest rates in July and later expanded a program to buy government bonds as a way to lower borrowing costs for the three countries most stressed by the debt crisis – Spain, Italy and Portugal. In the U.S., the Federal Reserve (the Fed) extended and expanded its bond buying programs. The Fed followed its previous Quantitative Easing programs with a new program to buy additional mortgage-backed bonds to help keep interest rates low. The Fed indicated it is committed to this program until employment growth can be sustained (QE 'Infinity'). Likewise, the Bank of Japan increased its own bond purchase programs during the quarter.

Despite the economic struggles, markets rallied, partly in response to central bank actions. Stocks, bonds and commodities all performed well during the quarter. It was an indication of how markets can be both contrarian and forward-looking.

The 4th quarter brings with it plenty of uncertainty. Elections in the U.S. are approaching. China will experience a leadership change. Policymakers in Washington must confront a looming "fiscal cliff" of scheduled tax hikes and spending cuts due at the start of the new year. On top of everything else, the global deleveraging that has occurred in the wake of the 2008 recession is far from over.

ECONOMY

THE 3RD QUARTER

The final reading of 2nd quarter GDP growth in the U.S., released just as the 3rd quarter ended, showed growth at an annualized rate of just 1.3%. The numbers confirmed anecdotal evidence that the already struggling economic recovery was slowing. Little improvement can be expected once 3rd quarter numbers are released. Even with modest GDP numbers, with the help of QE 'Infinity' the economy does not appear to be on the brink of another recession.

One favorable sign is an improvement in the long-suffering housing market. Home prices have gradually risen over the last six months and foreclosure and auction sales have steadily declined. A much awaited contribution to GDP growth by the housing sector may finally be occurring.

A major hurdle to a more robust recovery continues to be weak job growth. After several months of strong job gains early in the year, the economy was hard pressed to generate 100,000 new jobs per month in the 3rd quarter. This is far short of the 300,000 per month in new jobs that many economists estimate is needed on a regular basis to bring unemployment closer to normal levels.

As for consumers, personal income rose 3.5% and consumer spending was up 3.6% over the past year. The savings rate is holding steady at 4%. Consumers continue to work at reducing their debt. Although energy prices remain high, inflation is still mild. The Consumer Price Index, government's standard measure of the change in the cost of living, rose just 1.7% over the past year.

The service sector of the economy is expanding while the manufacturing sector is fluctuating between expansion and contraction. As capacity utilization remains steady and layoffs have been limited, businesses are still reluctant to hire and invest during the 2nd half of the year.

LOOKING AHEAD

Aggressive monetary policy by the Federal Reserve has become the norm in recent years, but now the focus will shift to fiscal policy (from lawmakers). As the "fiscal cliff" approaches, many expect a lame duck Congress to extend most existing tax rates for the short term. Beyond any quick fixes, markets will be looking for Washington to agree on long-term fiscal solutions that can restore confidence and strengthen the economy.

Near term, slow economic growth remains the outlook as the Federal Reserve and most economists have lowered their expectations for the rate of growth through the end of the year. Corporate earnings have also been trimmed, and companies may be hard pressed to match earnings growth rates in the 8% to 10% range of recent times.

It appears there is little left for the Fed to do to support the economy. The Fed's ongoing quantitative easing plans have probably contributed to improvement in the housing sector, but its actions raise the risk of future inflation. It will be up to government policymakers to put post-election plans in place to help restore full employment, reduce the long-term national debt and remove some of the uncertainty hanging over businesses.

BOND MARKET

THE 3RD QUARTER

The Fed's aggressive moves during the 3rd quarter emboldened investors to put more money to work in riskier assets and away from Treasury bonds. The yield on the benchmark 10-year U.S. Treasury note ended the quarter close to where it started, at 1.64%, although there was significant volatility (a range of more than half a percent) during the quarter. Price fluctuations on Treasury bonds were even more dramatic during the quarter than changes in the stock market.

