SMITH & HOWARD
WEALTH MANAGEMENT
Your family's CFO.

Fourth Quarter 2011

Your Family's CFO Report

A review of issues affecting your family's wealth

Happy New Year!

It is time for our annual review and a look forward into the economy and markets for 2012. We will start with a quick overview of wealth management services and end with our view on stocks and bonds and other asset classes. We look forward to visiting with you soon and wish you a prosperous 2012.

As you can see by the pictorial above, Smith and Howard Wealth Management does more than prudently invest your family's money with an eye on holding down risk and minimize taxes. Although investments are extremely important, it is only half of the services we provide you.

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We help you coordinate all of your financial affairs and put an overall financial blueprint in place. We then monitor that on an ongoing basis similar to the way in which we monitor your investment portfolio. After all, circumstances and tax legislation constantly change.

Here are just a few examples of when it is important to review your overall financial matters and why we do so regularly:

- You are thinking about selling your business.
- You are seriously considering retirement and, in fact, envision it around the corner.
- You have recently experienced heavy expenditures or come into a substantial sum of money and wish to discuss modifying your investment strategy.
- It's time to update your will.
- The stated beneficiaries of your IRA account or your 401(k) plan may not line up adequately with your overall estate plan.
- You are thinking about establishing a trust for the benefit of children or grandchildren.
- You are considering establishing a donor advised fund or a family foundation.

As a qualified client, we are here to advise you on these and other matters for no additional fee as part of our commitment to you.

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Economic Overview

On the positive side we saw continued U.S. Economic growth every quarter of the year and for nine quarters running now. Real GDP growth should come in about 1.8% for the full year. Looking forward, we see continued slow growth at the same 1.8% rate for the U.S. in 2012. Growth in China will slow but not to a painful extent. Europe will likely slip into recession, but since only 2% of U.S. GDP is tied to European exports the effect on our overall growth will be minimal.

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Manufacturing in particular continues to grow. U.S. manufacturing expanded in December for the 29th straight month according to the Manufacturing ISM Report on Business. Factories benefitted particularly in the second half of the year as businesses have increased spending on computers and industrial machinery, car sales to consumers are up, and companies have been restocking their warehouses. Industrial output as a whole is now only 5% below its pre-recession peak levels of September 2007.

Lending also continues to increase at a healthy pace. Commercial and industrial bank loans rose in the mid-single digits during the year (see chart below). Consumer credit is also rising, particularly at year end. The year-over-year rise in bank credit to consumers reached 10% in December.

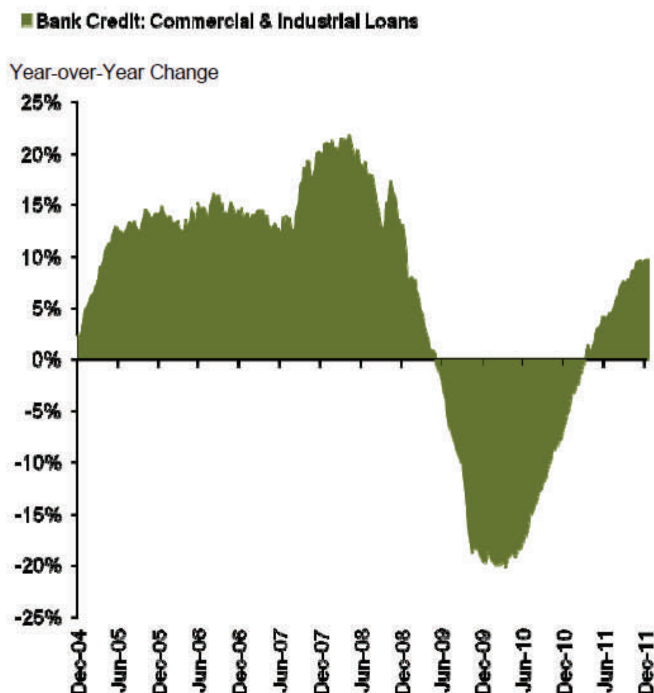

Chart 1

Despite this encouraging news, however, as we look back over our year-end letters of the past few years regarding concerns, and study the current research we can't help but be reminded of the old Bob Segar song, "Still the Same". While it has a good beat and is easy to dance to, it's not a positive song.

Those same three headwinds to future economic growth stubbornly remain – Jobs, Housing and Deficits. Though these issues are getting tiresome, progress on any one of them can make a substantial difference and help make 2012 a year of growth and prosperity. Summarized in the following paragraphs, therefore, is an update on these economic forces that have had the general public and investors on edge.

