



Market Spotlight

Index	Returns			
	Qtr	Annual		
	4 th Qtr	1 YR	3 YR	10 YR
Equities				
S&P 500	11.8%	2.1%	14.1%	2.9%
Russell 2000	15.5%	-4.2%	15.6%	5.6%
MSCI AC World exUS	7.2%	-7.4%	12.0%	4.2%
EAFE	3.3%	-12.1%	7.6%	4.7%
REITs	15.4%	9.4%	21.6%	10.1%
Barcap Agg. Bond	1.1%	7.8%	6.8%	5.8%
90 Day T-Bills	0.0%	0.1%	0.1%	1.9%

Despite disappointing 2011 equity returns, the last 3 months of the year were impressive with solid gains across all asset classes. The year started with promise as global economies looked better causing stocks to roar with approval! However, hopes were soon as a disastrous tsunami in Japan took both human and economic tolls, while revolutions in the Middle East (the Arab Spring) caused oil prices to spike. Investor confidence plummeted as negative developments continued to unfold with a debt crisis in Europe, bipartisan brinkmanship and gridlock in Washington, and a US credit rating downgrade. By early October, equity markets had collapsed to near bear market lows; down 19% from their April high. But then encouraging news out of Europe and reports of stronger than expected US corporate profits, triggered another market reversal that drove 4th quarter returns back into positive territory. At the end of a volatile year where we saw gains and losses of 2% or more on 35 trading days, returns for the S&P 500 were basically flat, small cap stocks were negative, and international and emerging equities suffered significant losses. What a frustrating ride for investors! REITs posted solid gains and treasuries surprised. Instead of the US downgrade spooking bond investors, fear drove them to safe havens, making treasuries one of the best bets of the year, up 7.8%.

As we enter the New Year, the investment landscape will be defined by issues such as upcoming government turnover globally, a continuing debt crisis in Europe, another debt ceiling and tax debate in the US, transition in Middle East countries, and geopolitical worries over Iran's determination to build a bomb. In Europe, neither resolution nor total dissolution is expected near term. Real solutions will be required to resolve the underlying debt problems rather than the piecemeal policy response we've seen to date. This will involve significant structural change, politi-

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Investment Commentary

'Rational' vs 'Normal' Investors

The Research Foundation of the CFA Institute has recently published another excellent monograph entitled, 'Behavioral Finance and Investment Management.' It is a compilation of articles written by several of the leading thinkers in Behavioral Finance who have significantly extended our understanding of asset pricing theory, portfolio theory and advisor/client relationship.

In no way should this diminish the importance of investment theory as conveyed previously through Modern Portfolio Theory (MPT) and the Capital Asset Pricing Model (CAPM) which were first articulated in the late 1950's and 1960's. These early theories established new paradigms for understanding asset pricing, investment risk and portfolio theory that have significantly advanced the science of portfolio management. They were premised on common assumptions that asset returns were most correlated with risk, that investors were rational, and that markets were largely efficient.

In the 1980's and 1990's theories of behavioral investing gained momentum and attained a heightened level of credibility in 2002 when Daniel Kahneman and Vernon Smith were awarded the Nobel Prize in Economics for their research on how we make economic and financial decisions. Behavioral investing drew a distinction between '*rational*' investors and '*normal*' investors, for whom decisions are influenced by a litany of mental traps that may relate to our individual psychological makeup, to social psychology reflecting the way we behave in the presence of others, and/or to the neurofinancial functioning of our brains.

Examples of each of these influences are probably more common to us than we are willing to admit. *Hindsight bias* causes us to extrapolate recent returns; *overconfidence* causes us to think our decisions are better than average; optimism increases our perception of the probabilities of favorable returns; *loss aversion* deters us from realizing losses; we think of our investment portfolio not as a single whole but as a *pyramid of individual goals*. Social psychology enters in as we are biased toward the safety of following the herd, in part because we fear being alone and exposed; we create stories and rationalizations for why trends should continue without basis in fact; and we have attention anomalies, focusing on one thing while failing to see the obvious.

The cognitive psychology or behavioral neuroscience comes into play when we feel the *rush of an anticipated reward* or seek *instant gratification* or when we are *overcome with fear*. Each of these emotional responses is part and parcel of a response within our brain, in sections called the 'amygdala' and 'prefrontal cortex', that trigger autonomic mechanisms which often execute decisions with little deliberate thought. A sharply rising stock price triggers a rush; a deer sees headlights and freezes.

Finally, there is a message from the behavioral sciences for the relationship with clients which resonates with us: establish the relationship recognizing tendencies of *betrayal aversion*, *overconfidence*, the *illusion of control* and *optimism*; be sensitive to issues of *emotion* and *narrow framing*; set clear goals; establish reasonable performance expectations over reasonable time frames.