High yield bonds, corporate bonds and global bonds all benefited from the bond buying actions of the central banks. High Yield bonds gained 4.3% and both Corporate and Global bonds rose 4.0%. Emerging Market bonds were up 3.1% and Treasury inflation-linked bonds (TIPS) gained 2.4% on rising inflation expectations. Lagging the market were Government Agency bonds, up 0.7%, and Treasury bonds, which returned just 0.6% for the quarter.

LOOKING AHEAD

Returns on corporate and high yield bonds are likely to moderate a bit during the 4th quarter. Yield spreads between these sectors and Treasuries have declined in recent weeks to a point lower than the typical average spread of the past few years.

The Fed's plan to buy mortgage-backed securities will give a much-needed boost to mortgage and agency bond sectors. These bonds provide higher yields than Treasuries and near equivalent safety. They are also better positioned in a rising interest rate environment. Emerging market bonds continue to be attractive, offering yields that rival corporate bonds. Improving credit trends overseas and dollar diversification for bond investors can also be beneficial.

The slow economy and the Fed's pledge to keep interest rates low through 2015 means that rising interest rates may not be an immediate threat. But with rates near historical lows, investors may want to include high dividend stocks, real estate investment trusts (REITs), preferred stocks and other sources of alternative income to supplement core bond allocations.

DOMESTIC STOCK MARKET

THE 3RD QUARTER

Although corporate earnings growth slowed in the 3rd quarter consistent with a sluggish economy, stocks climbed the "wall of worry" and generated a significant rally. Gains were broad-based across all investment styles, market cap sizes and nearly across all industry sectors.

The broad domestic stock benchmark, the Russell 3000 Index, gained 6.23% in the 3rd quarter. Large-Cap stocks, with a gain of 6.3%, modestly outpaced Mid-Cap stocks (+5.6%) and Small-Cap stocks (+5.3%). Value stocks generated a 6.4% gain, enjoying a modest edge over Growth stocks that rose 6.0%.

Cyclical stocks performed well despite the slowing economy. Energy stocks outpaced the rest of the market with a 9.5% gain. Consumer Discretionary and Technology stocks both rose 7.0%. Only Utilities stocks lost ground (-1.6%), a pullback after enjoying significant gains earlier in the year driven by yield-hungry investors. Industrial stocks and Consumer Staples returned just 3.0%, but still generated attractive dividend yields.

Performance Update

Market Index	*3rd Qtr*	*1 Year*	*3 Years*	*5 Years*
DJ Industrial Average	6.22	30.06	13.35	1.46
S&P 500	6.35	30.20	13.20	1.05
Russell 2000	5.25	31.91	12.99	2.21
S&P Mid Cap 400	5.44	28.54	14.33	3.83
Russell 3000	**6.23**	**30.20**	**13.26**	**1.30**
S&P Global BMI	**6.99**	**21.62**	**8.04**	**-1.24**
MSCI EAFE	6.92	13.75	2.12	-5.24
MSCI Emerging Mkts	7.74	16.93	5.63	-1.28
NASDAQ Composite	6.50	30.53	14.81	3.89
Barclays US High Yield Bond	4.53	19.37	12.90	9.34
Barclays US Aggregate Bond	1.58	5.16	6.19	6.53
Barclays Global Aggregate Bond	3.27	5.07	5.04	6.22
JPM Emerging Local Mkts Bond	3.14	5.19	2.46	3.61
Barclays US Government Bond	0.59	2.95	5.15	6.01
Barclays US Credit Bond	3.54	10.09	8.73	7.89

The above annualized total returns and betas represent All Star Financial models. Your actual beta may differ depending on your portfolio holdings.

LOOKING AHEAD

Stocks may not be the bargain they were after the 2008 recession ended, but their long-term value continues to be attractive. Price-to-Earnings ratios are still below long-term historical averages, dividend yields have improved and most companies enjoy healthy balance sheets.

