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RDM CAPITAL ASSOCIATES
WEALTH MANAGEMENT

2012 FOURTH QUARTER & YEAR END MARKET COMMENTARY

January 2013

EXECUTIVE SUMMARY

The U.S. economy in 2012 continued the slow expansion that seems to have become the new normal domestically. GDP plodded along at a 1-2% rate, as unemployment inched below 8% in 2012. While any positive momentum is welcomed by the markets, investors have recognized for some time that the economy is not clicking on all cylinders. As we have highlighted in several recent Market Commentaries, this economic sluggishness is the result of the unprecedented fiscal and tax uncertainty created by our political leadership, which has killed business and investor confidence and stifled business investment and hiring.

2012 Gross Performance
as of 12/31/12

RDM Capital:	15.09%
Dow Jones:	7.26%
S&P 500:	13.41%
Russell 1000 Value:	14.46%

The economic sluggishness and uncertainty from the first three quarters of 2012 continued in the Fourth Quarter. The Fourth Quarter 2012 began with two major sources of uncertainty: the presidential election and the impending Fiscal Cliff. Ultimately, the resolutions of these uncertainties paled in comparison to the drama leading up to them. The elections largely maintained the status quo in the presidency and Congress. And, as we predicted, our political leadership managed at the eleventh hour to avoid sending the U.S. economy free-falling off the Fiscal Cliff by agreeing to a deal that, among other things, would maintain 2012 tax rates for all but those individuals earning more than $400,000 per year.

Despite this backdrop of slow growth and uncertainty, the equity markets persevered. The DJIA rose 7.26% to finish at 13,104 for the year and the S&P 500 rose 13.41% to finish at 1426 for the year – only one point away from our prediction of 1425 back in January! RDM's composite of client accounts rose 15.09% on a gross basis, beating both of these indices. In short, 2012 was a good year for equity investors in general and our composite portfolio in particular.

We expect 2013 will be another good year for the equity markets. First and foremost, several sources of uncertainty in the markets are beginning to recede. President Obama has won re-election, and regardless of political affiliation, investors at least know what to expect out of a familiar White House for the next four years. Tax rates on investment income for the vast majority of investors will remain at or near the low Bush tax rates. Even Europe, a source of seemingly perpetual uncertainty and panic in the markets, has faded somewhat from the most prominent headlines. While the First Quarter of 2013 may bring continued political brinkmanship as Washington negotiates over spending cuts and the U.S. debt ceiling, we anticipate that the market will be poised for greater gains as the uncertainty of the negotiations finally recedes. Based on our estimates of earnings and GDP growth and inflation, we predict a year end 2013 S&P 500 target of 1,522, approximately 7% higher than year end 2012.

The U.S. Economy Was Inhibited by Political and Fiscal Upheaval in 2012

In 2012, the U.S. economy grew at just under a 2% rate, below the average GDP growth since 1960 of 3.1% and slightly below the growth rates of 2010 and 2011 of 2.4% and 2%, respectively. As we have suggested in our recent market commentaries, we believe that the U.S. economy will continue to grow at this slower rate until our fiscal and tax regimes are reformed, clarified and permanently codified, ideally in a business-friendly manner. Many businesses and investors have lost the confidence necessary to deploy capital into their businesses or other investments due to the uncertainty created by our political leaders over fiscal and tax matters, no better exemplified than the recent “Fiscal Cliff” negotiations. Indeed, record cash levels persist on corporate balance sheets today.

Fortunately, even in the face of such great uncertainty, the domestic economy has fared far better than Europe and other foreign economies that experienced recessions or much slower growth in 2012. The U.S. economic recovery is now entering its fourth year since the Great Recession of 2009, led by a resilient consumer and, in 2012, a long-awaited rebound in the housing market. A stronger housing market will continue to be a catalyst for growth in 2013. Housing is typically a growth catalyst in economic recoveries, but since the Great Recession was primarily caused by the real estate bubble of the 2000s, housing was actually a major contributor to the slow recovery from the Great Recession. Thanks to a low interest rate environment engineered by the Federal Reserve’s easy monetary policy, with the average 30-year mortgage rate currently around 3.5%, housing starts rebounded off their bottoms in 2012 to approximately 876,000 new housing starts and more growth is estimated for 2013 (*See Figure 1, left)*. This housing growth also will have a positive impact on employment, both through construction hiring as well as hiring in related businesses like banking, mortgage finance and home improvement/furniture retailers.