The understandings of Behavior Finance serve to complement the precepts of MPT. They suggest markets are not efficient because the forces that set security prices go beyond rational thinking. They further suggest risk is not an easily quantifiable notion and is about both probability and consequence, the latter of which is idiosyncratic and perhaps not even knowable in advance. Finally, it suggests there is not an optimal portfolio, but rather perhaps an optimal *set of portfolios* that meets the needs and makeup of the individual investor. Fascinating topic; more to learn!

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cal hurdles and unfortunately, time. So “muddling through” appears to be the best path forward for the eurozone for now.

In the US, two of the biggest drags on economic momentum remain the need to reduce debt and potential fallout from Europe. At the same time, a deeply polarized government and political dysfunction continue to undermine investor confidence. That said, it's important to point out that although the US economy is not yet out of the woods, it has persisted and is continuing to grow. Corporate profits have reached all-time highs; vehicle sales are trending upward; consumer balance sheets are improving; spending is up modestly; and the GDP is growing steadily, albeit at a slow pace. Unemployment remains stubbornly high, however new jobs are being added in the private sector. Vacancy rates are very low, forcing rents up. So with housing more affordable, it is becoming cheaper to buy although lending remains tight. As we review prospects for growth, it's also important to note that China and India are expected to account for about half of the global GDP growth over the next five years. These engines, although operating at a slightly slower rate than in the past, may help offset more sluggish growth in the US or Europe.

Looking ahead, we are reminded of Warren Buffett's classic line that the primary purpose of stock market prognosticators is to make fortune tellers look good! That said, we believe that the trend of political and macro-economic events that drove market returns and volatility in 2011 is likely to continue.

Although we can't know for sure what's ahead for the economy or the markets, we do know that if you buy stocks at low price to earnings ratios (P/Es), like we are seeing now, you are likely to get higher returns. Valuations matter in the long run. And although flock-like investor response to bad news in the short term leads to volatility and highly correlated asset classes as investments rise and fall together, for the long term investor, being diversified also matters. We've witnessed this first hand this past decade and again in 2011. So while uncertainties are reason for caution, opportunities argue for well-balanced portfolios that enable investors to participate in markets when the pendulum swings back.

Tax Changes Looming for 2013

While there are few meaningful federal income/estate tax changes scheduled to take effect for calendar year 2012, one can expect significant changes to take effect in 2013 with the expiration of the Bush tax cuts. Several of the most significant changes that will occur unless extended or modified include:

- All tax brackets will be affected with the top marginal tax rate rising from 35% to 36% - 39.6%;
- Bottom tax rate of 10% is eliminated, tax rate on the first \$34,000 of net taxable income will be 15% for single filers
- Long-term capital gains rate will increase from 15% to 20%.
- Qualified dividend treatment goes away, with dividends taxed at the individual's marginal tax rate;
- The “marriage penalty” returns.
- The phase-out of personal exemptions and itemized deductions for high income individuals returns.
- The federal estate tax exemption for each individual reverts back to \$1mm from \$5mm.

We have no insights as to changes that might impact these tax issues. We do expect they are not likely to be resolved until the end of 2012 and therefore suggest that the 4th quarter will be an important time to contact one's tax advisor.

Beware! 2011 form 1099's

Beginning with the 2011 Form 1099's, custodians (Schwab, Vanguard, etc.) are now required to report cost basis information to the IRS associated on sales of individual securities. In 2012 this requirement will be extended to mutual funds as well. As a couple of consequences of this change, Form 1099 reports will become drastically thicker since they will include segmented cost basis information for both securities and mutual funds associated with any sale transactions. Further, the information on the Schwab 1099 may not reconcile exactly with the information we provide you from the New England Guild because Schwab will be using 'average' rather than 'lot level' cost information. It is also important to note that all custodians may not be consistent in their interpretation of the IRS guidelines for these reports.

So what to do? Call us if you have questions about your report. We can answer most questions and/or refer you to a Schwab website that provides helpful tools and explanations. We also are available to talk with our clients' tax advisors and to provide consolidated capital gain reports that will greatly facilitate filing.

Winterfest in Bushnell Park!

Combine an afternoon or evening of free skating with hot chocolate at Hartford's downtown skating rink located by the Pump House on the east side of Bushnell Park. Food and beverage are provided by onsite vendors (courtesy of Vito's and Billings Forge). Or once you're done skating, warm up across the street at Bin 228 over “Funduta” fondue with a glass of fine wine! www.bin228winebar.com (860. 244.9463) Rink hours: 11 A.M. – 9 P.M., 7 days a week. Free ice shows from 6 – 7 P.M. Fridays & Saturdays. Don't own skates? Winterfest has free rentals. Enjoy – and remember the hardest part of skating is the ice!

QUOTE: *“If you don't know where you are going, you might wind up someplace else.”* — Yogi Berra

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