Special Report

An Annual Publication of Ferguson Wellman Capital Management

Outlook 2012

"Must Be Present to Win"

by George Hosfield, CFA
Chief Investment Officer

Last year was one of the most volatile periods in the history of the U.S. stock market. The Japanese earthquake and tsunami, a festering European debt crisis and dysfunctional U.S. politics weighed on consumer, business and investor sentiment in 2011—creating economic and market headwinds. Having endured a decade of boom and bust cycles in technology, real estate and commodities—U.S. investors are fatigued by a roller coaster stock market that has made little forward progress.

Domestic Equities

When all was said and done, domestic equity markets hardly moved last year, masking fundamental improvements in key underlying economic variables, such as employment and consumer spending. Global growth is likely to slow this year, but U.S. companies should continue to enjoy strong earnings due to their increasing exposure to faster growing emerging markets; tightly managed cost structures amid modest inflation; stronger balance sheets that limit interest expense; and robust cash flow that is being used to repurchase stock and pay dividends.

2012 Capital Market Themes

- Expect a modestly positive year … with plenty of turbulence
- Uncertainty, volatility and asset class correlations will remain elevated
- "Bond vigilantes" will force resolution to the eurozone crisis
- Europe in recession will slow global economic growth
- Political actions on both sides of the Atlantic will dictate market outcomes and asset allocation

We expect equities to gain in 2012, but it won't be an easy process. With European policy makers still grappling with existential threats to the eurozone and U.S. elections on tap this fall, political actions on both sides of the Atlantic will ultimately dictate how 2012 unfolds. Investors are fixated on European headlines for now, but a growing mountain of U.S. debt looms, threatening to suffocate the economy without fundamental reforms to entitlement programs and the tax code. Accordingly, attention will shift to U.S. elections and the need for fiscal change in Washington.

In contrast to the European Central Bank's reluctance to monetize European debt, the Fed continues to own long-term U.S. debt *en masse*, thus providing a benign backdrop for U.S. bond investors. The Fed's targeting of near-zero, short-term rates for the foreseeable future coupled with slower growth globally sets the stage for interest rates to remain lower, for longer.

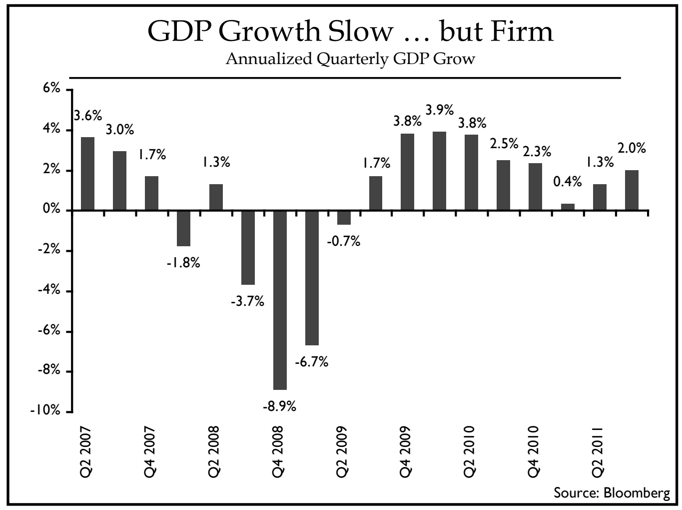
Against this backdrop, we enter the year with portfolios positioned in a relatively defensive manner. Our target asset allocation is neutral both stocks and bonds and, within equities, we are emphasizing domestic large-cap stocks, with a concentration in defensive sectors. We are likely to maintain this stance until we see evidence that (1) Europe is resolving its sovereign debt crisis, (2) the U.S. is achieving meaningful fiscal reform and (3) the U.S. is promoting policy certainty. Given low valuation multiples, high cash balances and elevated pessimism on the part of equity investors, any sense that there is meaningful progress toward addressing the three aforementioned concerns could very quickly cause the riskiest assets to rally substantially from depressed levels. We recognize that two years of almost unprecedented equity market volatility has caused fatigue, fear and frustration among equity investors. However, as the saying goes, one "must be present to win," and 2012 could ultimately prove to be one of those years.

