



Asset Class Performance

Asset Class	ETF Description	Ticker	1 Month	Quarter	1 Year
US Large Cap	SPDR S&P 500	SPY	1.0	11.7	2.0
US Small Cap	iShares S&P SmallCap 600 Index	IJR	1.2	17.1	0.9
Developed Int'l Equity	iShares MSCI EAFE Index	EFA	-1.0	3.2	-12.2
Emerging Int'l Equity	Vanguard Emerging Markets Stock ETF	VWO	-3.3	6.0	-18.7
Intermediate Bond	iShares Barclays 7-10 Year Treasury	IEF	1.7	1.3	15.5
Long-term Bond	iShares Barclays 20+ Year Treas Bond	TLT	3.4	1.8	33.6
Corporate Bond	iShares iBoxx \$ Invest Grade Corp Bond	LQD	2.8	2.6	8.9
Inflation Protected Bond	iShares Barclays TIPS Bond	TIP	0.1	2.6	13.4
Developed Int'l Bond	SPDR Barclays Capital Intl Treasury Bond	BWX	0.4	-0.1	3.6
Emerging Int'l Bond	PowerShares Emerging Mkts Sovereign Debt	PCY	1.9	4.3	8.3
Real Estate	Vanguard REIT Index ETF	VNQ	4.7	15.2	8.6
Commodities	iPath DJ-UBS Commodity Index TR ETN	DJP	-4.0	0.2	-14.5
Gold	SPDR Gold Shares	GLD	-9.9	-2.9	11.2

*as of 12/31/11

Tune in to KCMO Talk Radio 710AM every Saturday at 4pm as we discuss everything you need to know about ETFs and the world of investing.

The fourth quarter of 2011 saw equities bounce back from the big declines of the third quarter. Bonds were relatively flat and gold declined as the extreme pessimism prevalent during the third quarter moderated. For the year, the S&P 500 was flat which was noteworthy considering that 2011 was one of the more volatile years on record for US equities. Emerging and European equity markets experienced significant declines while bonds enjoyed significant gains. Global stock market capitalization declined 12% in 2011. After 2011, US bonds have now beaten US equities over the last 30 years. The last time that bonds had better returns than equities over a trailing 30 year period was 1861 at the start of the Civil War.

Economic Update

Like the quarters before it, the fourth quarter of 2011 was quite eventful. The European debt and currency crisis continued. The ratings agencies downgraded numerous European countries and European banks. A Belgium bank was nationalized. Italy and Greece changed governments. MF Global filed bankruptcy due to bad investments in European sovereign debt. European leaders met numerous times and came up with numerous plans to save the Euro and keep the crisis from spiraling out of control. Eventually, the European Central Bank cut interest rates several times and, in concert with central banks around the globe, agreed to provide virtually unlimited liquidity to European banks. This lifeline likely kept numerous European banks from going under.

The European region remains troubled with the European economy either already in or teetering on the brink of a deep recession. European governments are forced to cut budgets and reduce spending which will exacerbate the European economic woes. Interest rates are high for many European countries as they have spent beyond their means for many years now to support their social welfare states. The chickens have come home to roost, so to speak. Europe continues to face a very difficult environment.

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With significant amounts of European sovereign debt to be refinanced in 2012, Europe and its woes will remain front and center for some time to come.

The economic picture in the US is brighter only by comparison. The US economy continues to muddle along. Economic reports did indicate a brightening of US economic prospects in the fourth quarter. US equities were pressured in the third quarter in large part because third quarter economic reports indicated an increasing likelihood of recession; however, more recent economic reports indicate that the recession fears were misplaced which was a big reason for the strong US equity performance in the quarter. The employment picture continues to improve but at a painfully slow pace. Inflation remains steady in the 3.5% range which is right at the long term average for the US. Our view on the US economy remains the same – the economy is continuing its anemic recovery from the recent financial crisis and muddles along at a very slow rate of growth. Improvement continues grudgingly.

This slow US recovery has resulted in an uneven recovery with some regions and sectors recovering and some still under severe pressure. During the quarter AMR, the parent of American Airlines, filed for bankruptcy protection. Further, the city of Harrisburg, PA as well as Montgomery County, Alabama both filed for bankruptcy protection. Harrisburg is the capital of Pennsylvania and Montgomery is home to Birmingham, the biggest city in Alabama. As we have discussed in the past, there will be bankruptcies and defaults in the municipal bond market. It is unlikely that there will be a significant number of defaults, but it is likely that there will be more municipal defaults than in past years. We continue to recommend that investors utilize a municipal bond ETF rather than individual municipal bonds, in part because of this elevated risk of individual defaults.

Away from the US and Europe, the central banks of a number of developed and emerging economies began to cut interest rates. As we discussed in past commentaries, those central banks raised interest rates to combat rising inflationary pressures. Those pressures are beginning to fade. The S&P's global commodity index peaked in April 2011 and has declined 20% from that peak. The UN's world food price index peaked in February 2011 and has declined 5%. With inflation under control for now, those economies are refocusing on growth.

