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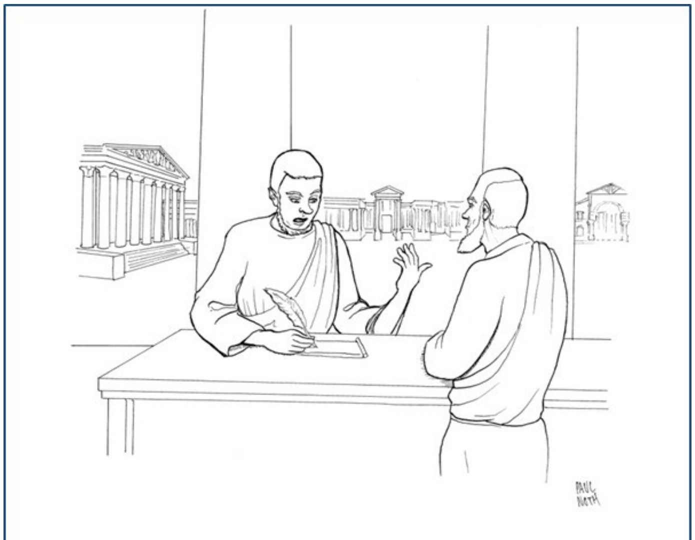
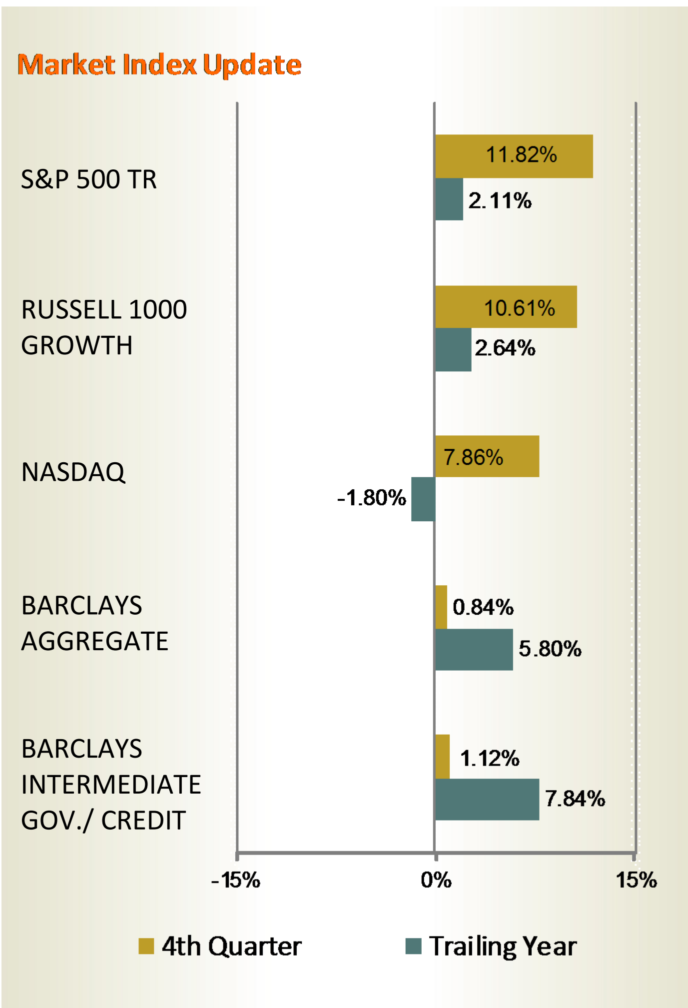


"There I go—still writing 'B.C.' on my checks."



2011: Flabbergasting Flatness

Like a habanero pancake, last year's stock market returns were flat, unusual, and difficult to digest. The S&P 500 ended 2011 at 1257.64, within .003% of where it began the year. This made 2011's stock market return the flattest calendar year return since 1947. As one might infer from that tidbit, flat one-year returns are outliers in the equity markets. Including the twelve months of 2011, there have only been 17 twelve month periods (out of 985 rolling twelve month intervals) since 1929 in which the S&P 500 returned between -.5% and +.5% for the year. This means last year's stock market return was among the flattest one-year periods in history [Chart 1].