Fixed Income

by Marc Fovinci, CFA
Principal

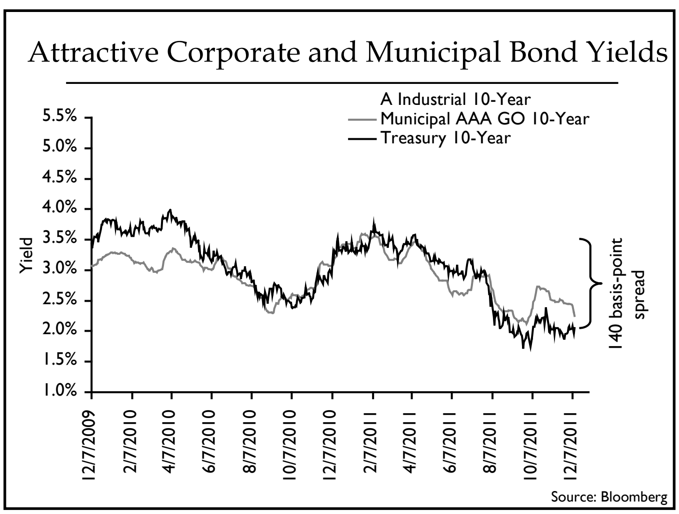
Although the relative motion of markets has become very predictable, the daily direction of markets has been a wild guess. By and large, stocks and bonds are moving opposite of one another; when stocks are down, bond prices are up. Both are being governed by the daily political headlines in Europe.

We see Europe's debt debate continuing to be a source of volatility. Politicians will find no silver bullet to resolve the European Union (EU) crisis. While it is more likely than not that the EU will stay together and resolve its fiscal issues, the process will likely be one of fits and starts characterized by political brinkmanship.



Europe appears to be in recession, but the U.S. will likely avoid one in 2012. U.S. holdings of European debt are not large enough in size to undermine our financial system should one or more countries default. A slowing of exports to Europe would also be insufficient to pull our economy into recession. While weak relative to past recoveries, our current GDP growth of 2 to 3 percent should withstand European headwinds.

Aiding the Federal Reserve's pledge to keep interest rates low, U.S. government bonds continue to attract capital as a safe haven for investors worldwide. Treasuries are likely to remain well-bid until markets see meaningful integration of European fiscal and monetary policy, as well as a faster pace of domestic economic growth. With inflation subdued by excess capacity, rates are likely to remain lower for longer.



While Treasuries retain their "risk-off" appeal, other sectors offer enough yield to be of value on a yield basis. An example would be single-A-rated industrial 10-year corporate bonds, which now yield 3.5 percent. In this case, credit risk is mitigated by strong profits and balance sheet strength, which possess unusually high cash balances.

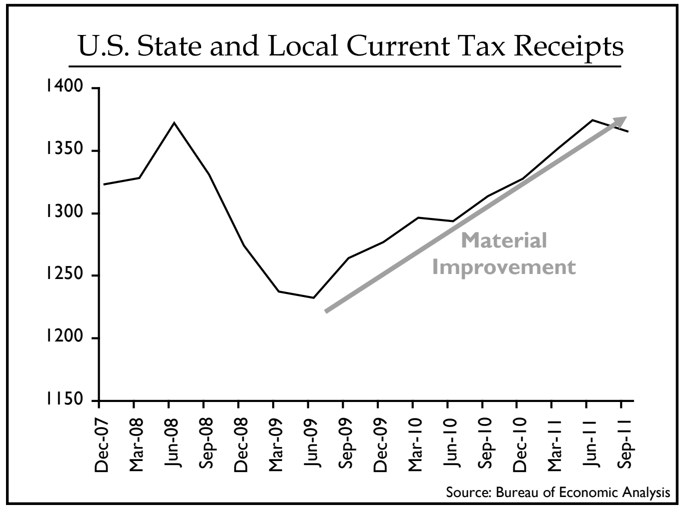
Municipal bonds are offering value now as well, and recently, some tax-free municipals have been good investments for some of our non-taxable clients. Yields of municipal bonds are at very attractive levels relative to Treasuries and other taxable bonds of similar quality.

