ALL STAR QUARTERLY

SECOND QUARTER 2012 VOLUME 18 ISSUE 2

2012 – 2ND QUARTER REVIEW AND PREVIEW

BOB'S CORNER

Why Did I Underperform the DJIA?

I typically like to address questions that clients are asking us in Bob's corner and this quarter is no exception. The smart-aleck answer is because very few of your dollars are in the DJIA (Dow). The Dow is basically flat since it last peaked in April 29, 2011, while the emerging market indices are down 20% since then. This difference in performance has created a significant underperformance issue for us short-term. Please be patient.

A softer answer would be that the time period you look at is so very important. If you look over the last three years, the Dow has outperformed the emerging markets by more than 30% and over the last five years by 15%. But if we take a look at the last 10 years; however, the emerging markets have outperformed the DJIA by more than 80%.

Much like Warren Buffet, Bill Gross and other top value driven money managers, we are underperforming over the short-term but have and will continue to outperform over the long-term!

Thank you for your trust in the All Star Team!

Multiple Cans Kicked Down A Longer Road

MARKET OVERVIEW

Overview

The 2nd quarter saw equity markets across the globe give back some of the big gains generated earlier in the year. Signs of weakening in the domestic and global economy gave investors pause. The center of attention continues to be Europe's debt crisis, which has driven many economies in the region into recession.

Europe's problems are resonating across the globe, showing how interconnected world economies have become. The impact was even felt in the "twin engines" of the global economy. In the U.S., business spending slowed and consumers became more cautious. In fast-growing China, exports fell as demand slacked worldwide.

In the meantime, pundits regularly refer to European and U.S. policymakers "kicking the can down the road." The phrase may be overused, but it seems to be an accurate description. The European debt crisis represents the type of "policy error" we mentioned at the beginning of the year that can create major risk for financial markets.

An encouraging sign occurred in the final days of the 2nd quarter; however, as Euro member nations agreed to measures to help recapitalize banks directly with bailout funds and purchase member nation sovereign debt to ease interest rate pressures. They also resolved to centralize bank supervision for Euro nations. These are two positive steps toward a tighter fiscal union, with more actions likely to occur down the road.

The focus on Europe overshadows what is referred to as the "fiscal cliff" confronting us in the U.S. A Presidential election looms as deadlines approach for the expiration of lower tax rates and forced government spending cuts. The fear is that a failure to address these issues could send the economy spiraling into another recession.

These issues have contributed to an environment of uncertainty for investors. It is at times like these when patience becomes tantamount. Fundamental factors remain favorable as corporate profits and cash levels are still at record levels. Stock valuations are reasonable. We believe the market is waiting for more progress by policymakers before rewarding investors.

ECONOMY

THE 2ND QUARTER

The economy remained in slow growth mode in the 2nd quarter, on the heels of 1st quarter Gross Domestic Product growth of just 1.9%. Business profits continue to set records, but the pace of earnings growth has slowed, as consumer and business spending has flattened. Consumer spending growth peaked at 5.1% (year-over-year) in 2011, but now shows just a 2.9% annual growth rate.

Job growth has leveled off as businesses become more cautious in hiring. Job openings declined from 3.7 million to 3.4 million in the most recent reading. The average rate of job creation in the 2nd quarter dropped to less than 100,000 per month after topping 230,000 per month in the 1st quarter. The unemployment rate tipped up modestly to 8.2% in June. These are all negative signs.

Despite these concerns, the economy is still growing. The ISM Manufacturing and Service Sector Indexes both stand above 53 (anything higher than 50 indicates expansion of economic activity). Industrial production and capacity utilization remain fairly steady as well.

Inside… 2nd Quarter Review and Review Continued… Performance Summary

The economy continues to benefit from low interest rates and modest inflation. Falling interest rates led to a rise in mortgage applications for refinancing and home purchases. Lower house payments give consumers more disposable income and recent data shows signs that the housing market might have turned a corner. The Case-Schiller Home Price Indexes show a 4.6% annualized housing price gain in its most recent release. If the housing sector can recover and start adding to economic growth instead of subtracting, it could provide a key boost for the economy.

LOOKING AHEAD

Economic growth is likely to remain sluggish in the near term. Businesses and consumers show no signs of boosting spending and expenditures until the election is decided and policymakers settle tax and spending issues. Consumer spending may need to be the primary driver of economic growth in the near term. If government budget cuts subside and the housing market recovers, then the economy will also benefit.

The Federal Reserve's commitment to low interest rates helps consumers pay down debt and should be a boost for housing activity. Lower gas prices have also been beneficial. All of these factors should contribute to consumers maintaining adequate levels of spending to keep the economy growing, even if it is at a modest growth rate.