Jobs

In addition to having a slow growth recovery, we continue to have a recovery that is relatively jobless. For 32 consecutive months, almost three years now, the U.S. has had an unemployment rate above or just below 9%. Officially, we ended the year at 8.5%, and that is below the number at which we began 2011. However, the drop below 9% did not happen until the very end of the year and many economists expect the rate to creep back to 9% during 2012.

Also of concern, the percentage of underemployed, which includes workers in the work force who are part time but would rather be working full time and those who are no longer eligible for unemployment benefits, is up over the last year. It has risen from 16.7% to about 18%. Job growth, of course, can have a significant impact on the economy since it directly ties into consumer spending which, in turn, accounts for 70% of GOP.

Housing

Housing continues to be a drag on economic growth. This is disappointing because in addition to construction jobs there are a number of add-on jobs that will be created as soon as housing turns the corner. A meaningful number of underemployed workers are tied either directly or indirectly to new and existing home sales, new construction, mortgage financing, appliance sales, title research, etc.

As Chart 2 on the next page shows, the median price for an existing home fell in 2011. The median price is now $165,000, off 27% from its peak. Unfortunately, just as we said last year at this time, we forecast more of the same in 2012. The end is in sight, however; 2013 may be the turning point for home prices as demand comes more in line with supply.

Economic Overview *(continued from previous page)*

A hopeful sign is that off of a low base, housing starts ended the year up 25% from December 2010 levels. Also, homebuilders are forecasting a year-over-year 17% increase in housing starts for 2012 and a 17% increase in sales as well. Finally, the National Association of Realtors expects inventory to drop in 2012 and for existing homes sales to rise 4% over 2011 levels.

Deficits

We wrote last year about the hope that a new shared Congress would work together and find the political resolve to bring about much needed change toward fiscal responsibility. Unfortunately ,we have seen little cooperation or progress so far. In 2011 the federal deficit was again in excess of $1 trillion and no viable plan has been hammered out to address the growing problem.

At approximately $15 trillion, our current liabilities are at 100% of our annual GDP. We need look no further than Europe to see that such a path is not sustainable. The tide has to turn but the big question is when will it begin?

While the economy continues to struggle with these three primary concerns and a few less prominent ones, the good news is that the stock market tends to climb a wall of worry and has lately been doing just that.

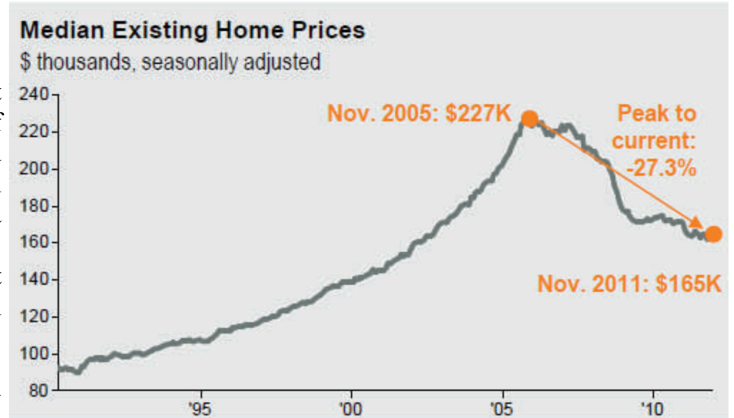

Chart 2

Asset Class Summary

Stocks

The S&P 500 was flat for 2011, although it rose 2% including dividends. The path it traveled during the year, however, was a volatile one. The index started out the year vacillating but strong, increasing 6% by mid-year. But in September, in response to disappointing GDP growth in the U.S., political strife over the debt ceiling, concerns about China, and a worsening of the European debt crisis, the market fell 17% in just three weeks. It then fell further before rising a dizzying 16% in just a month. It swooned another 9% before recovering once more at year end.

Near the bottom of the market in early October we added to our position in stocks as we viewed them as oversold. If volatility is similarly high in 2012, we will continue to look for opportunities to take advantage of that volatility and make changes to portfolios.

Despite the inherent ups and downs, we are optimistic about stocks as an asset class versus bonds and cash which have extremely low yields. Here are some of the reasons we view stocks as favorable:

Stocks are cheap on a historical basis. We expect earnings for the S&P 500 to come in around $97/share for 2011 and rise to $101 by the end of 2012. That means the forward P/E ratio for all of the market as of year-end is only 12.5 times. That compares to about 15 historically.