Despite the rather blasé full-year results, the stock market was anything but boring to those of us who follow the market action on a day-to-day basis. Investors were enthused by a 6% ramp up through the first six months of 2011, only to be trampled by a 14% market swoon during the 3rd quarter, and relieved to finish the year with an 11.7% 4th quarter gain. As if that were not enough, these larger multi-month swings were seasoned with a strong dose of daily price volatility throughout the year. There were 35 trading days in 2011 in which the S&P rose or fell by more than 2%, making last year the 15th most volatile year for daily price swings since 1929 [Chart 2].

(Continued on next page)

JAG

9841 Clayton Road St. Louis, MO 63124

800.966.4596 314.997.1277 jaglynn.com

Chart 1

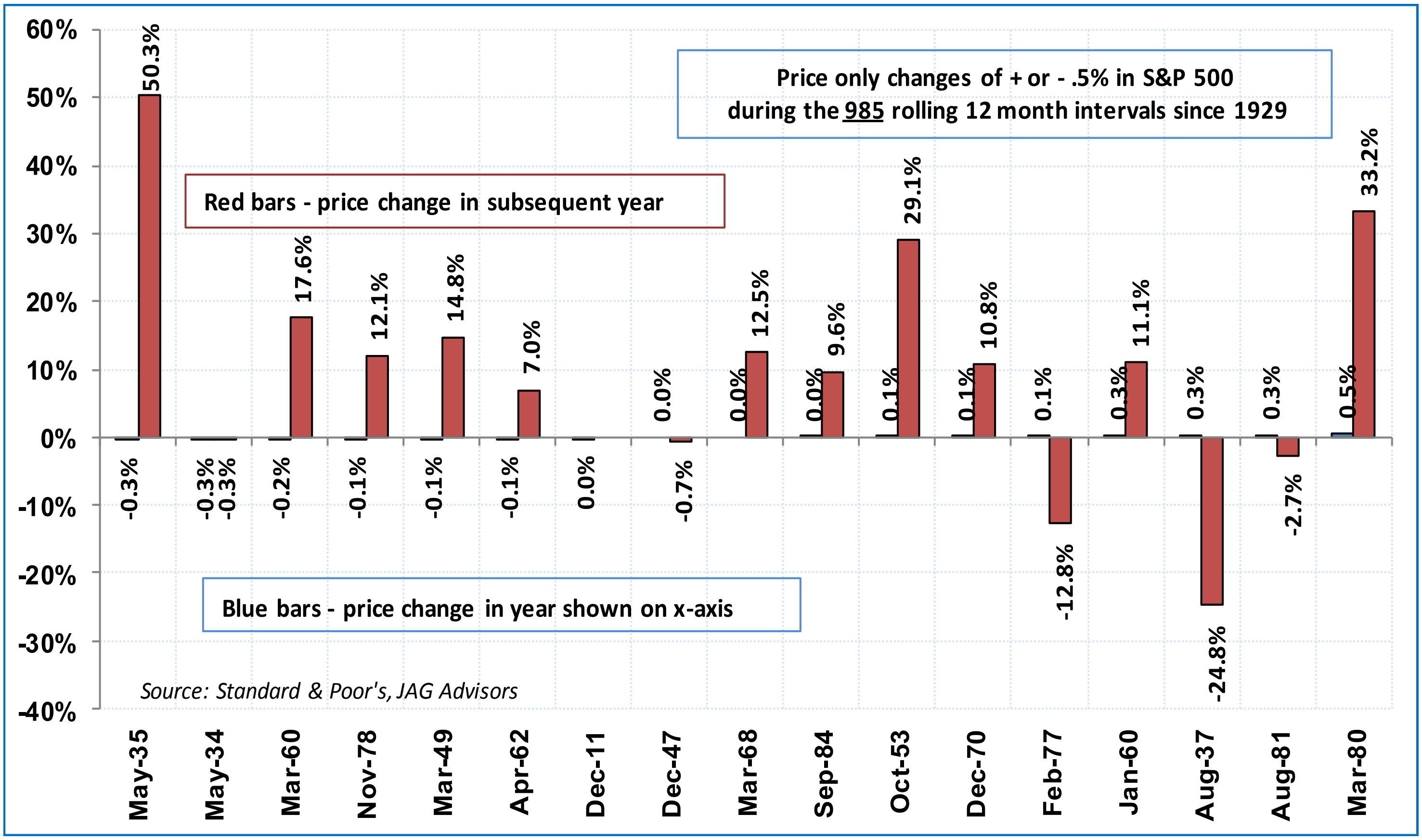
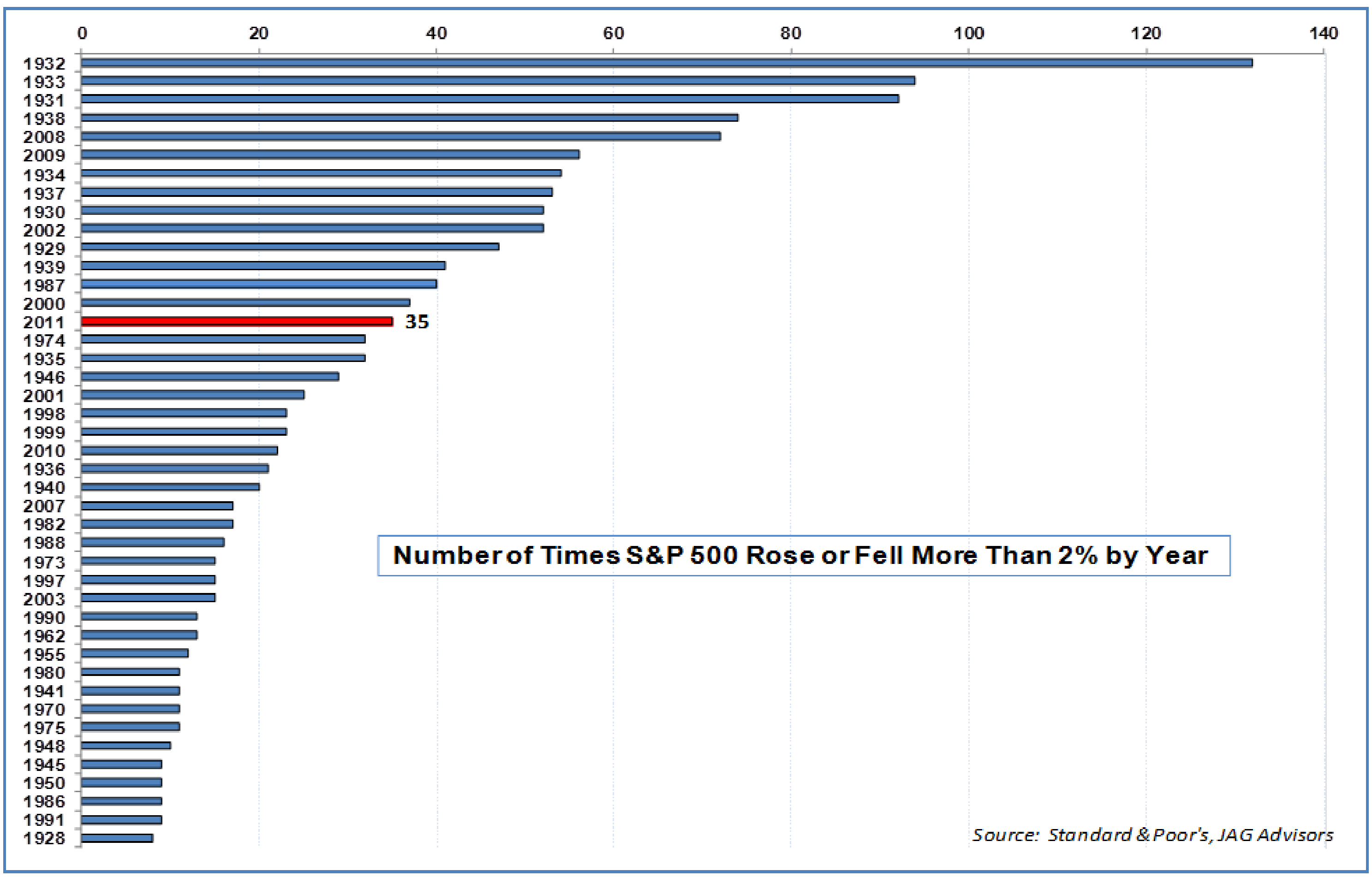


