TFC Financial Management

January 13, 2012

QUARTERLY INVESTMENT LETTER – 4Q 2011

Investing in an Era of Austerity and Administered Low Interest Rates (How Long Can Investors Resist Stocks in a World of P/E Ratios of 9-10x, Near-Zero Interest Rates and Low Inflation?)

The global financial markets today appear to be divided into three distinct economic modes: 1) Europe with its sovereign debt crisis seemingly headed into recession; 2) the emerging countries and Asia, most apparently back on a moderate growth track; and 3) the U.S. entering a surprisingly improved economic recovery which seems to have caught the "experts" unaware. What may be unfolding is a global picture of *divergent* investment market scenarios, not the free market *convergence* which investors have come to accept as gospel these past 15-20 years.

Confused by this disparity in outlooks, managing risk has become the overriding objective of a majority of professional and individual investors. Commodities and precious metals (in particular gold) have been admitted to the hall of acceptable portfolio risk management asset classes. The current buzz is that *active* portfolio management, short-term tactical asset class allocation shifts, and/or offsetting complex manager hedging strategy models, are the templates for the "new normal."

Not for a moment denying that it might be different this time, and that new portfolio strategies should always be considered, nor that the Euro-debt drama has yet to resolve itself, a few fundamentals deserve reaffirmation:

1) Investment market circumstances have always been and continue to be dynamic, but human behavioral patterns in response to events and shifts in outlook are remarkably predictable. Alterations in the level of investor confidence have become almost as important to portfolio performance as the economic realities themselves;

2) Information technology innovations have changed the structure of the global financial markets in ways which promote speculation and generate greater short-term price volatility;

3) Economic and financial globalization is running ahead of the world's structure of governance. Nationalism still predominates. Free market development continues to be vulnerable to policy errors by politicians unschooled in economics and who are driven by consensus-based decision processes; and

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4) The struggle with government, private sector, and personal deleveraging impedes any meaningful longer-term resolution of the imbalances left behind by the 2008-2009 near total implosion of the world's banking system.

All of the above is well recognized. But what should be an investor's practical response? As Tip O'Neill often reminded us, "All politics is local." Unfortunately, that mantra remains true, and our political class almost daily demonstrates the parochial perspective brought to Washington on issues of national significance. The question for equity investors is whether all of these crosscurrents have been fully discounted in today's stock market valuations? More on this later; but it strikes us that at current market levels, stocks, having priced in these uncertainties, going forward should outperform fixed income securities (including "riskless" U.S. Treasuries) by a wide margin.

A note on gold: In this risk-averse world, it might bemuse an investment fundamentalist that a now-accepted risk containment portfolio strategy is ownership of gold bullion (be it directly or through an ETF). The conventional gold investment case math is revealing, but prompts a cautionary pause. The extraction cost of an ounce of gold today averages around $950. Gold *users* might be willing to allow miners a 30% mark-up, indicating the remaining spread (i.e., $950 + $285 = $1,235 against today's price of $1,600) is determined by financial speculators and those who consider gold the new risk reduction currency. As an investment, on an inflation-adjusted basis, the last peak in gold was reached in 1980 at $2,470, and even during the present run-up still has not been exceeded. Then, as today, people were (are) walking about town attempting to sell the "just melt stuff." Tupperware parties have been replaced by BYG (Bring Your Gold) gatherings. The recent Christie's auction of Elizabeth Taylor's estate jewelry achieved record prices. Time to think of Warren Buffet's maxim, "When everyone wants it, sell; when no one wants it, buy?"

2011: A Volatile Year for Investors (Will We Ever Get Back to the "Old Normal?")

During the year just ended, global stock markets (as measured by the Morgan Stanley Capital International All Country World Index, or MSCI ACWI) declined 6.9%. Developed country European stocks were down 11.1%, and Emerging Markets were off 18.2%. For American investors, due to a stronger U.S. dollar (up 1.5% vs. other currencies), a globally diversified equities portfolio was also burdened by this currency headwind. Worldwide, risk-averse investors retreated from other currencies and, despite our fiscal mismanagement, bought dollars. Much to the dismay of some of our trading partners, by default the dollar remains the currency of last resort.