The challenge for companies going forward is to maintain earnings and profit growth in the face of a slowing global economy. Earnings forecasts have declined throughout 2012. An earnings growth rate of 8-10% is projected for 2013. More optimistic forecasters expect renewed hiring and spending later in 2013, but that remains far from certain.

Dividends are expected to play an important role in generating total return for investors in the months and years ahead. In fact, dividend yields on stocks are looking quite attractive compared to the low yields offered by government bonds and money market investments. Companies like Apple Computer recently announced plans to begin paying dividends or increase dividend payouts, a positive sign for dividend yield forecasts in the years to come.

INTERNATIONAL MARKETS

THE 3RD QUARTER

Foreign stocks joined in on the 3rd quarter rally as investors appeared to be pleased with progress in dealing with Europe's crises, particularly the increased involvement of the ECB in supporting countries facing sovereign debt issues. The ECB's actions have stabilized borrowing costs for Spain, Italy and Portugal. Based on the market's reaction, investors appear to be supportive of the ECB's moves and encouraged that Europe is slowly heading in the right direction.

European stocks gained 9% during the quarter even in the midst of a recession gripping much of the region. Asia Pacific stocks rose 8.2%, supported in part by currency gains against the euro and dollar. Broad emerging markets returned 7.5% as many central banks in these countries continue to shift their focus to spurring economic growth rather than fighting inflation. Japanese stocks lagged the rest of the market with relatively flat performance for the period. The country's export-reliant economy was hit hard by the global economic slowdown.

LOOKING AHEAD

Even coming off a strong quarter of performance, international stocks continue to offer attractive opportunities. Many European stocks remain relatively cheap and selected stocks pay some of the highest dividend yields that can be found across the globe. Still, Europe faces a number of challenges with excessive unemployment problems and a banking system sorely needing to improve its capital structure. Progress is evident, but there is a long road to recovery.

Two prominent emerging markets, China and Brazil, are lagging the broader market so far in 2012. Both countries however represent potentially attractive opportunities for long-term investors. Each is in a financially strong position and has the flexibility to launch stimulus programs in the near future. Yet there are many Chinese and Brazilian stocks with strong growth potential currently are available at attractive values.

SUMMARY

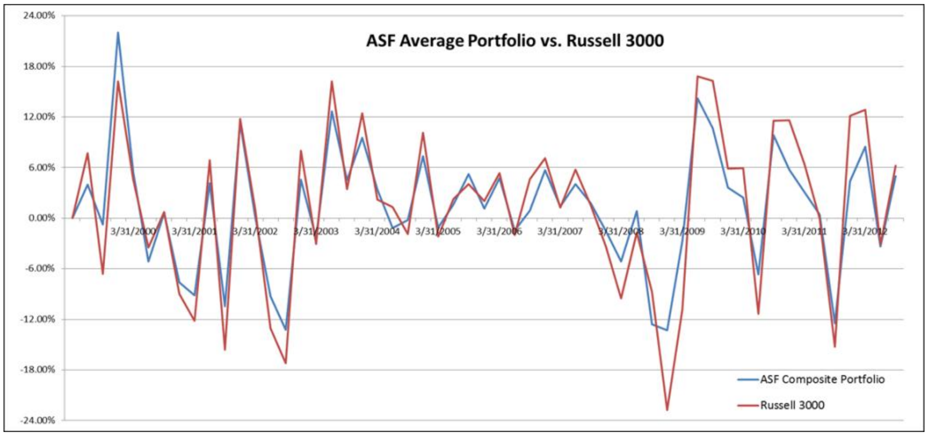
Uncertainty is the theme entering the final months of 2012. The outcome of spending and taxation decisions by Congress is an unknown. So is the state of the U.S. economy, which is approaching a "fork in the road." Can it achieve a higher level of sustainable growth on its own as the Federal Reserve runs out of effective ways to boost growth, or is there a risk of stalling and the potential for another recession?

