

SLOWDOWN

Volatility continued as deadlines and promises for a European plan come and go without resolution

During the fourth quarter of 2011, the equity markets recaptured some of the losses suffered in the third quarter but only after incurring significant losses in September followed by strong gains in October and by an intra-month loss and reversal in November and again in December. For the most part, this volatility was courtesy of the uncertainties surrounding the sovereign debt/banking crisis in Europe and its potential impact on global economic growth. For the three months ended December 31, 2011 the Dow Jones Industrial Average increased +12.77% (+8.38% ytd); the S&P 500 and Russell 1000 Indices gained +11.82% (+2.11% ytd) and +11.84% (+1.50% ytd), respectively; while the Wilshire 5000 advanced +12.02% (+.98 % ytd). The Russell 2000 Small Cap Index and the S&P 400 Mid Cap Index produced gains of +15.48% (-4.17% ytd) and +12.98% (-1.73% ytd), respectively. The MSCI EAFE Index gained +3.33% (-12.14% ytd), and the MSCI All Country World Index and the MSCI EM Index increased +7.18% (-7.35% ytd) and +4.42% (-18.42% ytd), respectively.

Outlook

We expect volatility to continue as the European crisis (or rational sovereign debt restructuring plan) unfolds. We are, however, encouraged by the resiliency of corporate earnings (notwithstanding a slower anticipated rate of growth in the fourth quarter when numbers are finalized), the health of corporate balance sheets (except European banks that are greatly exposed to sovereign debt and with a caveat for U.S. financials, that although improved, still prompt questions as to asset quality and valuation), share valuation at reasonable PE ratios (by historical standards and relative to bonds), and the continuing trend of increased consumption in developing economies by an emerging middle class. We are less encouraged by leadership in Europe that is not, in our view, tackling the big issues, instead pursuing a minimalist approach of postponing problems while attempting to calm markets in the near term. We are also disappointed that our own domestic political leadership has been unwilling to meaningfully address annual deficits, unemployment, and economic growth.

The outlook for economic growth in developed economies is expected to be subdued as policies of austerity are pursued by governments. In addition, individuals reducing personal debt in response to economic uncertainties further slow economic growth. Although emerging economies have slowed their rate of growth, we anticipate that they will continue to make a significant contribution to global growth.

In sum, a combination of macro issues here and abroad will likely continue to rule the psyche of the markets maintaining an environment of uncertainty. Will a sovereign default trigger an even greater lack of confidence in the capital markets and will bank capital be further compromised? Will European austerity trigger a deep recession or worse with spillover to emerging economies and our own? Will credit default swaps spread the contagion worldwide?

Uncertainty abounds.

How We Got Here.

Over the past several years, the common currency of the European Monetary Union facilitated the seemingly perpetual monetization of intra-European trade deficits. The absence of separate currencies and their resulting relative valuation adjustments meant the system lacked a critical “circuit breaker”. That is, because the importing country was paying with the same currency as the exporting country the seller exporter always had broad utility of the currency as compared to requiring such to be restricted in its use to purchases from or investments in the importer country. Meanwhile, net importer countries funded these trade deficits by issuing debt. Further, the common currency and the heretofore confidence in the euro and the EMU facilitated debt issuance by individual countries to fund not only trade deficits but also their operating deficits that ballooned as governments expanded and as the cost of entitlements grew. European sovereign debt multiplied as banks (and other investors), enabled by their regulators, deluded themselves that all euro-denominated sovereign debt was equal and ignored credit risk.

In the United States, our own trade deficits - - principally due to lower labor costs in emerging markets and energy imports - - have also contributed to increases in the national debt (although the cost of recent wars and increases in the cost of entitlements were the primary drivers of this 150% increase in national debt since December 2000). The trade imbalance with China without the apparent circuit breaker of currency revaluation is a function of China’s willingness to accept US currency and hold such for investment purposes as its domestic economy is not yet self-sustaining. China’s control of its currency so as to limit appreciation relative to the dollar is constrained by U.S. monetary and fiscal policies that reduce the relative valuation of the dollar. While the truth is in the eye of the beholder (as to currency control or manipulation), the imbalance in living standards and labor cost (between the U.S. and China) will continue to promulgate trade deficits until such is resolved in the future. Finally, the delusional economics of “buy now pay later” was not restricted to governments. Excess personal leverage fueled consumption and unrealistically inflated housing prices.

Add to this toxic mix: financial engineering, opaque leverage attributable to derivatives, accounting rules and principles that did not keep pace with the evolving risks and regularized socialization of private losses, bad judgment and political expediency.

