

ECONOMIC AND PRODUCT COMMENTARIES

FOURTH QUARTER 2011

Economic Commentary

Signs of Strength in the U.S.

Another year has come and gone. If you just looked at the numbers you would think that nothing much had happened ~ and you would be wrong. While the S&P 500 finished the year virtually unchanged (dividends brought the total return up to 2.12%) there was a lot of to and fro over the 12 months. The S&P bounced between 1250 and 1350 for much of the year through July. Then the market declined in “waterfall fashion”, entering August with a move straight down to 1150, finally working its way down to 1075 in early October, a decline of about 20%. In August the averages turned schizophrenic, with the Dow Jones Industrials ricocheting up and down over 400 points a day for four days running. After the market bottomed in October, it rallied smartly all the way back to the 1260 area. Volatility was rampant as measured by “all or nothing days.” An all or nothing day is a day in which the spread between the advancing and declining S&P 500 stocks is greater than 400, either positive or negative. This sort of event used to be fairly rare, but in 2011 we hit a record of 70 such days. To put that in perspective, between 1990 and 2004 were only 67 total all or nothing days. In addition, while the market was flat for 2011, individual sectors showed a lot of variability. The utilities group, a very defensive and yield-oriented sector, rose almost 15% while the more cyclical financial and materials sectors declined 18.4% and 11.6%, respectively. Overall, stocks with solid dividends outperformed non-dividend payers by a wide margin. In fact, when ranked by decile, the highest dividend payers were up by 10.4% while the lowest declined by 7.3%, a 17.7% difference.

While the market remained almost unchanged for the year, earnings continued their upward climb. The S&P 500 is estimated to have earned about \$97 per share for 2011, bringing the price/earnings ratio down to 13x 2011 estimated earnings. This is a very reasonable valuation level, especially given current levels of interest rates and inflation and is well below its 17.5x average P/E since World War II. For 2012 the consensus estimate for the S&P 500 rises to about \$103 per share bringing the P/E down further to 12.2x based on 2012 earnings. More than anything else, we believe the uncertainty over the financial condition of various European countries is hanging over the markets like a black cloud, causing the markets valuation to contract even as earnings go higher. Additionally, we have the Iranians making mischief in the Strait of Hormuz and the usual Mideast actors creating further uncertainty as to the stability of our energy supplies, sending oil prices back to the \$100 per barrel area. Nonetheless, as earnings keep rising, the stock market should eventually follow suit.

Meanwhile the economic news, at least for the United States, continues to get better and the signs are that we have escaped a double dip recession. For December, the economy added 200,000 payroll jobs and for the year 1.64 million were added while the unemployment rate fell from 8.7% to 8.5%. While not great, at least the numbers are headed in the right direction. One hundred fifty thousand jobs per month is the breakeven point to account for the growth in the working age population. Additionally, the Institute for Supply Chain Management reported that its employment index rose to 55.1, the highest reading since June and, at 27 months, it represented the longest monthly streak above 50 since 1972. Manufacturing is surprisingly strong with exports totaling \$1.07 trillion for 2011, not far from its 2008 peak.

Some of our favorite indicators fall in the transportation sector. Rail traffic is an excellent indicator of economic health because grains, coal, chemicals, lumber, iron, etc. move by rail and are inputs to other parts of the manufacturing process. The latest statistics show that rail traffic (intermodal) was up 5.4% over 2010 and 20.4% over 2009. Holiday sales were also robust, particularly in the online category, racking up a 15% increase over last year. FedEx hired 20,000 holiday workers to help with the load, an 18% increase from last year while UPS increased holiday hiring 10% to 55,000.

While the United States seems to be making a nice comeback, the biggest question mark for the economy and the markets remains the situation overseas, not only in Europe but also in China. China has been the economic engine for the world with its insatiable appetite for raw materials. It has been growing at least twice the rate of the world economy. However, China’s economy seems to be slowing down and its stock exchange remains in a two-year bear market that has wiped out about one-third of its value. The 17 member Euro Zone is China’s biggest trading partner and with austerity taking hold in Europe as it struggles to pay off debt, China is feeling the pinch. The only silver lining to this scenario is a drop in commodity prices as Chinese demand lessens. This would effectively serve as a multi-billion dollar “tax cut” for U.S. consumers and could serve to stimulate demand in the consumer sector.