Interest rates are still very low, which increases the value of those $101 of earnings.

Fund flows are intriguing. Tens of billions of investor dollars continue to flow out of U.S. stock funds and into U.S. bond funds. (See chart below). The $1.2 Trillion spread over the last five years is staggering. We view this as a contrarian indicator favoring stocks. When investors become less nervous and fearful of stocks, there will be plenty of money on the sidelines to fuel a rally in the stock market.

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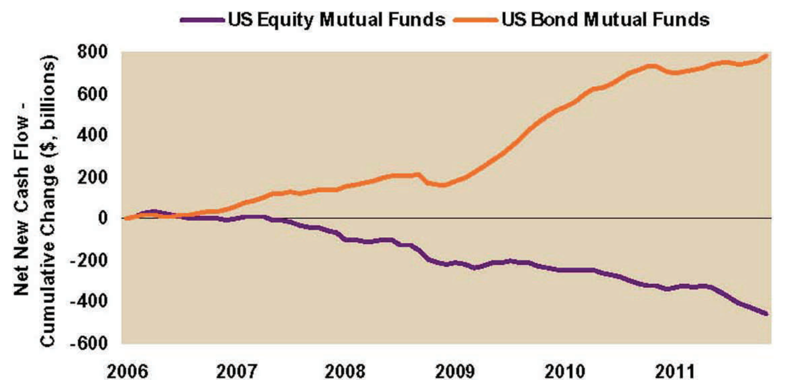


Source: Investment Company Institute

Asset Class Summary *(continued from previous page)*

The dividend yield on the S&P500 (2%) is high on a relative basis versus bonds and cash and treasuries. In an environment where dividend yields are low, stock yields look good.

Corporate balance sheets are strong as companies have decreased leverage, refinanced debt and accumulated cash.

A more pro-business political environment is possible as we close in our congressional and presidential elections.

Hedged Equities

The long-term goal for our hedged equity positions is stock-like performance with less volatility. Our current positions include structured notes and long-short mutual funds and two balanced, opportunistic mutual funds. Hedged equity positions were favorably adjusted in September amidst high market volatility.

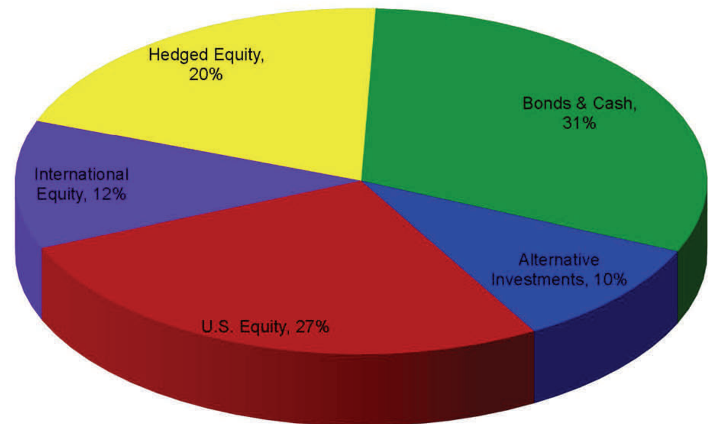
Bonds and Cash

Long-term bonds benefited from the "flight to safety" of 2011. Interest rates fell across the board, from already low levels to near record low levels. This pushed prices up, and the Barclays Aggregate Index of taxable bonds (Treasuries, Mortgages and Corporates) returned +7.8%. We are concerned about the effects of eventually rising interest rates, and have positioned portfolios to protect against this risk. While Treasuries benefited from the flight to safety, there is a cost to that safety. Current yields of 0% to 3% are unattractive, and hold significant risk, in our opinion, if rates start moving up. We therefore hold more corporate and municipal bonds, with well below average interest-rate risk (shorter maturities).

Alternative Investments

Our goal for this asset class is positive returns over time (from income, capital growth or both), with low correlation to the traditional stock and bond markets. We currently have exposure to energy pipelines (attractive dividend yield), a merger arbitrage fund (historically low correlation to stocks), and a diversified fund focused on long-term preservation of purchasing power (i.e., beating inflation). We are researching additional possible ways to gain exposure to the growing domestic energy boom, which we see as a partial answer to high unemployment, and as a positive to national defense by reducing our reliance on foreign energy.

Current Asset Allocation for Typical Client*



Thank you for taking a few minutes to read *The CFO Report*. Please call us at 404.874.6244 with any questions you may have or if you'd like to make an appointment.

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