Our central bank (Federal Reserve Bank) flooded the U.S. banking system with newly printed liquidity, as did many other national monetary authorities, pushing short-term rates to near zero. In response, intermediate, as well as long-dated fixed income rates, moved down to new lows. Cheap liquidity abounds, but demand lags and cash reserves on bank and corporate balance sheets continue under-employed.

Continuing, as they have, to operate in an unconstrained and highly leveraged mode, hedge funds speculated with this abundant and cheap liquidity, generating global stock market price volatility of record proportions. In the U.S. alone, there were 96 trading days out of 252 with price swings exceeding ±1%, 35 of which were 2% or greater. These high-frequency, super-computer-driven, algorithmic-trading techniques serve no constructive market or social purpose. Their deployment enriches only the hedge fund managers and those with enough capital for access. In the last analysis, over time, the average hedge fund performs no better than a long-only balanced bond and stock portfolio. This is an instance where rational regulation is imperative.

Is a Globally Diversified Balanced Portfolio Still Relevant?

2011 was a year in which a U.S. dollar investor would have been better off with an exclusively Dow Jones Industrial Index portfolio (+8.4%). The thirty stocks tracked by this benchmark are by definition broadly-based, diversified, dividend-paying, large, highly-recognized U.S. companies. An S&P 500 Index clone portfolio (e.g., Vanguard's S&P 500 Index Fund) ended the year virtually where it began.

Throughout the year, the Euro debt drama and the ebb and flow of emotions, driven by a daily diet of dour media headlines, generally obscured the hard economic data. "Double dippers" were fed just enough negative economic statistical fodder to keep their argument alive. The negative case kept investors on edge throughout the year. There were times, particularly during the August-September equity market decline when we felt quite alone in our "hold the line" recommendations.

What might happen if progress broke out and the Euro-debt crisis seemed resolvable, or if the news backdrop shifted from bleak to merely neutral, or if some of the pent-up buying power (i.e., bank and corporate excess cash reserves, institutional and investor money market balances), even marginally, began to be deployed acquiring at-risk securities? The pundits would then have to begin to focus on a worldwide equity market environment in which stock price-earnings ratios of 8-9 times prevailed against near-zero short rate bonds, with dividend yields exceeding 10-year riskless U.S. Treasuries and stock earnings yields above 8%! It won't be a smooth path, of course, particularly since it requires poll-driven politicians to make rational long-term policy decisions to solve the Euro sovereign debt impasse. And even if all this came to pass, it won't be a return to the "old normal," but rather a kind of reversion to the psychological mean during which investor behavior and confidence improves somewhat. Although presently being severely tested, a globally diversified portfolio still appears the best route for individual investors with the long view in mind.

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A Recap of TFC's Portfolio Strategy for Fourth Quarter 2011

"Information received…suggests that the economy has been expanding moderately, notwithstanding some apparent slowing in global growth. The Committee continues to expect a moderate pace of economic growth over coming quarters. (However,) strains in global financial markets continue to pose significant downside risks to the economic outlook." Federal Reserve Board FOMC Press Release, December 13, 2011.

Despite the dismal backdrop of a deepening financial and political crisis in the Eurozone, a sharper slowdown in emerging economies, and continued concerns about the sustainability of even moderate growth in the U.S., both large cap and small cap U.S. stocks posted double digit returns for the fourth quarter.

While the safe haven status of U.S. Government bonds and the U.S. Dollar remains intact, the strong rebound in U.S stocks in the 4^{th} quarter established our equity markets as somewhat "safer" and more stable than abroad presently.

In 2011, U.S. interest rates declined further, with the benchmark 10 year U.S. Treasury yield dropping from 3.4% at the beginning of the year to under 2% at year end. Contagion risk from the Eurozone debt and banking crisis, heightened fears, and extreme pessimism drove investors out of equity mutual funds again (-$102b for 2011) for the fifth consecutive year and into the relative stability of bonds. The Barclays Intermediate Government/Credit Bond Index posted a total return of 6% for 2011, which is unlikely to be repeated this year.

Fixed Income Strategy: Short-Term

Last year, our short-term, high quality fixed income portfolio effectively provided principal stability, liquidity, modest income and offset much higher volatility in global equity markets. Our fixed income funds have no direct sovereign debt exposure in Greece, Spain, Portugal or Ireland, nor do any of our short term money market funds.

