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FINANCIAL CONCEPTS, INC. – QUARTER 4 - 2011

MARKET RESEARCH & INVESTMENT COMMENTARY 16:

The philosophy of Financial Concepts is based on being long-term investors and focusing on capital preservation. Just as we emphasized last quarter and, in fact, over the last few years, the only certainty in today's market environment is volatility. In our last commentary, we cautioned investors about not overreacting to the negative third quarter headlines. These seem like the *best* of times with an impressive stock market performance in the fourth quarter going into January and a second half rebound in economic growth.

To give only the most recent example, the third quarter was one mired in disappointing to mixed data combined with the shock of the S&P downgrade and the effect of global events from the Japanese earthquake aftermath to the tremors from the continuing European debt crisis, not to mention the political and policy stalemate that defines Washington especially in an upcoming election year.

While the European debt clouds still hang over the markets, the economy has benefitted from better news and optimism. Growth in the fourth quarter was up to a respectable 2.8%, and about 200,000 jobs were created in December. The markets have continued to build on fourth quarter advances into 2012 with the broad based indices showing historically strong January gains.

Market observers are, however, more tepid in their expectations pointing out that the favorable trends were helped by comparison to the challenges earlier in the year, for example, economic activity was boosted by the recovery in production and demand after the natural disaster in Japan. In fact, the market gave back some of its month-long gains in late January after the announcement of the solid GDP growth number which nevertheless did not meet economist expectations[1].

The reasons for caution are still modest consumer spending and real disposable income flat at best from a year earlier, the risk that the European crisis perhaps is close to a "tipping point," and the restrained U.S. economic growth forecasts by both the International Monetary Fund and the Federal Reserve.

We continue to adhere to three long-term themes:

1. Volatility is part of today's investment environment and that risk should be acknowledged and managed.

2. Focusing on capital preservation while looking for opportunities that can offer growth and appreciation.

3. Developing and maintaining a long term strategy and perspective in navigating the financial landscape.

[1] Washington Post, January 29, 2012

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With these concepts foremost in mind, more than ever, we make every effort to remain diligent and proactive in monitoring world events and have not been in the habit to even consider engaging in short-term speculation or market timing practices. Rather, our investment philosophy and its execution are driven by the objective of protecting client's principal.

We will continue to stick to our firm's core philosophy and focus on investment fundamentals while working to keep a tight rein on emotion and reactions to the "noise," generated by the latest headlines.

This philosophy is incorporated in the FCU Model Portfolios that are diversified using a macro view, rather than concentrated in any one area or asset class. This strategy enables the preservation of capital for our clients in a world than can be unpredictable and uncertain.

Our goal is to invest in places that can offer favorable risk adjusted rates of return, and we view the globe as fertile ground for identifying such opportunities. Indeed, our quarterly commentaries are intended for you to gain insight into our approach.

Above all, we believe that wealth creation is possible by avoiding a permanent impairment of capital. An effective and ambitious way to accomplish this objective is to structure investments with a margin of safety that allows for capital preservation. This requires a more patient time horizon. It also means that we do not blindly mimic or duplicate broad equity indexes, including the S&P 500, Dow, and NASDAQ.

These benchmarks tend to be highly concentrated and tightly correlated to the present business cycle. We make every effort to diversify away risk, by using multiple asset classes, such as fixed income. Only by embracing such diversification can solid long-term risk-adjusted return performance be accomplished. There is no investment class that is immune from volatility, but we believe that our strategy controls the effects of such risks.

We take pride in staying committed to who we are, and always look to protect the downside. Therefore, we may lag the returns of leading benchmarks in a particular period but look to produce a more stable stream of results. You merely need to refer to the beginning of this discussion when we compare the out-sized pessimism in the third quarter to the optimism more recently. Investing is about looking objectively at data, information and markets and understand but not be consumed by emotions driven by the latest news or headlines.

<u>THE OUTLOOK</u>

Our longer term perspective has been rewarded as the markets and economy moved from the roller coaster third quarter to the more placid and upbeat year-end. While discussion of a recession has disappeared from policy and economic debate, the continued upswing is still considered tenuous, as demonstrated by importance placed on a payroll tax cut extension and the Federal Reserve's maintenance of accommodative polices and close to a 0% target interest rate.