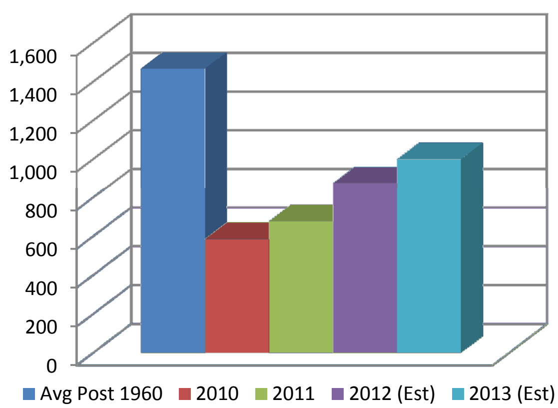

Figure 1. Housing Starts (in thousands).
Source: St. Louis Federal Reserve; Morningstar

We expect unemployment to continue its slow march downwards, aided in part by the housing improvements discussed above and in part by an improving business climate for business expansion. The decline in unemployment should accelerate after the First Quarter 2013 when much of the remaining fiscal spending and debt battle will come to a head in Washington. Unemployment could approach 7% by the end of 2013, down from its current 7.8% rate, should our economic and political forecast develop as expected. We do not expect, however, the unemployment rate to reach the 6.5% rate that the Federal Reserve targeted in its historic announcement in 2012. The Fed’s low interest rate policy, along with its planned continuation of the third round of quantitative easing through 2013, will remain a tailwind for the economy (despite the debatable benefits of QE discussed in our Third Quarter market commentary) since any abrupt changes to such policies in the short term would likely slow our economic momentum and spook the equity and capital markets.

2012 Was a Strong Year for Equities Despite the Political and Business Environment

In the face of some significant headwinds created by uncertainty over debt in the U.S. and Europe, China’s economic slowdown, Hurricane Sandy and the Fiscal Cliff, the S&P 500 still managed a very respectable 13.41% return in 2012. The S&P 500 finished the year at 1426, within ~ 1 point of our 2011 year end forecast! (Please see our 2011 Fourth Quarter Market Commentary). While the Dow lagged the S&P 500 by approximately 5%, due to the inclusion in the S&P 500 of more aggressive growth tech companies like Apple and Google, investors were nonetheless handsomely rewarded for adhering to their investment plans for the year and not allowing fear to dictate their investment decisions. Further, these market returns compare favorably to those of U.S. treasuries, the traditional safe-haven investment that we have highlighted in recent market commentaries for its bubble characteristics. Even treasuries with longer-dated maturities returned only 3.56%, as reflected by the Barclays U.S. Long Treasury Index.

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Much of the basis for the market's strength over the past few years was due to the abundance of liquidity in the capital markets. The Fed has been injecting trillions of dollars of stimulus into the capital markets since the Great Recession of 2009, boosting asset prices. However, despite increased corporate earnings and the Fed's historically accommodative monetary policy since the Great Recession of 2009, companies have been reluctant to invest and spend to grow their businesses, negatively impacting the economy at large. This began to change in 2012 as economic data moderately improved and the debt crises in Europe and the U.S. stabilized. Business and investor confidence began to return to the marketplace in the first half of 2012 in particular and looks to continue into 2013, despite concern raised by the Fiscal Cliff in the second half of the year.

While the equity markets rewarded many investors in 2012, RDM out-performed the major indices in part by emphasizing the Financial and Healthcare sectors in our clients' portfolios. Of the S&P 500 sectors, Financials, Consumer Discretionary and Healthcare were the three top performing sectors, increasing 26.26%, 21.87% and 15.19%, respectively. We also favored the Energy sector, which registered a more modest 2.3% return for the year. We believe that Energy was under-valued during 2012, as a combination of low energy prices, the domestic natural gas glut, relative calm in the Middle East, and tepid global economic growth served to dampen energy prices. As value investors, we will continue to emphasize, among others, the undervalued Energy sector into 2013.