As we enter 2012, our strategy is to target neutral portfolio durations relative to benchmark in order to hedge against further volatility, while overweighting corporate bonds to take advantage of their attractive yield. We believe it is prudent to earn more interest while waiting for volatility to subside in what we believe will be a relatively benign interest rate environment.

Municipal Bonds

by Deidra Krys-Rusoff
Portfolio Manager

Returning nearly 10 percent over the last 12 months[1], municipal bonds have outperformed U.S. Treasuries by three percentage points[2] on a tax-equivalent basis. Lower quality and longer maturity bonds have led the way, with top performance coming from hospital revenue and higher education issues.

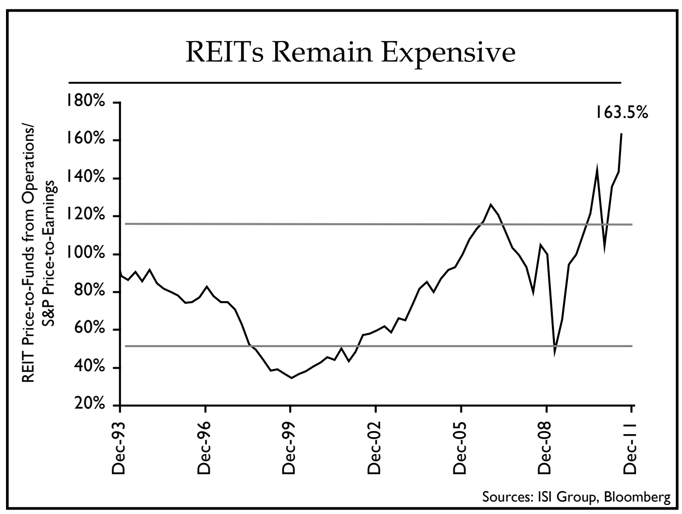


Municipal bond issuance was down about one-third from 2010, due to budgetary belt tightening and a reluctance to commit funds to new capital projects. Despite well-publicized fears of drastically increased municipal bond defaults, issuer defaults undershot historical averages and were miniscule, at only 0.05 percent[3]. In the year ahead, municipal bonds should continue to benefit from the prospect of higher federal tax rates, generally balanced budgets for states and superior yields compared to taxable alternatives.

Real Estate Investment Trusts (REITs)

by Ralph Cole, CFA
Senior Vice President of Research

Real estate securities had another good year in 2011 as the need for income drove investors into the real estate sector and inflated REIT prices to all-time high valuations relative to stocks (see chart). The good news is that fundamentals are solid across industries, and many REITs have yields exceeding 4 percent. REITs have demonstrated their long-term viability by accessing both debt and equity capital throughout this economic cycle.



With economic uncertainty remaining high, we are focused on owning REITs with both high quality assets and management. Operators of such companies are able to charge higher rents than peers on a consistent basis, while attaining lower-cost funding. Top-tier assets in the office, apartment and mall space tend to be concentrated in large, growing cities such as New York, Washington, D.C., and San Francisco.