Chart 2

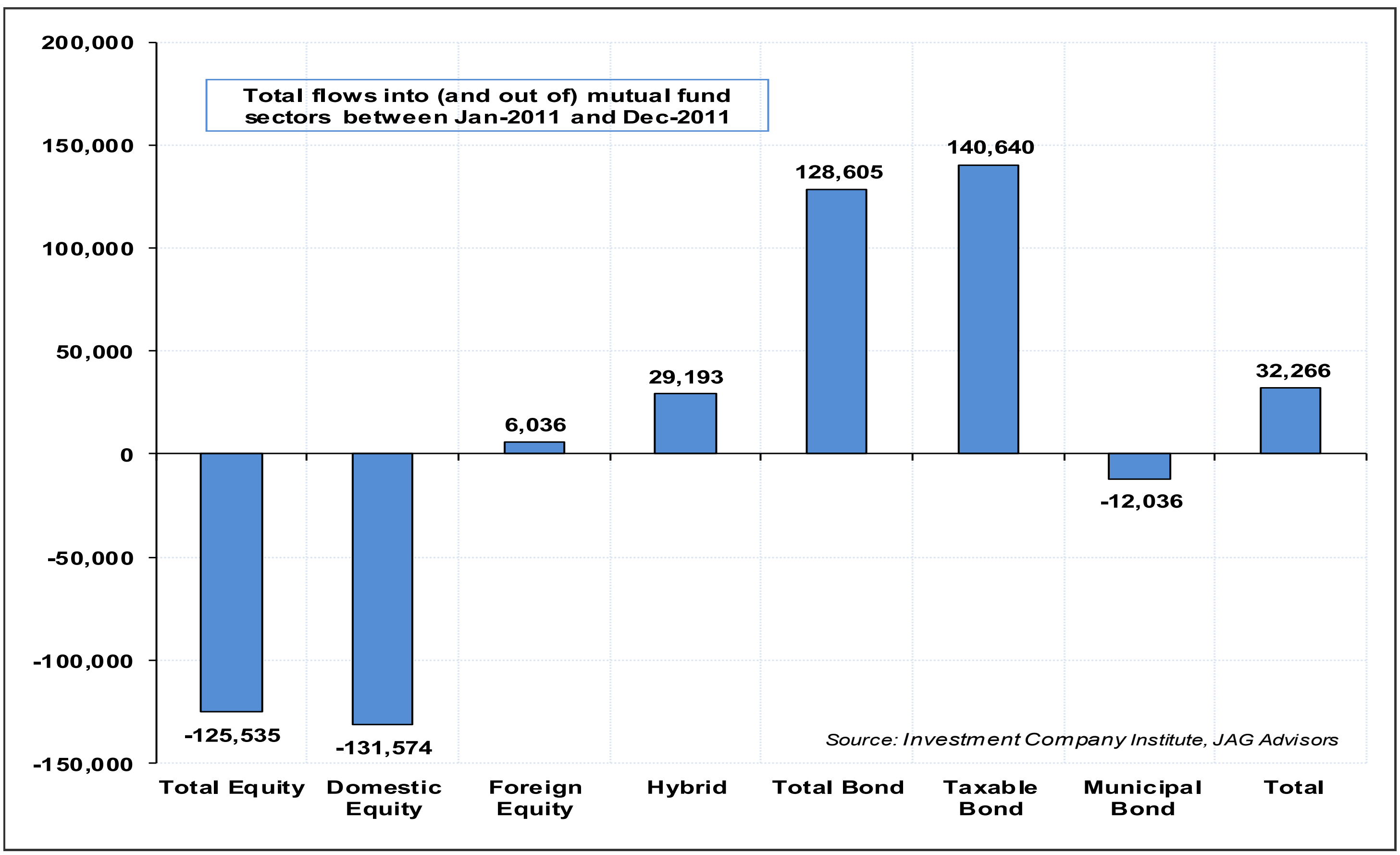


Short-term market volatility tends to be painful for the average investor. This is because most people tend to suffer from a cognitive bias known as myopic loss aversion.* Simply stated, myopic loss aversion refers to our tendency to weigh shorter-term losses more heavily than shorter-term gains. Researchers have actually quantified this effect by demonstrating that the average American adult derives approximately 2.5 times as much pain from a given amount of loss as the pleasure they experience from the same amount of gain. From a coldly clinical perspective, this makes no logical sense. But from a human perspective, it reflects one of the many behavioral "blind spots" that successful long-term investors must learn to overcome.

Largely due to the effects of myopic loss aversion, the day-to-day market roller coaster in 2011 left many investors in a sour mood. Even though the full year was (decidedly) flat, those who watched their portfolios closely saw a number of daily, weekly and monthly periods with losses. Although those same investors also saw plenty of daily, weekly, and monthly gains, their tendency from myopic loss aversion caused them to weigh the losses much more heavily. Net-net, to most people, 2011 "felt" much worse than it actually was.