While the recapitulation of key contributors to the current state of the capital markets is instructive, we recognize that a breakdown in culture, judgment and integrity were the insidious catalysts that promoted subversion of regulatory and accounting rules, and inappropriate dismissal of risk.

The Delusions Continue

European leaders are lined up to comfort the markets with assurances that private investors will not suffer losses on sovereign debt, but cannot agree on a course of action to improve the circumstances of seriously indebted members of the EU. The likely consequences of austerity, i.e., increased unemployment and protracted slow down or recession, seem to be more palatable to politicians than taking meaningful (and we believe necessary) action in the form of an orderly debt reduction. The European Central Bank is essentially where the Fed was three years ago – providing liquidity, lending to banks, and quantitative

easing type activities. Notwithstanding periodically increased capital requirements, banks in Europe are larger than their U.S. counterparts and remain more highly leveraged and exposed to sovereign debt.

In the United States, the housing market continues to suffer and underwater mortgages and excess supply burden the economy. Paring back or eliminating annual budget deficits seems remote given the political and philosophical tensions between funding entitlements and increasing revenues (taxes). The Fed remains strongly accommodative and has continuously entreated Congress and the Administration to get their fiscal house in order. Finally, U.S. bank exposures to Europe are not thought to rise to the level of systemic risk.

In both Europe and the United States, the hope that central bank policies will inspire economic activity, thereby reducing unemployment, increasing tax revenues, reducing deficits and paring national debt or the rate of increase of such debt, is the crux of the “plan”. Relying on future growth to fund prior and existing obligations doesn’t seem like much of a plan although some economists advise not to be too concerned about debt or deficits so long as economic growth is such that the debt can continue to be serviced and thus confidence maintained. Given dysfunction in government here and in Europe, we believe we are well beyond this point.

Some Improvements at Home

Recently, some better domestic economic data has been reported. The rate of unemployment though still high has been reduced to 8.6%. Jobless claims seem to have moderated. These trends and data, however, are often revised. Some recent gains have materialized in the manufacturing sector with corresponding sector employment gains. Housing data has also improved with a modest increase in construction and slowing in the rate of price decline coupled with some reduction in the inventory of existing homes although this data is heavily influenced by geographic region. Nevertheless, excess housing supply, credit qualification and underwater mortgages remain challenging.

S&P 500 revenues have returned to 2008 levels after declining by 12% in 2009 and recapturing 6% in 2010. Operating earnings in 2010 matched 2007 levels and are expected to increase by 15% over 2010 earnings when final accounts are settled for 2011.

Consumer revolving credit debt outstanding has declined 17% from 2008 levels. Consumer spending firmed but is not meaningfully accelerating as consumers reduced debt. Speculation as to pent-up demand is encouraging to some. Finally recent comments by the Fed highlight concern for recurring economic slowdown and conviction for additional quantitative easing if required.

Portfolio Construction

As calendar year 2011 drew to a close, the views we expressed in September remain much the same - - the political inaction in Europe and at home underscoring our concerns.

We continue to stress diversification in client investment portfolios with a substantial allocation to tactical managers who consider and address macroeconomic policies and events in managing their investment

portfolios. Our approach to portfolio construction is designed to mitigate, though not eliminate, the volatility experienced in the equity markets, while meaningfully participating in market gains. During the fourth quarter, client portfolios were not immune to volatility though the overall volatility was mitigated by allocation to fixed income and some tactical investment managers, notwithstanding appropriate moderate exposure to foreign equities.

Although emerging market exposure negatively impacted returns, we view the longer term trends of emerging consumption by a growing middle class worthy of investment. We note, however, that near term structural challenges to the developed world discussed above, as well as prior government action in response to domestic inflation fears, may dampen near term expectations. We are maintaining existing allocations for most client portfolios confident that we have achieved the appropriate balance between risk assets and more conservative investments.

Changes in Managers

We have recently made a change in most client portfolios to eliminate Growth Fund of America (GFA) and replace it with two mutual funds – JPM Large Cap Growth Fund (Select Shares) and BBH Core Select Fund. GFA had performed well for many years but had underperformed in the last two years. As a result of some changes in personnel and the inability of the Fund to provide clarity as to rationale and point of view in today's capital market environment we have determined to make a manager change. The overall risk – reward composition of most client portfolios remains unchanged.

As you are aware, each KLS account is managed separately. Please discuss your individual account performance with your KLS account manager.

Thank You

We take this opportunity at the beginning of a new year to thank you for your continued confidence in our firm. All of us at KLS wish you and your family a healthy, happy and prosperous year.

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