With moderate U.S. (Decision Economics' forecast of +2.6%) and (uneven) global economic growth (DE's forecast of +2.7%) currently projected for the year, it is possible that intermediate term U.S. interest rates and yields may rise.

In this baseline, "muddle through" scenario, maintaining a short duration fixed income structure remains an optimal and prudent investment strategy. Longer duration bonds would be at greater risk in a rising interest rate environment. For example, if the current yield on a 10-Year U.S. Treasury bond increased from 2% to 3%, the bond price would decline by approximately 9%.

Equity Strategy: Global

2011 was the first year in more than a decade that U.S. stocks (+2.1% for the S&P 500 Index) outperformed foreign equity market indices, including MSCI Japan (-14.2%), MSCI Europe ex-U.K. (-14.5%), MSCI U.K. (-2.5%), MSCI Pacific ex-Japan (-12.7%) and MSCI Emerging Markets (-18.2%). The relative strength of the U.S. Dollar, particularly against the Euro, also contributed to the negative foreign market returns for the year.

Chart 1 illustrates the annual and 10-year annualized return for regional and world equity markets. Global equity markets generated annualized returns of 4.2% over the past 10 years, with Emerging Markets producing 13.9%, the highest, and U.S. stocks posting 2.9%, the lowest.

Chart 2 illustrates the regional share of total global GDP (economies) and total global stock market capitalization. Today, the U.S. represents less than 1/5 of the world's aggregate economic value and less than ½ of the world's stock market value.

Despite higher volatility in foreign equity markets, we remain fully committed to a global equity strategy for long term economic, currency and market diversification. Our present equity allocation is 55% U.S., 32% international developed markets (including 11% in European stocks) and 13% in Emerging and Frontier markets, plus a targeted investment in global natural resources and global real estate equities.

As always, we welcome your comments and questions.