Theta Growth

Q4: Revert to the Mean

Over the very long term, tenured professors will tell you that stock valuations tend to be “mean reverting”. Meaning over time, stock market returns tend to gravitate towards a long-term average; price: earnings multiples tend to revert to a long-term average and things like dividend-yield tends to revert to historical comparisons vs. other asset classes.

While generally accepted, those theories were displayed in the stock market quite literally this year. The S&P 500 price only return finished 2011 unchanged from December 31, 2010. It's hard to imagine a year that had less than a 0.003% change. In addition to no change on the year, the S&P 500 closed exactly on its closely-watched 200-day average.

It took an 11.82% surge in the fourth quarter to get back to unchanged on the year, but that's exactly what happened. 2011 was a round-trip roller coaster in the stock market, finishing exactly where we started despite huge levels of volatility.

Which would you rather own, the stock market where stocks chopped higher for 6 months, crashed, then fought to get back to break even? Or an opportunity that was rarely lower during the year, rallied strong at several points, and finished 34% higher?

The second opportunity is stock market volatility. Volatility had several large moves higher this year. At first, volatility moved higher late in the first quarter when tensions flared in the Middle East and North Africa. The game-changer came in August when our domestic political agenda turned sour over the deficit ceiling debate. Volatility soared in August. In Europe, politicians were playing (and continue to play) kick-the-can regarding their very real debt problems; but in the United States, our politicians took their ball and went home. Sadly, this isn't going to change anytime soon, and if anything, it's going to get worse. There is an argument that stocks do better when politicians can't get anything done... let's hope that's the case in this instance because nothing substantial is going to come out of Washington in 2012.

The Outlook

Volatility will be sustained at very high levels, likely above 20% for the first half of 2012. We assume:

- The European financial crisis will flare-up but be contained
- The U.S. will avoid a double-dip recession
- No pro-growth agenda is debated in Washington
- Inflation is abated in the Far East
- Threats of attacks on Iran's nuclear facilities will flare-up but not actually happen

In the Theta/Growth Strategy; volatility is an asset class. The strategy generates income from dividends and the sale of covered call options. Those options get more expensive as volatility increases; so higher levels of volatility mean it's a better time to be an option seller. We expect income levels at or above 2011 levels going forward.

The Results

Over the past several years, the Theta/Growth strategy has been a good investment relative to other fixed income or equity-only strategies because the option sales (1) produce income and (2) reduce volatility. This year, U.S. Treasuries strongly outperformed anything equity related as 30-year Treasuries beat every stock in the Dow. That seems a bit odd considering our government lost its AAA credit rating for the first time in history.

On a total return basis, over full market cycles, we expect the Theta/Growth Strategy to keep-up with or outperform the S&P 500. Over shorter time frames (a month, a quarter, etc.) we like to compare the strategy to the BXM Index. The BXM is a hypothetical index of covered calls sold against the S&P 500. Although you can't invest directly in the BXM, and the BXM does not produce tangible cashflow, in theory, the absolute return performance should be similar to Theta/Growth. The Strategy finished the year in-line with absolute return expectations. 2011 was simply not a great year for anything related. However, we're pleased that the strategy outperformed the stock market by providing high and sustainable cashflow, something few other investments, including those stellar U.S. Treasuries, can do.

Large Cap Core Growth

On the surface, 2011 appeared to be a relatively “quiet” year based on the S&P 500's price return of negative 0.003% but appearances can be deceiving. There was a lot of movement under the surface with various sectors as well as individual companies both in the red and the black. For example, the utility sector posted a positive return of approximately 15% as investors focused more on dividend returns than growth. The more cyclical financial and material sectors declined by 18.4% and 11.6% respectively. Note that the flat return of the S&P 500 looks good when compared to the foreign averages. Germany and France declined about 20%, Brazil fell 26%, Japan 16% and India about 40%. Compared to these declines, the S&P 500 looks like a stellar standout.

Our Large Cap Growth strategy ended the year on a very strong note, outperforming the Russell 1000 Growth benchmark during the last quarter. Top performing stocks for the quarter had an energy flavor as Continental Resources (+38%), Occidental Petroleum (+32%) and Oceaneering International (+31%) led the pack. Dividend play Philip Morris was also a leader with a fourth quarter return of 27%. Our only negative return for the quarter was Oracle, down about 11% on earnings news. What we find most impressive about the quarter was how broad the performance was with about 2/3 of our holdings posting double-digit returns.