Equities in 2013 Will Build on the Momentum of 2012

The Fed's promise of open-ended bond purchases through 2013 and a near-zero interest rate policy until the unemployment rate falls to 6.5% creates an investment climate where traditional fixed income investments are less desirable, particularly over the long term when interest rate risk is at its highest. Purchasers of 10-year U.S. treasuries today receive only 1.9% interest (as little as 1.5% in July) for forfeiting their money to the government for the next decade. When one considers that inflation is expected to grow at least 2% per year, and that interest rates will undoubtedly rise in the future causing bonds issued today to be relatively less valuable than those issued in the future, a Treasury bond purchaser today is guaranteed to lose money on this investment. While 2012 mutual fund flows reflect that investors were still more eager to buy fixed income funds than equity funds, the smart money should begin to flow back to equity funds and away from fixed income investments going forward. The only obvious explanations for the continued flow to bond funds in 2012 are continued fear

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The equity markets will also be bolstered in 2013 by the Fiscal Cliff resolution reached at the end of 2012 and any additional spending cuts negotiated in the first half of 2013. The markets will likely react skittishly to developments in political negotiations over the coming months, as investors fear the government will hit its debt ceiling and further damage its credit rating in the process. However, the outcome of the 2013 negotiations will not likely harm investors in the long run as potentially harmful tax increases on investment income were negotiated and ultimately rejected for most Americans in the 2012 Fiscal Cliff resolution. Rather, the focus of the 2013 negotiations is expected to be government spending and entitlements. Any significant reduction in entitlement spending that results from the 2013 negotiations will be favorable to the long-run health of the U.S. economy and investors, as the Congressional Budget Office projects the unsustainable spending for Medicare, Medicaid and Social Security to reach 18.5% of GDP by 2050 and total debt – to – GDP to exceed 100% in 2024. However, not all spending cuts are positive for the economy, as reflected by the draconian European austerity cuts that are currently contributing to the European recession.

As mentioned above, the 2012 Fiscal Cliff resolution permanently established the Bush tax rates for all individuals earning less than $400,000 and couples earning less than $450,000. Importantly, the Bush tax rates also apply to investment income (such as long term capital gains and qualified dividends) for those under the $400,000/$450,000 income threshold. The top rate for those exceeding the income threshold will increase from 15% to 23.8% (including the 3.8% Medicare tax on unearned income for high earners that is contained in Obamacare). Thus, a full ~40% top marginal tax rate on investment income feared by many investors in 2012 did not come to fruition, which should make equity investments more attractive going forward.

Our Forecast for 2013

Figure 2. 2013 Projections

S&P 500	1,522*
Dow Jones Industrial Average	14,278
Nasdaq	3,316
Inflation	2%
Ten Year Treasury Rates	2.2%
GDP	2%
Oil	$110 / barrel

*based on projected 2013 P/E of 14.5 and projected 2013 S&P earnings of $105

At current valuations, based on 2012 corporate earnings, we believe the equity markets are fairly priced. 2013 corporate earnings, however, are projected to be moderately higher than 2012 and we believe that price multiples in the market may expand as investor confidence grows in the equity markets. As we discussed above, investor confidence should improve as additional layers of uncertainty are removed from the economy, particularly with an end to the political debt negotiations in sight towards the middle of the year. If this occurs, the excess capital injected into the markets by the Fed may finally return more significantly in 2013. Therefore, we project approximately 7-9% upside to the markets with a year end 2013 S&P 500 target of 1,522 and Dow Jones target of 14,278, based on a projected 2013 P/E of 14.5 and projected 2013 S&P corporate earnings of $105 (*See Figure 2, left)*.

Despite this positive forecast, risks to our projections do exist. A failure to cut entitlement spending in a meaningful way would undercut the market's momentum from the Fiscal Cliff resolution at the end of 2012. Further, an abrupt end to the Fed's quantitative easing purchases or change in its low interest rate policy would also cause the market to correct, because the Fed's accommodative monetary policy is buoying the markets currently through an abundance of liquidity. Lastly, a recurrence of geopolitical concerns, such as the European debt crisis, unrest in the Middle East, or a deterioration of economic conditions in Europe, China or domestically, would also cause the markets to react negatively in 2013.

Conclusion

In light of our positive outlook, but without losing sight of the several risks to our projections, we intend to maintain our current equity allocations for most clients. Within equity sectors, we will look to re-allocate slightly towards the energy, materials and industrial sectors, which underperformed in 2012 due to many of the concerns we outlined in this commentary. As contrarian value investors, we typically add exposure to those sectors that may be neglected or underpriced by the market and these are three sectors that we believe may outperform in 2013 as economic conditions continue to improve. We will also seek alternative sources of fixed income outside of the traditional bond markets for appropriate income-oriented clients. We look forward to the opportunity to discuss our ideas with our clients in more detail as they apply to each client's unique individual circumstances during our regular client meetings in the New Year.

Finally, we would like to wish all clients and friends a very happy and prosperous New Year!!!

As usual, all comments are welcome.

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