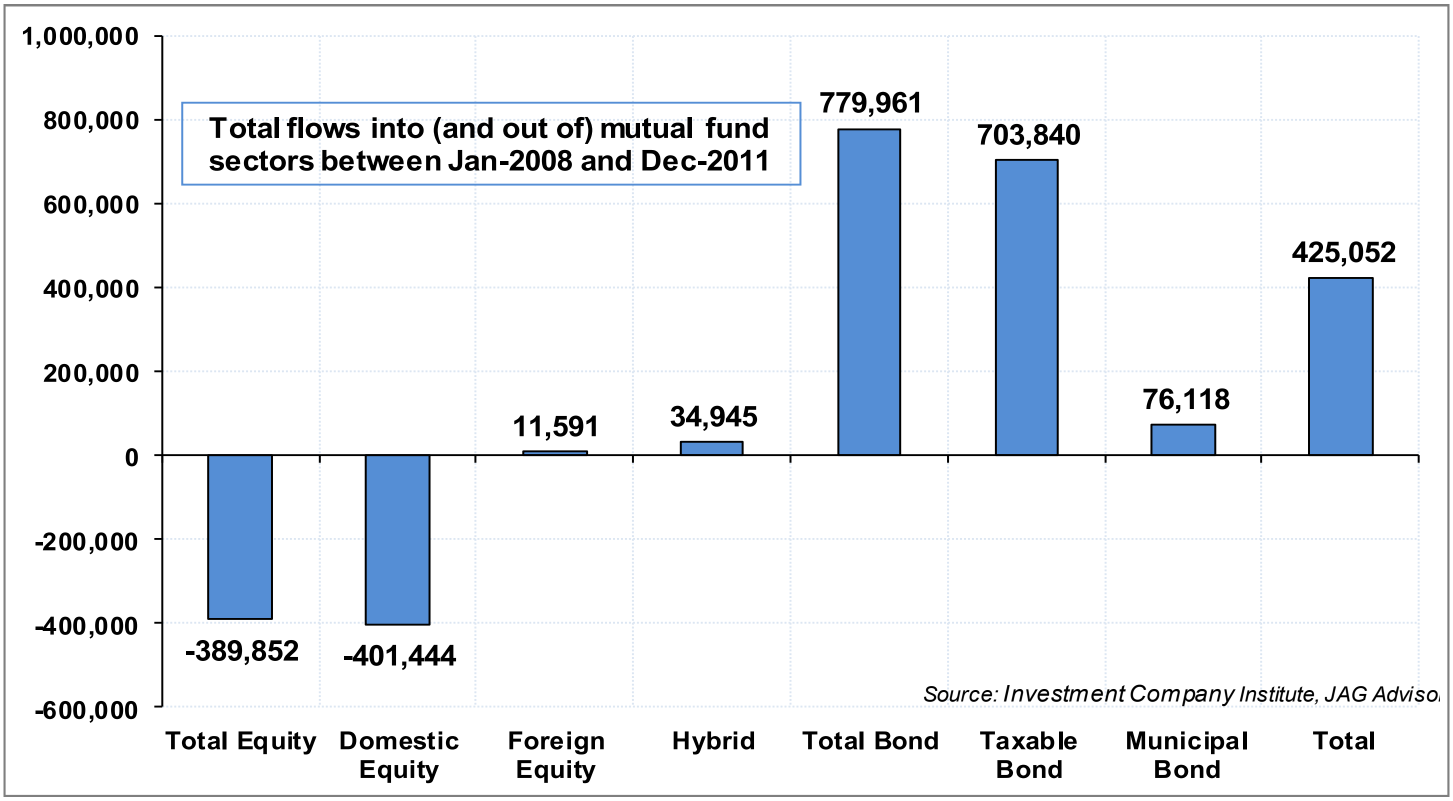
Gloom-ridden investors have voted on the stock market with their feet – by rushing for the exits out of stock mutual funds. Domestic stock funds experienced over $131 billion of net outflows in 2011 [Chart 3], bringing the total exodus from stocks to more than $401 billion since 2007 [Chart 4].