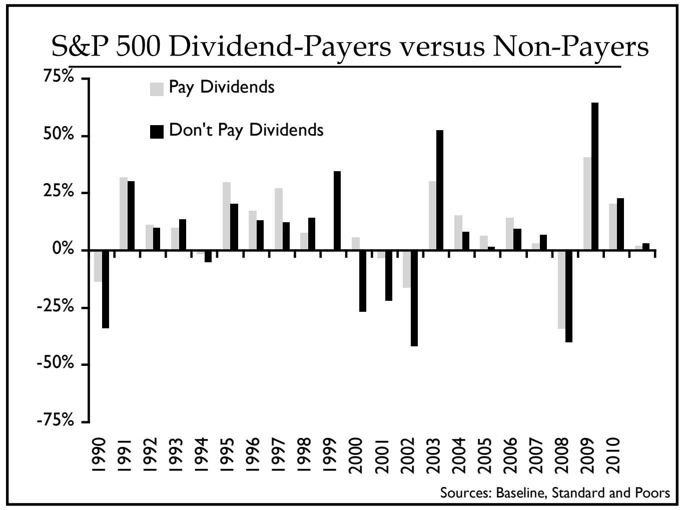
While the basic fundamentals of real estate are improving, we are not willing to pay a steep premium for the asset class. As such, we intend to remain underweight REITs until we see compelling value relative to other equity asset classes.

1 As of November 30, 2011
2 Barclays U.S. Municipal Bond Index, Adjusted for 38% Tax Rate
3 U.S. Municipal Bond Defaults and Recoveries, 1970-2009

Dividend Value

by Jason Norris, CFA
Senior Vice President of Research

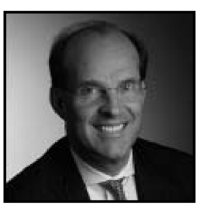
Looking ahead to 2012, we believe that elevated equity market volatility, low interest rates and muted economic growth remain the base case. As such, dividend-paying stocks should continue to be attractive to investors. Historically, such equities have given investors attractive returns while mitigating some of the broad market volatility (see chart).



Dividend increases were widespread in 2011 and we believe that payouts will be further enhanced this year. Against a backdrop of record earnings, companies have paid down debt and stowed record amounts of cash on their balance sheets, creating ideal circumstances for further dividend increases. Over the last century, dividends have comprised a meaningful portion of total equity returns and we foresee this continuing to be the case in a lower nominal-growth environment.

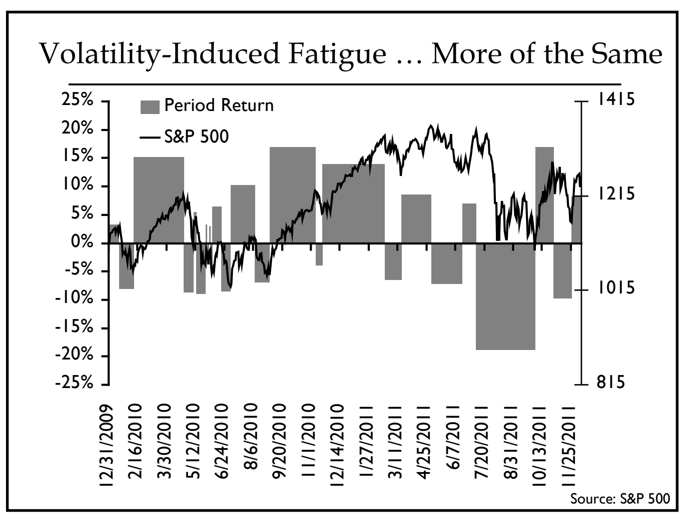
Not all dividend strategies are created equal and history has shown that focusing only on the highest yielding equities has resulted in poor relative performance. Therefore, investors should avoid buying "yield in a vacuum." The sweet spot for buying dividend paying stocks is to focus on companies exhibiting strong cash flows, good growth prospects and high returns on capital. Those with yields in the 3 to 6 percent range often work best. With *Dividend Value* focused on the key drivers, we believe that this strategy will again pay "dividends" in 2012.