These are some of the trends that we are looking at:

- Solid GDP growth suggesting acceleration of economic activity after the slowdown earlier in the year.
- Financial market and monetary policies by the Fed as evidenced by lower target interest rates.
- Record corporate profits and margins and cash-rich corporate balance sheets.
- Gains in job creation, business investment and manufacturing activity.
- Return of investor risk appetite and controlled inflation.
- Attention to finding a European growth crisis resolution.

The clouds on the horizon suggest prudence:

- Longer term risks associated with a shorter term Europe debt crisis solution and recessionary concerns.
- Subdued global expansion as emerging markets, such as China and India, see growth rates subside.
- Currency instability reflected in higher gold prices, as countries attempt to support rising monetary values.
- The continuing correction in the housing market complicated by the foreclosure documentation process.
- Less fiscal stimulus as policy shifts toward deficit reduction and strained state government budgets.
- Higher rates of unemployment and stagnant wage growth despite recent temporary employment gains.

Retail Investor Investment Sentiment

As noted in prior commentaries, the individual investor remains liquid based on holding nearly $7 trillion in cash and liquid assets as reported by Federal Reserve data through its "flow of funds" report. A tough third quarter affected individual balance sheets.

According to the "flow of funds" report, the household net worth was $57.4 trillion at the end of the third quarter, about $2.4 trillion less than at the end of the previous quarter. U.S. household debt fell at in the third quarter, continuing the contraction that began in the third quarter of 2008.[2]

The stock market improvement suggests that the net worth figure has probably improved, though that must be balanced against the continued slide in housing prices. The lower mortgage debt levels may be affected by some homeowners walking away from existing mortgages. Nonmortgage consumer credit has increased over the last four quarters.[3]

ECONOMY

GDP Growth Accelerates in Second Half But Remains Fragile

The economy continues to grow as it has for each quarter in 2011[4], including the fourth quarter by the 2.8 percent compared to 2.5% in the third quarter and 1.3 percent in the second quarter[5] and 1.7 percent for the 2011 year. The private sector – business investment and consumer spending – are now the larger drivers of the economy.

The 2.8% rate approaches the economy's long-term potential growth rate and is the strongest quarterly growth rate in more than a year but failed to match the 3% economist expectation[6]. The consensus view is that GDP probably would do well to match that rate in the coming year as the second half of the year performance was helped by production constraints from earlier in 2011, and there is concern that the inventories will remain elevated based on current demand.[7]

Should growth exceed expectations, interest rates could rise sooner than anticipated. Under such a scenario, the Fed potentially would be able to reverse its accommodative strategy but, given recent Fed communications and policy strategy, appears unlikely.

The consumer is the economic "king" accounting for 60 percent to 70 percent of our economy. Consumer spending gained 1.45% in the fourth quarter, a lower rate than a year ago but higher than the first three quarters of the year. The deleveraging consumer in the form of reduced consumer debt is a positive for spending capacity of consumers. Despite these positive data trends, longer term, the consumer is still going through a period of deleveraging, which places a ceiling on consumer spending.

Since hitting a peak in the summer of 2008 through August, nonmortgage household consumer debt has fallen by roughly $100 billion or 4%.[8] Whether consumers prefer to borrow vs. save will affect consumer spending as do wages and disposable personal income which remain "stuck in neutral."[9]

Despite the recent employment pickup, employment is still 6 million below its pre-recession peak of 145 million.[10] The jobless rate remains elevated despite declining to 8.5% in December from 9.1% in mid-2011 and from a peak of 10.1%

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[2] The Federal Reserve's Flow of Funds data combine individual and nonprofit organizations in their tabulation. http://www.federalreserve.gov/releases/z1/current/z1.pdf

[3] http://www.federalreserve.gov/releases/G19/Current/

[4] Washington Post, January 28,2012

[5] U.S. Department of Commerce data

[6] http://www.mcclatchydc.com/2012/01/27/137132/us-economy-grew-at-28-percent.html

[7] Bond Dealers of America economic survey, for example, bdamerica.org

[8] http://www.federalreserve.gov/releases/G19/Current/

[9] U.S. Department of Commerce, Bureau of Economic Analysis, http://www.bea.gov/

[10] Washington Post, January 28,2012

registered during 2009. [11] The favorable trend is tempered by the fact that some of that improvement is due to a 300,000+ decline of those in the labor force.