Chart 3



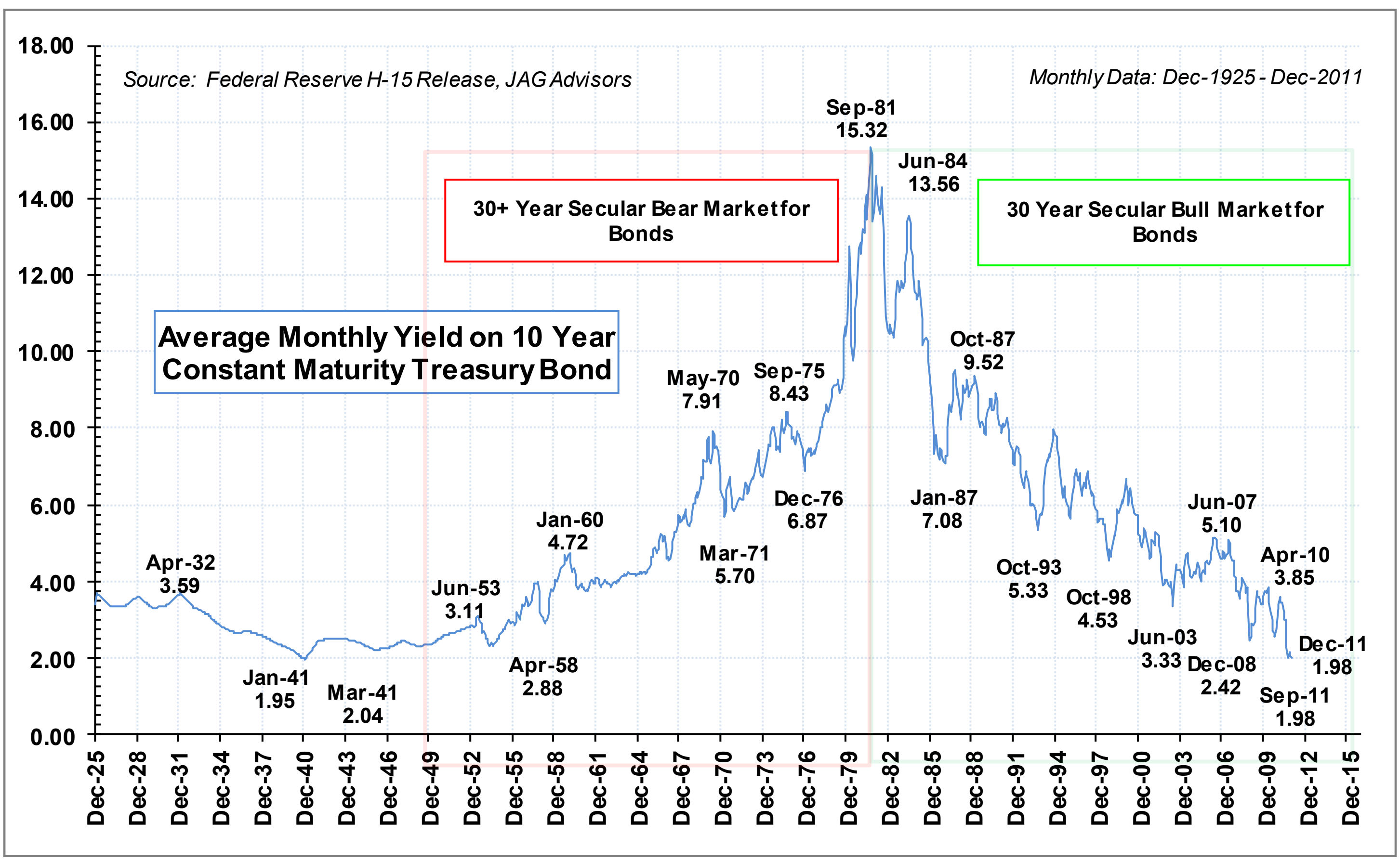
**Note:* *This concept was first introduced in 1979 by Daniel Kahneman and Amos Tversky. Professor Kahnemen, who went on to win the Nobel Prize in 2002 for his broader work on how people relate to risk and probabilities, is the author of a really wonderful new best-selling book titled* *Thinking Fast and Slow.*

Chart 4



In stark contrast, bond mutual funds have continued to experience healthy inflows - despite the lowest bond yields [Chart 5] in over a generation.

Chart 5



At the margin, this data shows that the average mutual fund investor is exchanging the perceived riskiness and long-term growth potential of stocks for the perceived safety of low-yielding, lower-volatility bonds.

2012 could be the year where the collective mindset begins to shift back from extreme cautiousness to cautious optimism

As a diversified money manager overseeing more than $500 million of fixed-income for our clients, we are by no means opposed to clients including bonds as part of their overall portfolios. To the contrary, bonds provide cash flow, permanence, and definition to a portfolio, and as such they are suitable for almost every institutional and individual investor. But through dozens of meetings with clients and potential clients around the country over the past year, we believe that many investors have allowed fixed income assets to become too large a proportion of their portfolios. We noticed the same phenomenon in reverse during the late 1990's. Back then, very few clients expressed any interest in any asset class *other* than stocks (in particular, technology stocks). Long experience has given us a feel for impending turning points in investor psychology, and this leads us to believe that 2012 could be the year where the collective mindset begins to shift back from extreme cautiousness to cautious optimism. If we are correct, equity mutual funds should begin to benefit from positive net inflows sometime in the coming twelve months.

2012 Outlook

Our equity outlook for 2012 has some similarities to our stance last year. We still believe that U.S. equities are as attractively valued as they have been in decades, that investor sentiment is too pessimistic, and that the U.S. economic recovery is continuing to make progress. While we did not foresee the extremely high daily volatility that played out in 2011, the S&P 500's flat return fit reasonably well with our expectation for a "mediocre" yearly gain for the broader stock market.