BOND MARKET

THE 2ND QUARTER

The European debt crisis contributed to an environment of fear, driving more investors into bonds. As a result, the bond market enjoyed another strong quarter as interest rates declined.

Long-term U.S. Government bonds gained 10.24% during the quarter as the yield on 30-year U.S. Treasury bonds plunged more than half-a-percent, to 2.76%. That is barely 1% higher than the current rate of inflation. The broad Government index gained 2.89% during the period, outpacing the Barclays U.S. Aggregate Bond Index return of 2.20%. Treasury Inflation Protected Securities (TIPS) and Municipal Bonds were also strong performers, gaining 2.06% and 1.79% respectively for the quarter. Municipal bonds held up despite the news of a Chapter 9 bankruptcy by Stockton, California, the largest municipal bankruptcy filing in history.

Credit sectors could not keep pace with government bonds, reversing a trend of the 1st quarter. Corporate High Yield bonds managed a 1.83% gain and Mortgage-Backed bonds rose 1.12% for the period. Global bonds were barely in positive territory as the European debt situation put a scare into these sectors of the bond world. Emerging Market bonds were negative 2.63%.

LOOKING AHEAD

The outlook is mixed for the bond market. For now, slow economic growth and the Federal Reserve's commitment to keep interest rates low should provide some stability for the bond market. But the "flight-to-quality" that we saw in U.S. government bonds last quarter is not sustainable. Interest rates on government bonds in the U.S., Germany and Japan, are already at record lows with yields often not even keeping pace with inflation. Investors are likely to soon turn to other investment options.

The better long-term value should be found in Corporate bonds, High Yield bonds, Emerging Market bonds and other global government debt. Governments outside of the U.S., Europe and Japan, not confronted with serious debt challenges, should offer reasonable opportunities going forward. Many of these countries continue to display improved credit profiles and low default rates while offering more attractive yields than bonds. issued by governments in developed nations.

DOMESTIC STOCK MARKET

THE 2ND QUARTER

The impact of negative headlines such as the European debt crisis and a slowing economy were evident in equity markets in the 2nd quarter. Investors demonstrated a greater aversion to risk and stocks suffered as a result. All broad domestic markets were down for the quarter, reversing some of the gains generated early in the year. All remain in positive territory for the year, a reminder not to become overly concerned with results from a single quarter.

Large-cap stocks declined 3.1% while Midcap stocks lost 4.9% and Smallcap issues dropped 3.5%. Value stocks (-2.3%) held up slightly better than Growth stocks (-4.0%). Investors leaned in favor of defensive industry sectors over cyclical stocks.

As a result, Utilities (+5.5%) and Telecom (+12.4%) stocks were the best performing industries. Investors appeared to be attracted by dividend yields that were more attractive than what they could earn from government bonds. Cyclical and growth sectors, including Financial, Technology and Energy stocks, all declined by 6% to 8% during the quarter. Profit expectations for companies in these sectors soured as economic activity slowed.

Performance Update

Market Index	*2nd Qtr*	*1 Year*	*3 Years*	*5 Years*
DJ Industrial Average	-3.14	4.19	16.82	0.60
S&P 500	-2.75	5.45	16.40	0.22
Russell 2000	-3.47	-2.08	17.80	0.54
S&P Mid Cap 400	-4.93	-2.33	19.36	2.55
Russell 3000	-3.15	3.84	16.73	0.39
S&P Global BMI	-5.57	-6.73	11.84	-1.98
MSCI EAFE	-7.13	-13.83	5.96	-6.10
MSCI Emerging Mkts	-8.89	-15.95	9.77	-0.09
NASDAQ Composite	-4.78	6.99	18.09	3.39
Barclays US High Yield Bond	1.83	7.27	16.28	8.45
Barclays US Aggregate Bond	2.06	7.47	6.93	6.79
Barclays Global Aggregate Bond	0.62	2.73	6.03	6.70
JPM Emerging Local Mkts Bond	-2.63	-7.12	2.90	3.92
Barclays US Government Bond	2.63	8.32	5.65	6.64
Barclays US Credit Bond	2.46	9.54	10.09	7.59

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

LOOKING AHEAD

It is reasonable to assess that equities still offer long-term values for investors, especially in an environment where interest rates remain low and inflation is under control. Stock valuations are below historical averages and dividend payouts are rising.

Corporate earnings growth is likely to slow or remain flat as profits are reported for the 2nd and 3rd quarters, but we anticipate some improvement by the end of the year. Technology, Financials, Energy and Materials, all poor-performing sectors in the 2nd quarter, offer significant value going forward.

INTERNATIONAL MARKETS

THE 2ND QUARTER

Overseas markets declined sharply in the 2nd quarter as the recession across much of Europe took hold. The slowdown in Europe's economy had an impact around the globe, even tempering growth rates in emerging market economies, which are largely dependent on export activity to Europe and the U.S.