The increase in hiring took place in the private sector, with declines in private sector employment at the state and local level.[12] Faster economic growth is necessary to put a significant dent in the unemployment rate which is likely to stay above the 8 percent range.[13]

Consumer confidence has been on the upswing since the low point at the time of the S&P rating downgrade. The Conference Board's consumer confidence index rose both in November and December.[14] Another gauge of consumer sentiment, Thomson Reuters/University of Michigan index, has continued to rise through January.[15]

Housing Correction Still Has a Way to Go: Prices and Credit Standards Hold Back Housing Recovery

As measured by the closely followed S&P Case-Shiller index, as of the most recent reading for October, national housing price decline has continued from the additional slide in 2010 with prices more than 3% lower than a year ago. Only Detroit and Washington, D.C. showed positive housing price trends over the past year.[16]

Foreclosures ramped in October but the backlog remains. Overall foreclosure inventory is at an all-time high, 4.29% of all active loans. The distressed properties will sell at a discount. While there is considerable investor demand for distressed properties, new foreclosures are still outnumbering foreclosure sales by over 3:1.[17]

Together with foreclosure overhang and negative equity mortgages, the credit standards are holding back housing recovery. The stricter underwriting standards and "underwater" mortgages have resulted in a large homeowner market segment unable to refinance.

Core Logic estimates that about a fifth of mortgaged properties are now "underwater" or mortgage balances higher than the value of the residential mortgaged property. [18]

The one positive indicator for housing is long term mortgage rates are near record lows and have been below 5% for all but two weeks this year. The average rate on a 30-year fixed loan is now below 4%. But lenders typically require homeowners to have equity in their homes to refinance and lenders are approving borrowers with high credit scores.

Lower rates have boosted sales and slightly reduced the inventory of unsold homes. Existing home sales are picking up, reaching 4.6 million on an annualized basis in December up over November and compared to a year ago.[19]

Will Relaxed Lending Standards Lead to More Business Lending?

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[11] http://www.tradingeconomics.com/united-states/unemployment-rate

[12] Newsweek January, 2012

[13] The Bond Dealers of America Economic Survey, for example, November 1, 2011, bdamerica.org

[14] http://www.conference-board.org/data/consumerdata.cfm

[15] http://www.travelagentcentral.com/trends-research/consumer-confidence-gains-due-job-growth-33341

[16] http://www.standardandpoors.com/servlet/BlobServer?blobheadername3=MDT-Type&blobcol=urldocumentfile&blobtable=SPComSecureDocument&blobheadervalue2=inline%3B+filename%3Ddownload.pdf&blobheadername2=Content-Disposition&blobheadervalue1=application%2Fpdf&blobkey=id&blobheadername1=content-type&blobwhere=1245326665736&blobheadervalue3=abinary%3B+charset%3DUTF-8&blobnocache=true

[17] Fortune Magazine – December 2011.

[18] http://www.corelogic.com/

[19] http://www.realtor.org/press_room/news_releases/2012/01/ehs_dec

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Commercial credit availability may be improving. Banks have eased standards on commercial and industrial business lending for the last several quarters through the most recent survey after an extended period of tightening, according to the Federal Reserve's quarterly senior lender survey.

The report produced mixed results in loan demand after indicating rising business deals and consumer real estate transactions in the previous survey. [20] The Fed survey is closely watched as a barometer of the credit lending market.

Cash Rich Corporate Balance Sheets, Profits Remain the Source of Hope for Accelerated Economic Expansion:

Businesses propensity to invest and hire is a function of demand and confidence in the global economy. Corporations are still cash-rich, buoyed by an ever rising stream of revenues.

Profits and investable liquid funds are a source of potential economic expansion once invested. Fourth quarter increases in business spending are encouraging in that regard, but greater business capital investment requires increased faith that the operating environment is stable.