Strategic Opportunities



by Dean Dordevic
Principal

Volatility in the capital markets last year was felt most acutely in the *Strategic Opportunities* strategy. At the beginning of the year, we did not envision an environment where the markets would so dramatically bounce back and forth between the risk-on and risk-off trades. We started the year overweighted cyclically exposed names and added to positions throughout the first months of the year. At its height, energy and commodity exposure reached 25 percent of the total portfolio.

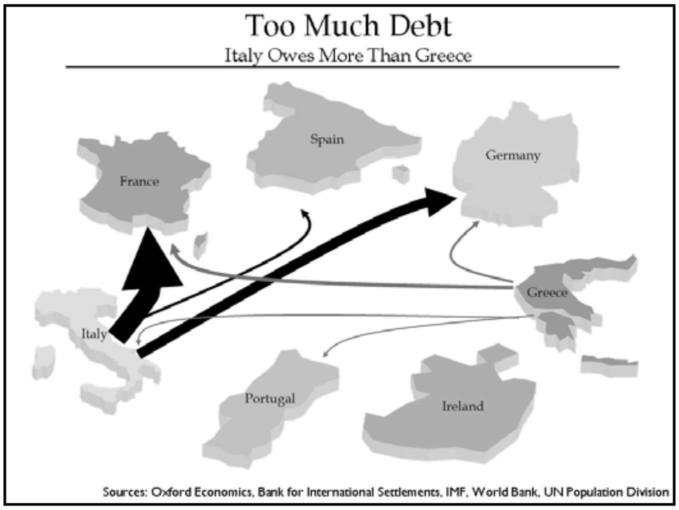


As the year wore on and political drama ramped up on both sides of the Atlantic, markets shed risk very quickly and we were too slow in unwinding our cyclical emphasis.

As the markets turned more risk averse, we increased cash positions and became more defensive. Historically comprising between 25 and 35 percent of the portfolio, spin-offs are now only 10 percent of the strategy because their smaller-cap, lower quality nature is not consistent with our current defensive posture. We believe volatility will continue to be elevated in the coming year. With that in view, we will seek opportunities to selectively add "beta" and exploit mispriced names and sectors.

International Equity

by Ralph Cole, CFA
Senior Vice President of Research



There has never been a more challenging nor exciting time to invest in international equities. Stress and uncertainty regarding Europe has created value in equities all over the globe, but risk aversion therein makes it difficult to realize.

What exactly is the problem in Europe? With the notable exception of Germany, many countries in Europe have spent well beyond their means, running substantial budget deficits that have caused debt loads to swell. Without the legacy currencies that preceded the euro—that would otherwise have provided a shock absorber to countries suffering a loss of investor confidence—the peripheral countries today are caught in the throes of fiscal austerity without self-correcting mechanisms to mitigate the stress. The result has been skyrocketing interest rates in Greece, Portugal and in the larger economies of Italy and Spain, which are considered too big to bail out. Italy's debt structure has the potential to cause far greater economic turmoil than Greece (see chart). The eurozone has made progress dealing with the liquidity crisis, but it has not been able to achieve the fiscal unity necessary to restore solvency to the afflicted countries.

Essentially, we believe that the eurozone has two choices: increase fiscal unification or move further apart monetarily. This means that Greece, Italy and other overly indebted countries need to increase taxes, cut spending and institute enforceable sanctions against countries that violate the rules. Otherwise, the wealthier countries will continue to resist helping them pay their debts and the European Central Bank will be less prone to monetizing them. This impasse has caused a great deal of consternation within Germany, the de facto leader of the European Union. If the debtor nations fail to institute meaningful austerity measures, we expect that one or two of the peripheral countries could exit the eurozone. We believe this would be very disruptive for all EU countries.

Tighter bank credit and soon-to-be adopted austerity measures will send many of the EU countries into recession in 2012. To prepare for this inevitability, we are underweight European financials and the eurozone region as a whole. The European positions that we maintain are dominated by healthcare companies whose multinational business is global in nature.

