ALL STAR QUARTERLY

FOURTH QUARTER 2012 **VOLUME 18 ISSUE 4**

2012 – 4TH QUARTER REVIEW AND PREVIEW

Bob's Corner

<u>What Goes Up Must Come Down?!</u>

As 2012 comes to a close we can look back at the year with the belief that as your Wealth Management partner, the team at All Star Financial did a very good job navigating a significant amount of volatility.

2012 started with the "same old concerns" but after a volatile January good news about the restructuring of the Greek debt and recapitalizing of other European debt, shot both the S&P/Global BMI and the Russell 3000 up 12-13%.

The Second Quarter gave back 3-5% of the year's gains as both the U.S. and Europe kicked the can down the road again in what to do with the massive debt.

What goes down must go up right? Yes, indeed! The 3^{rd} Quarter earned a +6-7% in the U.S. and globally. More monetary policy actions promised continued interest rate cuts and $85B/month being thrown into the economy by way of new debt issued and mortgage buyback programs.

The elections highlighted our initial 4^{th} quarter thoughts as the market lost ground before gaining post-election momentum to end relatively flat.

As the year ends, we can say that we lived our mantra of **"It's not how much you make, it's how much you keep!"** We created portfolios that produced double digit returns with only 50-80% of market risk!

THANK YOU for letting the All Star Team guide your financial FUTURE! Looking forward to visiting with all of you very soon.

A Turning Point in 2013 – Restoring Growth or Returning to Recession?

MARKET OVERVIEW

<u>Overview</u>

As we prepared for 2012, we saw opportunity with improving corporate profits and an increasingly confident consumer. One of the outstanding risks to the markets however, was a government policy error. By the end of the year this came to be known as the "fiscal cliff."

Fiscal and monetary policy as well as politics played a significant role in the market's fluctuations during the year, far more than the generally healthy underlying fundamentals. This was especially true during the 4^{th} quarter, which saw finality to a drawn-out election cycle in the U.S. but increasing uncertainty over the tax and spending policies that created the fiscal cliff uncertainty.

Policymakers in Washington finally managed to put together a tax plan that sets rates for 2013 and beyond. Except for restoration of the full payroll tax to fund Social Security (ending the payroll tax "holiday" that saved wage earners 2% in FICA taxes in 2011 and 2012), most taxpayers will see very little change from previous years. While tax policies are settled for now, lawmakers have failed to address continued deficit concerns, meaning more standoffs are likely in Washington in the coming months.

Does that dim the outlook for investors in 2013? If 2012 is any guide, not necessarily. In the past year, markets had to cope with a variety of distractions, yet generated solid returns across most asset classes. The hurdles we had to navigate included:

- **Europe's continuing debt crisis**. Despite fears to the contrary, the economic union survived and even made strides toward tighter fiscal integration that will soon include central bank supervision. The European Central Bank is committed to government debt purchases that should help calm credit markets and reduce borrowing costs. Even while coping with a recession, Europe's stock markets rallied during the 4^{th} quarter and outperformed U.S. stocks for the year.

- **Fears of a "hard landing" for China's economy**. Instead of turning down, the world's second-largest economy showed signs of accelerating growth again, with both industrial production and retail sales expanding at healthy rates. China's economy is improving and it has made a successful transition to new political leadership, helping push Chinese stocks higher.

- **Continued political standoffs in the U.S.** With the election decided and tax policy settled for now, the markets are looking for policymakers to address long-term fiscal issues in a way that can restore business confidence and contribute to a brighter investment outlook.

ECONOMY

<u>THE 4TH QUARTER</u>

Unemployment remained stubbornly high, while business spending and investment slowed and corporate profits leveled off. All could be presumed to be signs of a stalling economy. Yet 3^{rd} quarter Gross Domestic Product (GDP) numbers came in at a surprisingly strong 3.1% annualized rate. Exports, government spending and an improved housing market all made positive contributions. Growth in the 4^{th} quarter is expected to slow but still show a steady upward path.

The Federal Reserve (the Fed) continues to provide much of the fuel that is keeping the economy running, through its aggressive monetary policy. Along with maintaining short-term interest rates near 0%, it launched a series of asset purchase programs (known as “quantitative easing”) designed to keep long-term interest rates low and encourage more borrowing by businesses and consumers. The Fed has indicated it will continue its aggressive stance and continue to buy $85 billion a month in treasury and mortgage assets until the unemployment rate dips to 6.5%. This is more than a full percentage point below its current level.

The housing market responded to the Fed’s actions. Home prices began to rise again and building activity showed steady signs of growth. Consumer spending remains stable and although the unemployment rate remained high, the economy added an average of more than 100,000 jobs a month over five months through November.

The decline in government spending, at least at the local level, appears to have bottomed out and local tax revenues are rebounding from recessionary lows. Business spending slowed markedly in the quarter, to just a 1% annualized growth rate. Many business leaders indicated they were taking a “wait-and-see” attitude about the direction of the economy.

LOOKING AHEAD

Our “crystal ball” for 2013 is cloudy. A compromise over tax policy enacted at the start of the year is helpful, but the nation’s long-term fiscal issues still need to be addressed. Most economists anticipate this will occur and the economy will be able to maintain its slow, steady recovery of recent years.