2011 was a very difficult year for investors to navigate. The average hedge fund was down over 4% in 2011, the second worst year for hedge funds ever. Some big names in the investment world struggled mightily. Bill Gross of PIMCO lagged his benchmark and peers significantly. Fairholme Fund, run by Morningstar's manager of the decade Bruce Berkowitz, declined 29% for the year. John Paulson, hedge fund hero of the 2008 financial crisis, saw one of his funds decline over 50%. Bill Miller of Legg Mason Value (more on him below) effectively retired from managing his mutual fund because of poor investment performance. Many "superstars" of the investment world experienced a very difficult 2011. We continue to believe that a focus on asset allocation using ETFs is a better investment solution for most investors than trying to pick the "superstar" fund managers.

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The environment continues to remain uncertain. Europe will continue to dominate headlines. European economic conditions are negative and deteriorating while in the US and the rest of the world, economic conditions are improving but at a slow rate. The US employment picture continues to improve, though at a snail's pace. The upcoming election season promises to be extremely partisan and negative with lots of blaming. Do not expect any political compromises – and we need many compromises to get the Federal budget under control and the economy growing again.

In this uncertain environment, caution is warranted. Our primary focus is on risk management. We have said before that the global economic recovery is fragile and susceptible to shocks. We are getting those shocks. Most asset classes appear to be reasonably priced for the current environment; however, they are by and large not reasonably priced if global economic conditions worsen considerably from here. While there is an extreme amount of pessimism and uncertainty today, remember that the problems discussed above will be addressed and resolved over time. Financial markets will respond once conditions become less uncertain. In our view, there will be attractive investment opportunities in the future – equities are relatively cheap, commodities have corrected significantly, and investor sentiment is decidedly negative; conditions which are usually associated with bottoms in financial markets. While the near future is uncertain, we believe there will be attractive opportunities later this year.

Our final note for this commentary concerns the extremely low interest rate environment. Interest rates on fixed income investments are at or near multi-decade lows. The mainstay investment for most retirees is fixed income. With interest rates so low, retirees need a larger nest egg to produce the same level of income than they did several years ago. In this environment, low fees are critically important and ETFs are extremely cost effective investment tools.

We believe that the most important determinant of long term investment success is to have a proven, disciplined asset allocation strategy that is consistently followed over time. Our investment processes have a strong risk management aspect to them. We will rotate away from areas of the global financial markets that are showing signs of new or continued deterioration. We will rotate to areas of the global financial markets that are showing signs of new or continued improvement. As always, we believe a disciplined, adaptive investment approach founded on proven, time tested investment strategies will help our investors achieve their financial goals over time.

Have ETFs Killed the Mutual Fund “Rock Star” Managers?

Legg Mason’s Bill Miller recently announced he was stepping down as the manager of Legg Mason’s flagship Value Fund. Miller was one of the last of a dying breed of high profile, “rock star” mutual fund managers trying to beat their benchmark indexes each year.

Unfortunately, Miller’s unlikely run of outperformance came to an end in 2006 and Miller has struggled mightily since that time. A recent article from Reuters titled “Miller’s Fall Shows Luck at Play in Investing” had some

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interesting comments from the President of Fund Research at Morningstar, Don Phillips, who said that Miller himself “always acknowledged what a difficult competitor the S&P 500 is” and that “even when he was getting all the praise, he (Miller) was very skeptical”.

California Institute of Technology professor Bradford Cornell continued with “most of the annual variation in performance is due to luck, not skill. Annual rankings of fund performance provide almost no information regarding management skill”.

It makes sense, then, that investors are continuing to gravitate in huge numbers towards passively managed ETFs, where investors can capture the benchmark returns at a fraction of the cost charged by overpriced actively managed mutual funds. Investors are realizing that it's more important to pick the right asset classes than trying to pick the right individual stocks or bonds. And what better way to pick the right asset classes than with ETFs?

As Phil Pearlman, executive editor of StockTwits, commented on CNBC.com, “Mutual funds remind me of AOL dial-up: a dwindling collection of old people who don't know better, contributing monthly to a comically inferior product and Miller was the symbol figurehead of this beta minus fees charade”.

It looks like the charade is up and Miller is smart enough to recognize that. ETFs are quietly killing the actively managed mutual fund industry and “rock star” mutual fund managers are becoming a relic of the past.

Fidelity to Offer ETFs

A company known primarily for its actively managed mutual funds might finally be coming to grips with the fact that they can no longer just ignore the fast growing ETF space. According to The Wall Street Journal, Fidelity Investments appears set to begin offering a broad array of ETFs after recently filing an application with the SEC.

As we explained way back in May of 2009, ETFs were already “eating Fidelity's lunch”. Back then, it had already become clear that a primary reason for Fidelity's deteriorating asset levels was the rapid growth of ETFs. Fidelity was clearly concerned with entering a market that was an obvious competitor to their lucrative actively managed mutual fund business. Remember, actively managed mutual funds charge significantly higher fees than ETFs (and more often than not, underperform the same benchmarks those ETFs are tracking). Unfortunately for Fidelity, investors have continued to vote with their money and it looks as if Fidelity is finally realizing where the future of investing is heading.

As they say, better late than never...

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