Corporations have a higher share of cash on their balance sheets than at any time in half a century, as businesses build up reserves instead of investing in new plants or hiring new workers. Nonfinancial companies held more than $2 trillion in cash and other liquid assets at the end of September, with cash accounting for about 7.2 % of all company assets, the highest level since 1959.[21] The most recent quarterly Department of Commerce report does indicate business equipment and software spending increasing 16% and 5% over the last few quarters, respectively.[22]

Concerned about the future but still flush with cash, many companies are buying back their own stock to enhance shareholder returns. Buybacks are on a course to record $540 billion in authorizations, according to Birinyi Associates which would be the third-highest amount in U.S. history. During the first three quarters of this year, companies completed more than $376 billion in repurchases which both full-year 2010 and 2009.[23]

Inflation Looks to Be Under Control; Will Energy Prices and Commodity Prices Continue to Slow?

Inflation remains historically low. The most recent unadjusted CPI index reading as of November was 3.0 percent year over year and the core CPI excluding food and energy increased 2.2 percent. But the headline CPI has been virtually flat the two most recent months and core CPI rose 0.2% and 0.1% in the last two months (November and December). These trends are indicative of an inflation rate within the Fed's 2 percent target range.[24] With excess capacity and a soft labor market, core inflation appears to be under control.

As China begins to experience moderation in growth and with the effect of the European debt crisis driven volatility, agricultural commodity market prices are weakening.[25] The slowdown has been apparent for months in some commodities.

The price of copper was down 21% from a year earlier. Cotton was down 45%. Natural gas prices continue to fall, and crude oil has retreated from peaks hit in April, though not as sharply as other commodities. Some forecasters see U.S. inflation cooling further in the coming year.

Economists at J.P. Morgan project that the consumer price index will rise just 1.2% in 2012 and emerging market economies will grow 4.7% this year, a sharp slowdown from 5.7% in 2011 and 7.3% in 2010.[26] The reduced commodities price trend is undoubtedly a relief to the Fed and gives the Fed greater flexibility to keep its target rate low, close to 0%.

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[20] http://www.federalreserve.gov/boarddocs/snloansurvey/201111/default.htm

[21] The New Yorker, November 2011

[22] Washington Post January 28,2012

[23]Birinyi Associates – January 2012.

[24]http://www.bls.gov/news.release/cpi.nr0.htm

[25] Wall Street journal, January 27,2012

[26] Barrons, December 2011

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Global Growth Affected By Emerging Market Growth Moderating

Inflation fighting strategies in emerging markets lead analysts to worry about dampened demand for exports and global growth, further slowing economic activity in developed countries. Global manufacturing activity was subdued going into 2012, with the euro zone's industrial sector having declined for five straight months through December.

There is concern that China, the world's second-largest economy, is encountering slower growth, thus reducing its capacity to compensate a potential recession in debt-stressed Europe and a still fragile U.S. recovery. India, by contrast, saw strong factory activity in December in contrast to recent weakness in Asia's third-largest economy.[27]

Longer term, despite the pullback, we continue to see the emerging (and frontier) markets as engines of global growth. We continue to be persuaded by the analysis that says that emerging economies with growth generated through internal consumer demand – such as India – may outperform external growth oriented economies – such as China.

Need for Fiscal Discipline in a Difficult Political Environment

On the fiscal side, there is a public consensus for restraining the budget deficit but the degree to which it translates into action is the critical issue. The economy faces another fiscal year of $1 trillion plus deficits, and indeed the forecast is for record deficits in this fiscal year. The political will is a critical variable, and the November demise of the congressional “super committee” on debt reduction does not instill much confidence.

While borrowing rates still remain low, there is no assurance that the markets will continue to keep yields on U.S. government debt low and the thus the cost of financing the deficit at the current levels. Longer term, entitlement and especially Medicare expenses are looming. Medicare's trust fund for inpatient care has been projected to run out of money in 2024.[28]

What is clear is that deficit reduction is the focal point of economic debate and fiscal expansion is largely off the table. Economic policy “stimulus” is on the monetary side. The Fed reiterated the intent to keep its target rate low or close to 0% but extended the time period from mid-2013 to the end of 2014. Federal Reserve policymakers leave open the possibility of additional asset purchases.