The Fed appears committed to maintaining low interest rates for the foreseeable future, and it is likely to remain actively engaged. Among other aspects of the private economy, we’ll continue to watch the renaissance in American energy production, a factor that may help keep energy prices in check. If Congress can provide more certainty about future fiscal policy, we’d expect to see piles of corporate cash put back to work, leading to more business spending and hiring.

BOND MARKET

THE 4TH QUARTER

Monetary easing policies from central banks across the globe supported bond markets in the closing months of the year. So did continued demand for bonds by investors. Most sectors of the fixed income market experienced positive returns for the period as investor demand for the perceived safety of bonds remained strong.

Credit spreads (yields above Treasury bonds) continued to narrow and credit risk was generally rewarded during the quarter. Corporate high yield bonds and emerging market bonds led all sectors with returns of more than 3%. Gains were more minimal (less than 1%) for Treasury bonds, agency bonds and investment grade corporate issues. Global bonds were flat, due in large part to a weakening Japanese yen, which held down global bond index returns.

LOOKING AHEAD

The long rally in bonds can’t continue forever, but in the near term, interest rates are likely to remain stable. The Fed’s aggressive monetary policy will help temper significant interest rate risk and healthy corporate balance sheets should lead to further spread tightening in corporate and high yield bond markets. Floating rate bank loans appear attractive, offering competitive yields and protection against future interest rate increases.

European credit markets should continue to improve and create some attractive opportunities. Emerging market fundamentals remain strong. Most of these countries are in a strong fiscal position and continue to enjoy faster growth than developed markets. Diversifying across broad sectors of the bond market will be critical to achieving favorable returns as the interest rate environment becomes more challenging.

DOMESTIC STOCK MARKET

THE 4TH QUARTER

In a challenging environment that included a heated election and fiscal cliff uncertainty, domestic stocks held up reasonably well in the 4th quarter, with lower-than-expected volatility.

Stocks finished the quarter relatively flat, with the broad domestic Russell 3000 Index up 0.3%. Value stocks, boosted by a trend of increasing dividends, including some firms declaring one-time dividends before year end, returned 1.7%. They outpaced growth stocks (-1.2%), which were affected by slowing corporate revenue and earnings growth, particularly in the technology sector.

Small-cap stocks modestly outperformed large-cap stocks, with the Russell 2000 Small Cap Index gaining 1.9% while the Russell 1000 gained only 0.1% for the quarter. From a sector standpoint, Financial stocks stood out, rising 5.1% as the improved housing market boosted prospects for the financial industry. Industrial and Material sectors also posted gains of 4.8% and 3.5% respectively as companies capitalized on improving global demand. Technology and Telecom sectors both declined 7%, reflecting weaker business spending.

	3 Yr Beta	3 Yr Alpha	5 Yr Beta	5 Yr Alpha				
	VS. GLB BMI		VS. GLB BMI					
Income	0.48	2.04	0.44	3.44				
Balanced	0.63	0.67	0.58	1.94				
Cons Growth	0.73	-0.19	0.67	1.09				
Growth	0.80	-0.83	0.78	0.42				

Market Index	*4th Qtr*	*1 Year*	*3 Years*	*5 Years*
DJ Industrial Average	0.14	16.32	11.20	2.16
S&P 500	-0.38	16.00	10.87	1.66
Russell 2000	1.85	16.35	12.25	3.56
S&P Mid Cap 400	3.61	17.88	13.62	5.15
Russell 3000	**0.25**	**16.42**	**11.20**	**2.04**
S&P Global BMI	**3.21**	**17.15**	**7.56**	**-0.26**
MSCI EAFE	6.57	17.32	3.56	-3.69
MSCI Emerging Mkts	5.58	18.22	4.66	-0.92
NASDAQ Composite	-2.65	17.45	11.19	3.68
Barclays US High Yield Bond	3.29	15.81	11.86	10.34
Barclays US Aggregate Bond	0.21	4.21	6.19	5.95
Barclays Global Aggregate Bond	-0.48	4.32	5.17	5.44
JPM Emerging Local Mkts Bond	1.13	7.45	2.49	2.95
Barclays US Government Bond	-0.06	2.02	5.48	5.23
Barclays US Credit Bond	1.04	9.37	8.73	7.65

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

LOOKING AHEAD

The stock market remains fairly valued in the current slow growth environment. There doesn't appear to be a significant edge for any particular market capitalization, investment style or industry sector given the current outlook.

Earnings growth, which tapered off in 2012, is expected to gradually improve later in 2013, especially if some fiscal policy certainty is put in place. Comparisons to earnings in the latter half of 2012 should look favorable in the second half of 2013. Corporate balance sheets are very strong, with $1.7 trillion in corporate cash on the sidelines. These reserves could help finance merger-and-acquisition activity and dividend increases, both of which would be beneficial to stock market performance in 2013.