If the economy stalls and interest rates remain low dividend-paying stocks, could become more attractive. If full economic growth is restored, bond allocations could be at risk as higher interest rates could result. We continue to review all investments and our asset allocation alternatives to prepare for whichever road the economy takes in the coming months.

ALL STAR FINANCIAL REGISTERED INVESTMENT ADVISOR

Making Money in a Volatile Market!

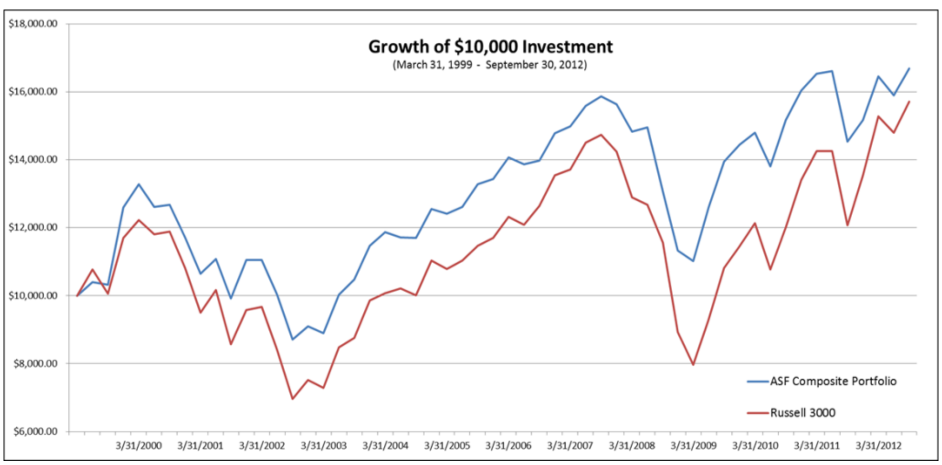
From day one All Star Financial's money management discipline has been built on the fact that if you manage for less volatility (risk), your portfolio has a more efficient compounding effect with your dollar. The end result is that you can have less risk but have more money in your bucket in the end. (Have your cake and eat it too!). We took our 4 portfolios, Income, Balanced, Conservative Growth, and Growth and calculated the average path of volatility (see graph #1). As you can see we have lived up to our statement: "It's not how much you make, it's how much you keep!" We really do not want to beat the market on the upside as much as beat it on the downside. Going all the way back to 3/31/1999 (right before the market peaked) we have consistently protected your downside risk by creating less volatility.



Graph #1

As a result of reducing your risk, graph #2 shows that for every $10,000 invested on 3/31/1999, on average of the four portfolios you currently have a portfolio value of $16,691 as of 9/30/2012 compared to the broad Domestic Market index the Russell 3000 as it would have grown to only $15,717. With approximately 27% less risk we outperformed by 0.34%/yr. on a compounding basis.

The new index that we are using (S&P 500 Global BMI (broad market index)) did outperform our portfolio but from a risk/reward we have a positive alpha over the past 13.5 years of approximately 0.58%/yr.



Graph #2

ALL STAR FINANCIAL
3800 American Blvd. W.
Suite 1450
Minneapolis, MN 55431

Phone: 952-896-3820
Fax: 952-896-3819
Toll Free: 888-809-7901
E-mail: asf@allstarfinancial.com
Website: www.allstarfinancial.com

ASF CONTACT INFO:

Bob Klefsaas, CFP®, AIF®
President 952-896-3816
Maren Aipperspach, CFP®
Vice President 952-896-3817
Bruce Bonner, CFA
Research Analyst 952-896-3818
Beth Johnson, CPA
Tax Advisor 952-896-3829

Paul Sommerstad, AIF®
Qualified Plan Mgr./Acct Exec. 952-896-3835
Matt Cosgriff
Paraplanner/Jr. Account Exec. 952-896-3815
Elise Pederson
Marketing Mgr./Jr. Acct Exec. 952-896-3830
Andy Peters
Account Executive 952-896-3823