Though emerging economies continue to grow at robust rates, their markets have fallen even more than developed countries in recent months, which provides a reminder that emerging or "growth" markets still have the highest beta (i.e., risk) in our ACWI ex US universe[1]. Though we believe this sell-off creates an opportunity, it probably will not materialize until the second half of 2012. In response to slowing economic growth, Brazil is cutting interest rates and China has begun to reduce the reserves that banks in that country are required to keep on deposit with the central bank. Both actions should spur economic activity by the end of 2012. On a country level, of particular emphasis in our model currently are Brazil, Canada and Switzerland.

We are underweight international equities in our asset allocation across client portfolios. However, as the year progresses and we potentially gain some clarity on Europe, we will be looking to opportunistically add to emerging markets.

[1] Morgan Stanley Capital International All Country World Index excluding U.S. (MSCI ACWI ex-US) is a market-capitalization-weighted index maintained by MSCI. The ACWI ex-U.S. includes both developed and emerging markets and provides a way to monitor international exposure apart from U.S. investments.

Alternative Investments

by Dean Dordevic
Principal

We continue to have success with our allocation to tactical and alternative asset managers. Over the past few years, we have developed a number of relationships with some outstanding managers in the private equity and debt, as well as hedge fund and specialized mutual fund markets. These managers are located both in Portland, Oregon and other cities in the U.S. Below is a brief summary of the offerings in which we have invested in 2011.

Keystone National Group is a private markets manager utilizing a fund-of-funds approach in building its portfolios. Keystone's managers have an accomplished history in the business and utilize those skills to select managers to execute their strategies. We have participated in three of their funds.

Keystone II is a $75 million fund that invests in three basic strategies: debt, buyout funds and energy funds. More than 60 percent of the committed capital is in debt funds that they believe provide a compelling risk/reward tradeoff.

Keystone III is also a $75 million fund, but its focus is on credit. Unlike Keystone's previous private equity offerings, Keystone III does not take ownership of companies or divisions therein; its objective is to invest in the private credit markets through cash-flow-producing loans, leases and other financial obligations purchased at prices deemed to be below intrinsic value. Its credit strategies seek to exploit dislocations in the banking system caused by the financial crisis.

Keystone IV completed funding in early 2011; its strategy is very similar to Keystone III and nearly all the funds have been committed.

Vista Ridge Diversified Fund is a traditional private equity fund-of-funds. The fund consists of a private equity portfolio purchased at a significant discount. Due to the seasoned nature of the underlying investments, distributions are already being made.

Lazard is a fund-of-hedge-funds that invests in four principal strategies: relative value, long/short, event-driven and tactical trading. Returns have been muted by market volatility, but as with most hedge funds, the drawdown has been as well.

Hatteras Multi-Strategy Institutional Funds are a leading provider of alternative investment funds. It provides a diversified multi-strategy fund-of-funds that is uniquely structured to provide investors with a return profile more commonly associated with larger endowment funds.

Forward Tactical Growth Fund was added last October. It is designed to help investors reduce risk exposure during downturns while participating in market growth through an active asset allocation strategy. The fund uses a momentum model, a fundamental model and a macro overlay to identify mispriced securities. It primarily invests long or short in a variety of exchange-traded funds, with net equity exposures to U.S. large cap, U.S. small cap and emerging markets.

Altegris Macro Strategy Fund was also added last October. This strategy invests in managed futures funds whose strategies are macro based, not trend following. In other words, the managers express their top-down, global economic views through opportunistic investments in equity, fixed income, currency or commodity futures in any one of the global futures exchanges. It provides investment access to four premier managed futures managers: Denali Asset Management, Krom River Investment Management, Ortus Capital Management and P/E Investment—funds that by themselves would require substantial minimum investments to employ.

As is the case with alternative investing, the criteria, composition and frequency of these opportunities will vary throughout 2012. We are continually monitoring these distribution channels for compelling investments in what is an increasingly important and growing portion of our recommended global asset allocation.