



The Quarterly Report



After huge volatility throughout 2011, the S&P 500 index ended the year where it started, with its 2% return coming from dividends. Smaller and mid-cap stocks closed the year down 4.2% and 1.7%, respectively, despite also posting double-digit fourth-quarter gains. Fear over Europe and slowing growth in China dragged foreign stocks down 11.8%, with China concerns and a flight from risk hitting emerging-markets stocks even harder; they fell 18.8%.

High-quality bonds were on the other side of the volatility, with sharp flight-to-safety rallies that helped net the Vanguard Total Bond Market Index a 7.6% full-year gain. Our allocations to flexible bond and absolute-return-oriented funds hurt performance in our balanced portfolios because they provided less of the short-term protection of high-quality bonds, but we remain confident that our bond allocations will provide better longer-term returns than the pure high-grade benchmark at still-acceptable risk levels. Underperformance from some of our active managers also detracted from performance. Over shorter periods in which investors' decisions about getting in and out of stocks are driven by macro headlines (often referred to as "risk-on, risk-off") there is less consideration for fundamentals of individual stocks. This creates long-term opportunities, but can be frustrating over shorter periods.

As the media saturates us with political coverage that will only grow over the coming year, we can relate to the grind a politician faces in staying on message for an extended duration. Our message is not positive enough to get us elected to any office, but we hope it will earn us respect for intellectual honesty and well-reasoned

decision making amidst an environment that we expect to be a far longer grind than that of a presidential election year.

The grind we are dealing with—and the same message we've been delivering since 2008—is that the developed world took on massive and unsustainable levels of debt that in all likelihood will take a decade or more to fully unwind. This will reduce economic growth below the levels we had come to think of as normal; levels which themselves became distorted upward based on the spending of all this borrowed money. As that debt is reduced going forward, there will be less money available to spend.

“What lies behind us and what lies before us are tiny matters compared to what lies within us.”
~ Ralph Waldo Emerson ~

Another way that debt is reduced is through defaults, and this leads us to the reiteration of another very important point, which is that the risk of defaults—such as in Europe—poses a significant threat to the financial system, and in turn to the global economy. Very briefly, investors are afraid that Europe lacks the political unity and possibly even the financial capacity required to provide a sufficient financial backstop for the eurozone. That increases the risk of weaker governments defaulting on their debt, which makes investors demand higher yields for taking on that risk. Those higher yields contribute to a feedback loop that makes a default even more likely, because governments can't sustain interest payments above a certain level, so

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Returns of Major Indexes <i>(preliminary data)</i>	4th Qtr. 2011	12 Months
Vanguard Total Bond Market Index (VBMFX)	0.93%	7.56%
Vanguard 500 Index (VFINX)	11.78%	1.97%
iShares Russell 2000 Index (IWM)	15.45%	-4.19%
Vanguard Total Int'l Stock Index (VGTSX)	4.22%	-14.56%



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only some type of unified policy action and intervention can allow governments to roll over all the debt that is coming due.

A bright spot in recent years has been the strength of emerging-market economies, but this is also a source of risk. Of particular concern is China, which depends on demand from developed economies like Europe and the U.S. to drive its export machine. To offset the initial decline in demand that followed the financial crisis in 2008, China took steps to fuel infrastructure spending at home, but in so doing ignited a bubble of its own. Our concern about a "hard landing" in China is that it may be unable to deflate this bubble without a harsher than expected impact on its economic health, with damaging effects on the rest of the globe.

Staying true to our commitment to deliver a message that is apolitical in its honesty demands we make another important point. No matter how self-servingly confident anyone comes across about how things are going to play out, the truth is that no one (ourselves obviously included) can predict complex macro outcomes with any certainty, and this is especially true given the huge number of variables at play today. Confident predictions may make you more "electable" with your constituents, but honest investors base their decisions on realistic analysis that accepts that some aspects and time frames relating to the overall environment can be analyzed with confidence and some cannot. We build portfolios that take these many tradeoffs into account, and it is important that clients understand the limitations of the decisions we make and where their own decisions are required.