The statement at the conclusion of the most recent Federal Open Market Committee meeting on January 25th confirmed the Fed’s plans to maintain the strategy of selling short-dated instruments and buy longer-term debt. The government’s formal statement indicated that the maturity of debt will be extended to keep interest rates low.[29]

The State and Local Finance Drag on Economic Prospects May Be Moderating

Unlike the Federal government, most states are required to balance their budgets and the economy and related tax revenues have hit budgets, which have led to some states raising tax rates and dipping into their “rainy day” funds and other one-time sources. Governors and lawmakers must look for new places to cut spending.[30]

Furthermore, some local and state governments’ capacity to finance looming pension obligations is at risk. In addition to the local government effect on the national economy, the state and local finances of course have implications for municipal bond prices and credit quality.

Although municipal securities have recovered since early 2011, the markets are increasingly differentiating between financial strong and weaker municipal bond issuers, especially with the removal of bond insurers from the marketplace.

MARKETS

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[27] New York times, January 2012

[28] CNN – Money November 2011

[29] http://federalreserve.gov/newsevents/press/monetary/20120125a.htm

[30] Baltimore Sun, December 2011

Equity Markets Trend Up After a Volatile 2011: Prospects Depend on Continued Profit, Fed Policy, Economic Growth Trends and European Crisis Management

Equities have across sectors experienced historically high rates of volatility in 2011. To give a sense of price volatility, during the August to October period, the broad S&P index fell by early October by a little over 16% from levels reached late last summer.

The S&P equity index was at its highest level since August 1st and climbed 14% by October 28th.[31] The three major broad indices rallied over the fourth quarter and continued with a historically strong advance into January before a modest retreat in the latter half of the exact same month.

While the three broad equity indices ended in positive territory for 2011, those indices with smaller cap exposure were mixed for the year. Volatility measures have moderated more recently, but given trends especially over the last few years, we should not count on continued subdued volatility.

There are three dominant factors that may affect future equity market performance at least in the near term. First, there is the corporate profit growth at record levels but with a cautious economic growth outlook for 2012 by both the Federal Reserve and the International Monetary Fund. The second pillar is the expectation of Fed policy to keep the recovery on track and "remove the punchbowl" at the correct time to manage inflationary expectation threats.

The Fed's low rate stance communicates continued growth concerns. The third is the outcome to the European debt market situation. There should always be prudence in market strategy and outlook, ensuring that expectation of values be grounded in underlying fundamental trends. Finally, there is the outlook for the European debt crisis and global market contagion.

U.S. Fixed Income

As higher quality (lower credit risk) bond yields have fallen and prices appreciated, there is heightened interest up the "risk curve" in order to generate yield and thus the attraction of corporate bonds. The liquid balance sheets and positive profit trends reduced fundamental corporate credit risk.

Going forward, a few investment considerations need to be taken into account: whether corporate bonds are approaching full value and supply to take advantage of low funding costs eventually will have price implications.

Finally, the highly liquid corporate balance sheets are likely to be pared down when corporations put the cash to work in response to shareholder demands and public policy pressures. Default rates globally have been scaled back through 2011 based on rating agency metrics to the lowest rates since 2008.[32] There is a developing consensus that default rates will edge up but to no more than (and perhaps less than) long term averages.[33]

<u>The International Bond Perspective: European Debt Situation</u>

Much rests on the outcome of the European negotiations, including the expanded European rescue fund. Policy makers have made progress toward stabilizing the euro zone in the last few months including an apparent agreement on how to leverage the euro zone's European Financial Stability Facility.

This program could potentially insure the bonds of debt-stricken countries with guarantees of 20% to 30%, depending on circumstances of each issuer.