Sincerely,

Jim

James L. Joslin
Chairman, CEO & CCO

Renée

Renée Kwok
President

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Chart 1

Annual and 10-Year Annualized Performance for Global and Regional Equity Markets

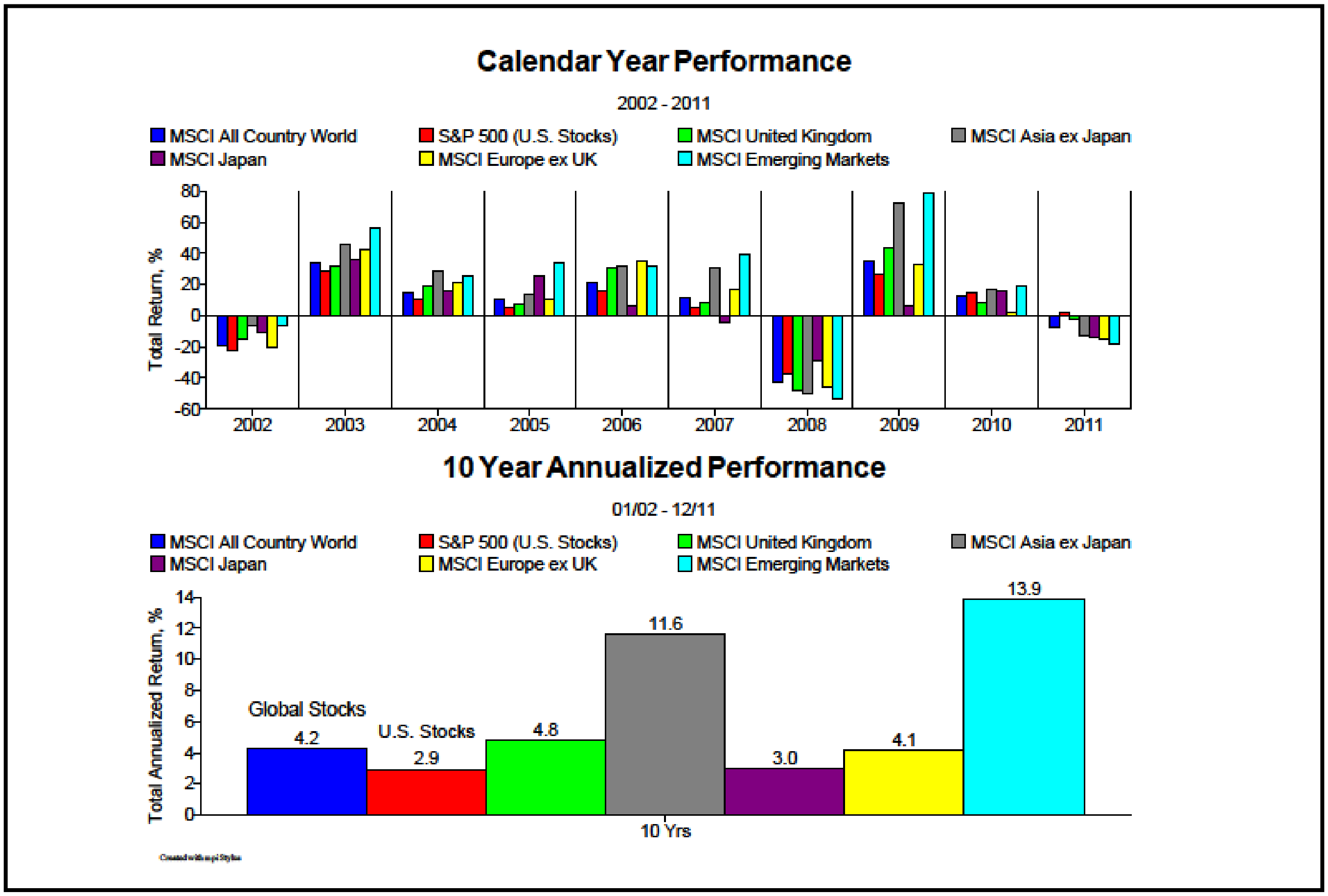
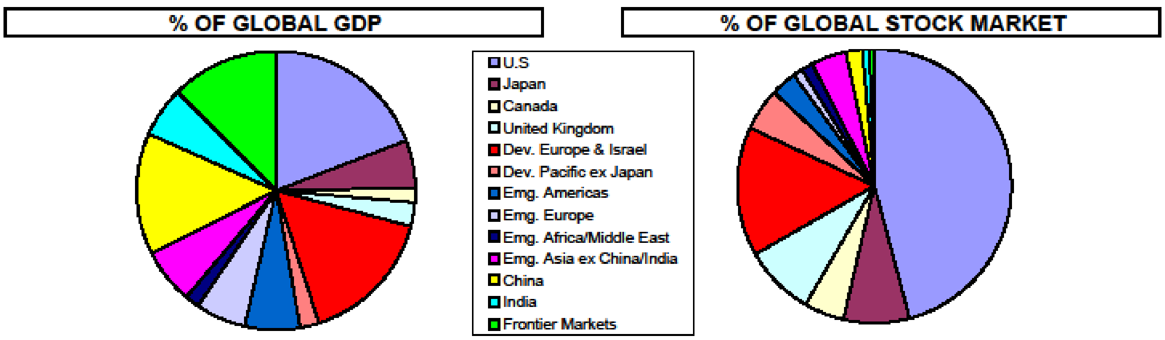


Chart 2

U.S. Represents 19% of Global Economic Value (GDP) and 46% of Global Stock Market Values



Region	Allocation
U.S	19.1%
Japan	5.6%
Canada	1.8%
United Kingdom	2.9%
Dev. Europe & Israel	15.7%
Dev. Pacific ex Japan	2.2%
Total Developed Markets	28.1%
Emg. Americas	6.4%
Emg. Europe	5.9%
Emg. Africa/Middle East	1.6%
Emg. Asia ex China/India	6.4%
China	14.4%
India	5.7%
Total Emerging Markets	40.2%
Total Frontier Markets	12.6%
Total	100.0%

Region	Allocation
U.S	45.8%
Japan	7.9%
Canada	4.5%
United Kingdom	8.3%
Dev. Europe & Israel	15.3%
Dev. Pacific ex Japan	5.2%
Total Developed Markets	41.3%
Emg. Americas	2.9%
Emg. Europe	1.2%
Emg. Africa/Middle East	1.3%
Emg. Asia ex China/India	4.4%
China	1.9%
India	0.8%
Total Emerging Markets	12.4%
Total Frontier Markets	0.5%
Total	100.0%