For clients who want (or need) to emphasize protecting capital in the event of a very negative scenario playing out, it is important to choose an appropriately conservative strategy. In fact we have reduced

risk by a greater amount in our more conservative strategies because we believe that capital preservation is more important to clients in these strategies. That same client has to also understand how they will feel if a bad outcome doesn't happen. By choosing a more conservative strategy they will have missed a chance for greater returns and may feel regret.

Toward the other end of the spectrum, clients with long time horizons can take some comfort in knowing that even if we see a sharp short-term decline, our analysis gives us confidence that over 10 years and beyond they will earn better returns in our more aggressive strategies, *provided they don't bail out if we do see a sharp decline.*

We accept the risk of trailing under some scenarios for a number of reasons. First, while the odds of a very negative scenario playing out are relatively low, its effects would be highly damaging, and we think our optimistic scenario is even less likely. Second, our most-likely scenario involves no crisis but slow growth for many years, with mediocre returns for stocks (in the mid-single-digits), and periods of high volatility that create opportunities to add back stocks at more attractive prices. Third, our process and the decisions that result reflect our commitment to thorough research, intellectual honesty, and discipline, and we believe this kind of process has the best *long-term* likelihood of success. Finally, although some might conclude we are wrong if these risks don't happen (and we think this is the greater likelihood) it is our job is to make decisions that we believe best serve our clients, not our business.

As always, we appreciate your continued confidence. If you have any questions, please don't hesitate to contact me.

~ RWT ~



Getting Ready for Tax Season: Changes for 2012

The IRS has issued cost-of-living adjustments for the 2012 tax year that modify brackets, deductions, and other thresholds for inflation.

Although most Americans will not have to worry about 2012 taxes until early 2013 when 2012 tax returns are due, self-employed individuals or anyone who must pay quarterly tax payments will want to plan ahead. And there's good news for those that do. The IRS recently announced cost-of-living adjustments for the 2012 tax year that bump up brackets, deductions, and other thresholds for inflation.

The following is a summary of the key changes for 2012.

- **Exemptions are up:** The personal and dependent exemption increases to \$3,800, up \$100 from 2011.
- **Standard deductions have increased:** The 2012 standard deduction increases to \$11,900 for married couples filing jointly, \$5,950 for singles and married individuals filing separately, and \$8,700 for heads of household.
- **Tax-bracket adjustments:** Tax-bracket thresholds have increased for each filing status (see table below).
- **Estate tax exclusion has increased:** The estate tax exclusion increases to \$5,120,000, up from \$5,000,000 for 2011. The annual exclusion for gifts will remain at \$13,000.

2012 Tax Brackets

	Single	Joint Filers	Married Filing Separately
10%	\$0 - \$8,700	\$0 - \$17,400	\$0 - \$8,700
15%	\$8,700 - \$35,350	\$17,400 - \$70,700	\$8,700 - \$35,350
25%	\$35,350 - \$85,650	\$70,700 - \$142,700	\$35,350 - \$71,350
28%	\$85,650 - \$178,650	\$142,700 - \$217,450	\$71,350 - \$108,725
33%	\$178,650 - \$388,350	\$217,450 - \$388,350	\$108,725 - \$194,175
35%	Over \$388,350	Over \$388,350	Over \$194,175

- **Earned income credits rise:** The maximum earned income tax credit (EITC) rises to \$5,891, up from \$5,751 in 2011. The maximum income limit for the EITC increases to \$50,270, up from \$49,078 in 2011.

Several tax benefits are unchanged in 2012. For example, the additional standard deduction for blind people and senior citizens remains at \$1,150 for married individuals and \$1,450 for singles and heads of household.

This column is produced by the Financial Planning Association, the membership organization for the financial planning community, and is provided by Robert W. Tull, Jr., a local member of FPA.



Are You Living Your Dreams?

A new year often means renewed dreams, and we want to remind you that *we are here to help you achieve your dreams*. Read inspiring stories on our new *Living the Dream* page:

www.TullFinancial.com/LivingtheDream

And if savvy financial planning has enabled you to accomplish one of your life goals, we want to hear about it. Please contact us to share your story — we may feature you on our website!

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