The ECB's three year loans are meant to ease liquidity fears in Europe's banking sector, which has had trouble accessing money on the open market. But in reality, early indicators pointed to banks holding back on riskier debt purchases,

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[31] Washington Post, October 30, 2011

[32] http://www.usatoday.com/money/perfi/stocks/story/2011-10-11/corporate-defaults/50796848/1

[33] http://blogs.barrons.com/incomeinvesting/2011/12/08/u-s-default-rate-holds-steady-at-2-0-in-november/; http://uk.reuters.com/article/2011/11/21/debt-defaults-ing-idUKL5E7ML2M820111121

favoring safety. As expected by the investment community, the European Central Bank has left its key lending rate unchanged, with investors looking for signs of further cuts and additional steps to bolster the euro zone system.[34]

Gold

The price has more than doubled in value over the last 5 years. The metal's price dropped sharply in December, recovering in January but remains modestly lower than at the end of the third quarter standing at $1,700 at the end of January.[35] Four factors are at play – near term factors including the European debt crisis aftermath; Middle East instability; how much is being bought and sold by national central banks; and long term fiscal and monetary policies.

Certainly, a case can be made for gold and other commodities in a diversified investment portfolio. While prices have surged over the past year, however, bullion prices can be volatile. The fourth quarter gold sell-off brought with it lessons to investors and recognition that there is no such thing as the price of gold always rising and that precious metals are not immune from price volatility.[36]

Financial Concepts Unlimited Approach

Financial Concepts Unlimited continuously monitors and assesses its investment strategy, informed by market valuations and trends along with multiple sources of financial data. Our team evaluates these events and variables as summarized throughout this document, then may act with prudence, taking into account any potential risk exposures.

We continue to stand by our commitment of capital preservation with a longer term view, and are always looking to manage client wealth with attention focused on downside protection. The asset classes and investment managers we have chosen to provide diversification within our portfolios continue to offer what we think to be an excellent benefit as we incrementally invest our way back into the stock market. This approach to diversification continues to be our primary goal.

In closing,

I wanted to thank you again for your continued support and state that we remain confident in the enduring power of the financial market's potential to create wealth over the long term, despite the challenges and risks that are a necessary part of the investment process. The overall sentiment from the investment community appears to be increasingly positive as reflected in recent trends.

The markets in the coming year may certainly experience challenges, and we take into account market volatility and the risks that it presents. We must never forget that opportunities for creating wealth are constantly evolving, and as part of our commitment to managing your assets, we are always looking for the best way to implement them.

Finally, permit us to wish a you a Happy and Prosperous New Year.

Sincerely,

Michael S. Standridge

Portfolio Analyst
Financial Concepts, Inc.

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[34] Financial Times January 2012

[35] http://www.goldprice.org/

[36] Investment Adviser

FINANCIAL MARKET DATA AND STATISTICS FOR FEBRUARY 6, 2012

Year to Date Statistics*	Current Rates*	Current Yields*
DOW – ▲ 5.30 %	Oil Price @ $ 98 barrel	Federal Funds @ 0.25 %
NASDAQ – ▲ 11.50 %	Gold Price @ $ 1737 ounce	30 Y Mortgage @ 3.99 %
S&P 500 – ▲ 6.90 %	Euro per Dollar @ 0.7599	10 Y Treasury @ 1.94 %
Russell 2000 – ▲ 12.20 %	Core Inflation – ▲ 2.96%	5 Y CD'S @ 1.36 %
CBOE VIX – ▼ 26.90 %	Unemployment @ 8.50%	Money Market @ 0.51 %

- YTD statistics, current rates, and current yields are all from the Wall Street Journal as of Feb 6, 2012.

There is no guarantee that a diversified portfolio will outperform a non-diversified portfolio in any given market environment. The price of commodities such as currency and gold is subject to substantial price fluctuations of short periods of time and may be affected by unpredictable international monetary and political policies. The market for commodities is widely unregulated and concentrated investing may lead to higher price volatility.

Foreign investments involve special risks including greater economic, political, and currency fluctuation risks, which may be even greater in emerging markets. Indexes cannot be invested in directly, are unmanaged and do not incur management fees, costs or expenses. Investors should be aware that there are risks inherent in all investments, such as fluctuations in investment principal. With any investment vehicle, past performance is not a guarantee of future results.

Sector investing may involve a greater degree of risk than investments with broader diversification.

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