We still believe that U.S. equities are as attractively valued as they have been in decades

We expect to see a more significant price move for the S&P 500 in 2012 than we did in 2011. As we discussed earlier in some detail, last year's returns were unusually flat. Following the 16 prior historical examples of flat yearly returns since 1929, the subsequent year's returns tended to be anything but flat. Both the average and median yearly returns following flat years have been 10% excluding dividends, and returns were positive almost 69% of the time [Chart 6].

Chart 6

#	12 Month Rolling Period Ends	S&P 500 Year-Over-Year Percent Change	S&P 500 Year-Over-Year Percent Change: Next 12 Months
1	5/31/1935	-0.3%	50.3%
2	5/31/1934	-0.3%	-0.3%
3	3/31/1960	-0.2%	17.6%
4	11/30/1978	-0.1%	12.1%
5	3/31/1949	-0.1%	14.8%
6	4/30/1962	-0.1%	7.0%
7	12/31/2011	0.0%	
8	12/31/1947	0.0%	-0.7%
9	3/31/1968	0.0%	12.5%
10	9/30/1984	0.0%	9.6%
11	10/31/1953	0.1%	29.1%
12	12/31/1970	0.1%	10.8%
13	2/28/1977	0.1%	-12.8%
14	1/31/1960	0.3%	11.1%
15	8/31/1937	0.3%	-24.8%
16	8/31/1981	0.3%	-2.7%
17	3/31/1980	0.5%	33.2%
	Average		10.4%
	Median		10.9%
	Max		50.3%
	Min		-24.8%
	% > 0%		68.8%
	Number of rolling periods		985

Although we were incorrect last year in our belief that interest rates would rise in 2011, we note economist Herbert Stein's classic quip, "If something cannot go on forever, it will stop." While the Fed will probably continue to anchor short-term rates near zero, we think sub-2% yields on U.S. 10-year Treasury bonds are the very definition of unsustainable. Therefore, in our view, the probabilities favor modestly higher 10-year and longer rates in 2012, especially if conditions in Europe improve and/or the U.S. economy continues its modest recovery.

A (Very) Brief Comment on Europe

A staggering amount of airtime, newspaper print, investment research, and blog space has been spent over the past 20 months on all things Europe. For many days in 2011, it seemed as if the only news worth covering emanated from Western and Southern European capitals. From our perch, the "European crisis" has become the longest and most-exhausting crisis we can remember. This has caused some of our peers to attempt to offer seemingly-expert opinions on the European Central Bank, regional German and Italian politics, and the International Monetary Fund.

Unlike many in our industry, we have avoided the temptation to offer any detailed thoughts on a resolution to Europe's woes. Suffice to say that, in our view, any resolution will likely be incremental rather than earth-shaking. If we are correct in this assumption, there is unlikely to be a "Eureka" moment anytime in the next year in which the world collectively realizes that all of Europe's problems have been solved in one fell swoop of legislation or central bank action. Instead, the resolution is very likely to follow the path the U.S. followed after the financial crisis in 2008: a combination of central bank action, political maneuvering, and market forces will coalesce to allow the European economy and banking systems to "muddle through." This is not to say that a European economic collapse is outside the realm of possibility – after all, anything is possible. But investing is a game of probabilities, not of certainties. In our view, it is probable that the situation in Europe will gradually fade from the headlines with a series of "whimpers" rather than a "bang."

Conclusion

All of the market's trials and tribulations of the last several years have made us more convinced than ever that our methodical and diligent approach to investment management gives us the best chance to generate competitive long-term returns for our clients. Thomas Edison once said, "Opportunity is missed by most people because it is dressed in overalls and looks like work." Rest assured that our team at JAG is ready, willing, and able to work hard to find investment opportunities for our clients in 2012.

All of us at JAG wish you and yours a happy, health, and prosperous year.

Norm Conley

CEO & CIO