Looking forward, we believe the U.S. market can post a meaningful increase if the European Union takes the steps necessary to prevent an unraveling of the Euro and if China can avoid a major slowdown in its economy. The United States is beginning to post good economic numbers and valuations are compelling. We invest in companies, not economies and there are plenty of good choices within our universe. The S&P 500 is trading at only 13x estimated 2011 earnings and 12.2x 2012 estimates and earnings continue to march higher. We choose stocks individually based on company fundamentals, so any sector weighting is a result of choosing the best opportunities. For example, we have benefitted from our position in energy but are looking at an array of opportunities in other sectors with numerous product cycles. We believe there is considerable upside potential for our holdings.

Global Equity Income

Performance

After the substantial drop in equity returns during the third quarter, the global markets responded with significant valuation gains in the fourth quarter of 2011.

The Global Equity Income benchmark, the S&P 500, ended the quarter with a positive return of 11.82%. The secondary benchmark as represented by the S&P Global 1200 gained 8.17% and the developed international market universe as represented by the S&P ADR index rose by 7.05%. The Global Equity Income strategy slightly underperformed the S&P 500 but substantially outperformed the S&P Global 1200 during this quarter with the model portfolio returning 11.11%. The portfolio equity allocation is 65% U.S. and 35% international with a weighted dividend yield of 3.86%.

For the year 2011, the Global Equity Income strategy gained 6.63% while the S&P 500 returned 2.12% for the year and the S&P ADR and the S&P Global 1200 returned -10.56% and -4.99% respectively.

Factors Affecting Performance

With the Euro Zone fiscal drama continuing to make daily headlines during the quarter, equity markets experienced periods of high volatility. U.S. company earnings continue to improve as the S&P 500 posted third quarter growth of 17% over the same period one year ago with 69% reporting positive earnings surprises. This had the most significant market impact on the energy sector which climbed 18.19% and was closely followed by the industrial sector which rose 16.52%. All sectors reported positive performance for the quarter.

The largest impact to relative performance versus the S&P 500 was exposure to the international equity markets which in aggregate substantially underperformed the U.S. in the fourth quarter. The sizable outperformance by the Global Equity Income strategy over its secondary benchmark of the S&P Global 1200 during the quarter clearly demonstrates the additional return provided by the portfolio's holdings.

The largest positive contributors included holdings such as Hubbell Inc. (+35.78%), a manufacturer of electronic products which beat third quarter earnings estimates on a 12% increase in sales. The company also announced a \$200 million share buyback program. Genuine Parts Co. (+21.39%), a distributor of automotive replacement parts reported its 11th consecutive positive earnings surprise while raising its estimates going forward. Companhia Energetica de Minas Gerais (+24.38%), a Brazil based electric utility posted a third quarter earnings increase of 19% over the same period one year ago.

The Global Equity Income strategy's quantitative screens for stock selection proved to be effective in the financial sector with First Financial Bankshares, Inc. (+28.76%), a Texas based regional bank which reported third quarter earnings that were up 11% on increased lending that grew 12% over the course of the year. These are outstanding results in a very challenging environment. While the global macro-economic environment remains volatile, the strategy will continue to seek high quality dividend paying companies that can provide solid performance over the long term.

Global Equity Income Strategy

The Global Equity Income strategy pursues its objective through the investment in U.S. and non-U.S. dividend-paying stocks that have demonstrated above median yield, a positive trend in dividends and favorable earnings growth. These companies also represent a broad spectrum of the global economy. The objective of this strategy is to provide current income and the potential for capital appreciation at lower than overall market risk.

Tactical Asset Allocation Portfolio "TAAP"

Capstone's Tactical Asset Allocation Portfolio is designed to forecast and react to changes in the investment landscape. It is an opportunistic all cap equity strategy. The portfolio may include, over time, ETFs of equity style boxes, cap-sizes and industry sectors. Defensive allocations into non-equity positions may occur when we believe equities will provide low or inadequate returns. Asset allocation is determined by our strategic decisions and investment selection is determined by our tactical decisions.