European stocks fell 10.1% during the 2nd quarter. Not surprisingly, Greece was the worst-performing market, as the debt-plagued nation saw its stock market decline 18.3%. Global stocks (ex-U.S.) fell 7.6% for the quarter. Large-cap stocks, mostly based in Europe, weighed heavily on the weak performance of the broad global index. Stocks in Japan declined 6.9% as rebuilding activity from last year's tsunami tailed off.

Emerging market stocks were off 8.9% for the period. Stocks in energy- and resource-rich Latin America fell 12.3%, reflecting a big drop in energy prices during the quarter. Emerging Asian stocks declined 7.4%, performing slightly better than broader foreign stock indexes. Stocks in Turkey registered a modest gain of 1.2% for the quarter as the nation is proving to be a stable and growing market bridging the divide between Europe and the Middle East.

LOOKING AHEAD

Foreign stocks, particularly those in emerging markets, should be positioned to recover from the 2nd quarter setback. Central banks in the U.S., Japan, the United Kingdom and soon in Europe are nearing the point where they can do little more to spur economic growth through monetary policy. But China, Brazil and other emerging market nations have much more flexibility to lower interest rates and have begun to do so to stimulate economic growth.

Unlike U.S. companies, emerging market firms are enjoying a solid profit growth, due in large part to favorable demographic trends in many of their home countries. That should offer opportunity for investors. The same is true of European multinational firms that have been hard hit due to the impact of the debt crisis, but are well-positioned to benefit from global growth going forward. Some European blue chip stocks are paying dividends in the 4% range, double the yield of U.S. stocks.

SUMMARY

Investors must accept the reality that risk can't be avoided in the kind of environment that exists today. As one manager stated, "There are no risk free assets; the question is which risks do you want?"

Our focus is on investing in asset classes that represent the best relative long-term values. We monitor global risks and daily developments, but remain focused on long-term fundamentals that ultimately mark the difference between success and failure for investors. While rapidly revolving events can result in short-term underperformance, we remain convinced that fundamentals will eventually reward patient investors.

Among the catalysts that could spark improved returns are signs of visible progress in Europe's debt struggles, a resolution to our own government's "fiscal cliff," improvement in the housing market and an end to dramatic cuts in government spending that have weighed heavily on employment numbers. All of these factors could turn favorable in the months ahead, which would likely be seen as positive signs by investors.

While policymakers have "kicked the can down the road" for too long, we may be close to the end of that road. Fundamentals will again be rewarded, as will patient investors.

The Longer View

The last decade has been challenging for investors and returns have been far less than what long-term historical averages would have suggested. We are seeing the culmination of several long-term trends that are impacting investments and causing markets to be less driven by market fundamentals and more by demographics, debt levels, and government policies.

We live in a global economy and true diversification requires a global approach. Unfortunately, everywhere you look across the globe, economies are different and face significant challenges. Long-term demographic trends are supporting economic growth in Emerging Market nations and markets. Emerging market stocks outperformed other equities during the last decade and are expected to do so again in the next decade according to long-term capital market forecasts.[1] Unfortunately, during the last one, three and five year time periods they have not.

Developed Markets have high debt levels, aging populations, and slower economic growth. We expect modest economic growth and equity returns to these markets in the coming decade, though the U.S. has outperformed during the past year, when uncertainty in Europe has been high. Investing in assets with higher growth rates, less debt, cheaper valuations, and higher dividend yields normally pays off in the long-term but does not always lead to better performance in the short-term. Globally diversified portfolios have underperformed U.S. stocks during the past year, despite boasting better GDP growth, lower debt/GDP ratio, lower price/earnings ratio, higher dividend yields, as well as the best 10 year returns when compared to the US market and developed Europe:

	Emerging Markets	**Developed Ex-US Markets:**	**U.S. Markets**
GDP Growth%:	**5%**	1%	2%
Debt/GDP:	**29%**	108%	70%
Stock Price/Earnings:	**9.0x**	13.9x	15.8x
Dividend Yield:	**3.43%**	3.34%	1.91%
1-Year Return%:	-16.5%	-14.04%	**+2.77%**
10-Year Annlz'd Ret%:	**+15.07%**	+6.87%	+6.17%

Policy driven markets have wreaked havoc on the performance for many legendary fundamental investors during the last few years. [2] It is tempting to focus on short-term performance that disappoints but it may also take your focus off the long-term fundamentals and that may be damaging to your long-term investment performance and achieving your financial goals.

1 JP Morgan, Goldman Sachs, State Street, GMO
2 (Buffet/Miller/Fairholme/CGM/Gross)

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
Nick Hohn, CFP®
Account Executive 952-896-3823
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
Valerie Moorhead
Executive Assistant 952-896-3826