INTERNATIONAL MARKETS

THE 4TH QUARTER

International markets overcame a trend of lagging the performance of U.S. stocks. Foreign stocks took leadership of the market in the 4th quarter despite the fact that many countries were in recession. European stocks gained 7.0% as bargain-hunting investors recognized value in the region. Stocks in Japan also showed positive momentum, gaining 5.8%. Investors were encouraged by the pro-business policies of the new political leadership in Japan. Stocks in both of these regions are attractive because many pay higher dividends than those in the U.S.

Emerging market stocks stood out with a 5.6% return for the quarter. Chinese stocks returned 12.4% as the country's expanding economy and new leadership led to an improved outlook. Asia, ex-Japan, gained 5.7%. Latin American stocks were up 4.3% despite weakness in Brazil's currency.

LOOKING AHEAD

Emerging markets continue to offer the most attractive potential as 2013 begins. Stocks in that segment could benefit from faster growth, younger populations, expanding workforces and lower government debt levels compared to their developed market counterparts.

The performance of markets in Europe and Japan in the 4th quarter was a sign that investors expect economic recovery in both of these regions in the year ahead. The unknown is the timing of an economic recovery. Europe still has plenty of work to do resolving its debt problems, and Japan has gone through a number of different leaders in recent decades with little progress achieved.

SUMMARY

The 4th quarter was far from spectacular but the market's resiliency in the face of continued uncertainty was notable. All of our portfolios ended the quarter with positive returns even though the domestic stock market was essentially flat. It now appears there is more certainty in regards to tax policy for the coming years, though spending issues have yet to be addressed in a serious way. We hope the fiscal cliff "deal" is a catalyst for corporate earnings growth to resume and give a second leg to this bull market. But we remain cautious about how remaining budget issues will be resolved.

Over time, we expect the 30-year bull market for bonds and historically low interest rates to come to an end, but it is hard to say when it might happen. We remain focused on what we can control – the amount of risk in your portfolios. Over the past 6 months we took steps to reduce potential risk by 6% to 16% less than what our target policy range is. We plan to capitalize on attractive market values when we see them, maintaining strong diversification and keeping you informed and educated as we help you achieve your financial goals.

Focus On What You Can Control – Your Financial Plan

Most of us go through periods of financial anxiety from time-to-time. The media doesn't do us any favors by often focusing on the negative aspects of the current economic, political and investment environment. In recent weeks, it was impossible to watch the news and not hear the term **"the fiscal cliff"** repeated over-and-over, with little context about what it means for you. It is no surprise that anxiety levels have been elevated given the uncertainty of the situation and the flailing of our policymakers in trying to agree on a solution.

This is not to downplay today's reality. There are significant concerns in the U.S. and global economy. But you need to sift through the noise and focus on what is truly in your control – **your financial plan** and what it will take to achieve **your goals**. It is important, when it comes to making financial decisions, to keep your emotions in check. You don't want to react in a way that could derail **your financial plan**.

Common mistakes of investors

Here are three examples of typical but very correctable flaws in the approaches of investors:

1. **The Psychology of Losing** – as humans, our aversion to loss is twice as powerful as the attraction to potential gains. In the investment world, it is important to be aware of our tendency to avoid losing, because in the long run, choosing the "safest" investments is not always the most effective way to reach your goals.
2. **Recency/Present Bias** – we tend to believe that while we're in the midst of a bull market, our assets won't lose value. This was the case for many during the unprecedented bull market of the 1990s. Similarly, when we're dealing with a bear market, which occurred more frequently in recent times, we're convinced that investing is too risky. By maintaining your focus not on current market conditions, but a disciplined process focused on achieving your goals, you can better navigate your path to investment success.
3. **Herd Mentality** – a result of our natural fear of losing and our failure to see past the current situation is a tendency to follow the crowd. Too often investors buy high (choosing the most popular investments) and sell low (giving up when bad news about an investment is at its peak). Today's example is investors pouring money into bonds when interest rates are near all-time lows while avoiding stocks, which offer some of their most attractive values in more than a decade.

Thinking about your ultimate goals

Rather than dwelling on the emotionally-charged headlines of today, here are four long-term investing themes that **you can focus on**. Each of these themes can help you deal with today's uncertainty and periods of short-term volatility:

1. **Dividends** – 88% of companies in the S&P 500 now pay dividends. This can be a powerful contributor to building wealth.
2. **Demographics** – aging populations in the U.S., Europe and Japan are increasingly focused on investing for income. Emerging markets have younger populations, a key for faster and sustained growth.
3. **Diversification** – this is as important as ever! In periods of uncertainty, owning a broad mix of asset classes (stocks and bonds, domestic and international) helps temper volatile periods in the market.
4. **Discipline** – staying true to an investment process and to your plan in the face of the "crisis of the day" helps avoid emotional decision-making and the psychological risk of doing the wrong thing at the wrong time.

It is part of our human nature to exhibit tendencies that can make investing more difficult. We at All Star Financial take pride in doing what's best for our clients in trying to help them achieve their ultimate goals. We continue to enhance our process and we will have new reporting and tracking software available in 2013 to help you monitor your progress in a more effective and timely fashion.

Thanks for your continued trust in us and may you have a healthy and prosperous New Year!

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