The "Risk-On/Risk-Off" trade dominated the fourth quarter as it has dominated the entire year. It's amazing that the volatility in equities has increased over 30% this year, yet somehow, the S&P 500 managed to close the year exactly where it started. Of course, the S&P 500 was one of the best performing markets this year. Record changes in volatility actually make sense when you look at global returns:

S&P 500	+0.000%
Mexico	-14.97%
Brazil	-27.04%
Euro Stoxx	-19.73%
Nikkei	-12.79%
Hang Seng	-19.91%

Equity markets can certainly be fickle. It probably doesn't make great sense that the stock market in Brazil was among the worst performing this year. Does it make sense that U.S. Treasuries were the #1 performing asset class during a year when our domestic debt lost its AAA credit rating? Does it make sense that the stock market "is concerned" about sovereign debt downgrades in Europe when France has a higher credit rating than the United States?

With the outlier exception of the United States, 2011 was a bad year for the equity markets. The U.S. received a tremendous boost as a "flight to quality," and because the U.S. economy is gaining momentum as others slow, we expect to see greater divergence amongst equity markets next year which supports the tactical allocation portfolio. The reason we see greater divergence amongst returns is because we are starting to see diverging economic momentum in the world's major economies.

Just two months ago, the U.S. economy was flirting with a double-dip recession, but it now seems to have gained positive momentum. At long last, growth in jobs is spurring consumer spending. Key economic indicators have been better than expectations. The failure of the Congressional "super-committee" to hammer-out a debt reduction agreement really doesn't hurt the short-term economic picture. In fact, it's quite possible that our totally ineffective government is exactly what the doctor ordered. Sometimes, if you can just get the politicians to do nothing for a while, the markets do quite well on their own... just as Bill Clinton.

Earlier concerns about China also have not materialized. China's economy grew over 9% in the third quarter. Coming into 2011, the biggest risk in China was inflation. But inflation has slowed as China's biggest customer (Europe) is entering a recession. It's a bit counter-intuitive, but a slowdown in Europe actually gives policymakers larger room to maneuver to avoid a pending inflation problem. Chinese equities (and emerging markets in general) have only stabilized, they are not outperforming yet; but we expect that they will in 2012.

Europe remains a dark cloud over the world economy. It's amazing how much debate is taking place over the issue; but odds are very high that Europe is already in a recession. All we know for sure is global-non-U.S. equities are in a bear market; and Europe is to blame. The popularity of the Euro experiment is waning amongst the populations of the individual countries within the continent, and the political leaders have little choice but to face that reality or lose their jobs.

Put that all together, and the picture is this: global equity markets will remain extremely volatile (that's not much of a bold prediction given the debt policy issues in Europe and a nasty presidential campaign in the United States.) Assuming the European problem is contained, emerging market returns should once again reflect their high-growth economies. And the U.S. economy will muddle along through 2012.

We will continue to avoid Europe. Until we see some substantial pro-growth agenda brought forward along with the various austerity budgets being forced through the system, we see no way that Europe doesn't experience a lengthy and painful recession.

The TAAP strategy has erred on the defensive since late July, but things are changing and so we must change.

We intend to increase exposure to equities heading into 2012, but overall, the portfolio will maintain a defensive bias. Domestically, we will stay committed to defensive equity exposures like consumer staples, healthcare and utilities. We will continue to avoid Europe, but we expect to increase exposure to emerging markets, particularly those of Latin America.

Fixed Income

The bond market as measured by the Barclays Government/Corporate Bond Index generated a return of 8.74% for the year ended 2011. U.S. Treasuries were once again the best performing sector in the investment grade universe. Although rates are at historical lows, bonds continue to provide attractive total returns with income in the low single digits. The Fed has been clear that it will keep rates low until the economy shows more strength and many analysts continue to believe that 2012 will not bring a strong recovery.

There has been a slow, continuous improvement in economic indicators throughout 2011. Statistically speaking, we are somewhat better off at the end of 2011 than we were at the beginning, but we have a long way to go before arriving where we need to be. The policies enacted by our government have not been very effective in improving the economic environment. For example, unemployment remains very high at the 8½% to 9% bond, the housing market remains anemic with an estimated 30% of mortgages under water and GDP has been revised downward from a respectable 3% to 2% for 2011. The lack of economic improvement has led to significant changes in Congress and spirited debates regarding the upcoming Presidential election. While the voters have taken to the polls to express their discontent, some citizens have taken their dissatisfaction to the streets of our cities with a movement called “Occupy Wall Street”. Unfortunately, the demonstrators seemed more intent on vandalism than constructive activity but surely the message was received. Perhaps the November election will brighten the outlook, however we believe that the economy is unlikely to experience much improvement in the coming year.

Outside the U.S., Europe continues to be a worrisome question mark. The daily headlines are no longer screaming peril at us but the problems are far from gone. The good news is that the situation will be resolved but at a cost. Germany has refused to issue a blank check, which means that the weaker countries will have to begin to live within their means. Unfortunately, the financial institutions in Europe are all connected through loans so the balancing act will be difficult.

The circumstances surrounding the U.S. economy and Europe would appear to point to higher interest rates. Inflation has certainly been picking up in some areas including food and energy, however we do not believe that interest rates will see a significant increase this year. The U.S. has undergone a significant deleveraging in the last few years and that reduction in debt is more than offsetting current policies that have historically led to higher rates. It is unlikely that the effects of that deleveraging will be overcome in the near-term; therefore we believe that the U.S. economy will continue to struggle. It is difficult to imagine U.S. Treasuries continuing their price performance in 2012. We have been underweighted in U. S. Treasuries in favor of high quality corporate bonds which bring higher yields and more income, however we also believe that corporates will outperform U.S. Treasuries in overall total price return and plan to continue to overweight corporate bond securities.

Municipal Bond

The year 2011 was interesting in many ways for municipal bond investors. Pricing completed a full cycle as a flood of inventory in January and February dropped prices early in the year and then dissipated from a drought of inventory by August, bringing prices back to where they were in quarter 3 of 2010. Couple this with the fact that the Federal Reserve kept short-term interest rates unchanged at historical lows and it made for quite a memorable year.

State fiscal conditions continue to improve, but at a very slow pace. A fall 2011 survey of state legislation fiscal officers found that the deterioration that dominated state finances in recent years has eased. States continue to reduce services and expenditures, including a steady layoff of workers which may continue through 2012 as Federal stimulus money used to assist states has dried up. Revenue performance has improved, expenditures in most states are stable and, in a significant departure from past years, few states are reporting budget gaps in the early months of fiscal year 2012. The combined states budget gap of \$26.7 billion for FY11 has closed to just \$4.4 Billion in FY12 as fiscal conservatism without tax increases is working. 45 of 50 states recorded growth with tax collections growing by a healthy 8.9% margin in the third quarter of 2011 as people return to work and sales tax revenues improve. Housing and real estate prices, which determine general obligation tax revenue, remain a challenge for cities and states.

The media induced fear early in the year when they projected massive defaults in the municipal bond marketplace yet then this prediction became unfounded, as the default rate was slightly less than the historical average. Municipal bond mutual fund investors sold positions for 29 consecutive weeks, compounding inventory oversupply early in the year. We took advantage of the lower pricing and higher than average inventory and had quite a bit of activity throughout the year. First, we used the cash that we had raised to reposition portfolios and put it to good work. As the inventory shrank, fears subsided and typical taxable fixed income investors crossed over to municipal bonds to take advantage of the higher yields available. At mid-year when inventory levels dropped and prices rose, we sold positions ripe for the sale, took some profits and shortened the duration with purchases of premium intermediate-maturity bonds with call features.

Returns on municipal bonds may be limited to the coupon rate for 2012. The capital gains that have been a bonus to fixed income investors may not develop as there is very little room to produce capital gains with rates so low. However, municipal bond coupon returns are greater than Treasuries and remain attractive on an after tax basis when compared to other fixed income securities~ including corporate bonds, while continuing to offer high levels of safety. We are poised to take advantage of market conditions as events beyond interest rate changes develop. We are finding value in the secondary market with municipal bonds rated A or better involved with essential services like water, sewer, power, streets, highways, school education and general obligations. The ideal maturities on the yield curve are in the 5 to 10 year range with a call feature between 2013 and 2017. Building new portfolios and repositioning existing securities takes a little longer in this environment as we balance improving supply with an increase in demand and conduct thorough due diligence on all decisions and direction. We plan to use any market volatility to opportunistically adjust and polish the portfolios entrusted to us.

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