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WEALTH MANAGEMENT

2012–2013 Investment Strategy

Capital Markets Outlook

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Capital Markets Outlook

We are taking an optimistic view of the capital markets, due to relatively low valuations, improving economic performance and excess levels of cash in the financial system.

Despite Odds of Near Term Correction, We Are Positive

While a near term correction is likely in the next few months, we are positive towards equities. In our 50% probability scenario – "Kick the Can Europe, Muddle Through Rest of World" – we project the US equity market will rise +23.7%. However, the range of potential outcomes – from +41.0% to (36.1%) - is quite wide (Figure 1). Therefore, we believe that there is a significant amount of thought that should go into a well-balanced and diversified portfolio that will maximize returns in multiple scenarios.

Figure 1: 2012-2013 Capital Market Forecast, by Asset Class

		Earnings Estimates		P/E Ratio		Bond Market		
	S&P 500	2012	2013	2012	2013	10 Year	HG Corp	HY Corp
Current Market Valuations (4/10/2012)	1358.59	$105	$118	12.9X	11.5X	1.99%	3.37%	6.80%

		Equity			Debt		
Scenario	Probability	Int'l	Emerging	S&P 500	10 Yr	HG Corp	HY Corp
Deep Recession Europe & Emerging, Contagion US	5%	-41.1%	-46.1%	-36.1%	34.4%	15.7%	-13.2%
Recession Europe, Mild Recession US & Emerging	40%	0.0%	-7.0%	-7.0%	1.3%	7.1%	7.5%
Kick the Can Europe, Muddle Through Rest of Worlc	50%	10.0%	23.7%	23.7%	-9.7%	-0.3%	11.4%
Recovery Europe, Emerging & US Growth + Inflation	5%	51.0%	56.0%	41.0%	-31.8%	-21.7%	15.6%
	100%						

Source: Sapling Wealth Management, S&P[i], Wall Street Journal[ii]

Domestic and International Equities

The S&P 500 is currently trading at 12.9X projected 2012 earnings of $105. We believe that in our most likely scenario, the market will be valued at 14.0X 2013 projected earnings of $118, or 1,652, +21-22% from current levels. The components of the capital appreciation will be derived approximately ½ from earnings growth and ½ from multiple expansion. Combined with a 2-3% yield, we calculate total return registering +23-24%. Our earnings estimate is based on the S&P survey of 2013 consensus earnings. The slowly improving US economy and absence of a cataclysmic negative European event underline our basis for multiple expansion. A 14.0X earnings multiple is equal to a 7.1% earnings yield, which is in line with the current trading range. We believe the risk in our base case projection is on the projected earnings, which if it came in at $111 would negatively affect our total return by only (6%). At this point, our two most

probable scenarios (90% odds of occurring) we see more upside than downside risk in the projected range of equity investment returns, +23.7% - (7.0%).

Correction In Spring Likely

The robust returns of +27-29% from lows in October 2011 may lead to a short term 5-10% correction, which would be a nice entry point for investors that have been on the sidelines. We believe the most appealing market, from a risk/reward standpoint, is the US stock market. Timing an entry point to the European market will likely be the most important call of 2012.

Fixed Income

We believe the higher yielding corporate and high yield sectors, and certain specialized securities, have merit in many portfolios. US Treasury securities offer little long term investment appeal. Traders may find these securities ideal in those cases of "risk off" moves caused by negative headline events. Strong flow of funds to this sector will provide strength for the year.

Commodities

Commodities have done well in the past few years, but we believe that these assets will not perform as well in the next 12-18 months, as governments attempt to wean economies off monetary largess and massive fiscal deficit spending. In addition, we believe the rabid Chinese consumption of commodities will slow.

2012-2013 Will Be A Stock Picker's Market

Near Term Stability Will Drive Performance of Select Names

Fundamentals and intrinsic value will mark the financial assets that outperform in the next 12-18 months. Therefore, we project that a more creative and thoughtful investment strategy will beat broad asset allocation/indexed investment styles that have done so well in the risk on/risk off trading environment.

We Would Be Even More Positive, Yet Long Term Risks Remain

If there was a realistic strategy to resolve long term fiscal issues, we believe the markets would have significant upside from current levels. However, the major problems of fiscal solvency that caused the sovereign debt & financial market crises have not gone away, but have been obscured or postponed. When these issues come back into focus is difficult to predict. While we believe that the current level of corporate profitability, fiscal spending and tax cuts are all unsustainable, there is nothing to derail it near term (except Europe). We have been disappointed with a lack of domestic political foresight, which to date has relied on brinksmanship vs. statesmanship to solve difficult issues. However, the myriad of levers policy makers can pull to "kick-the-can" down the road via fiscal

half measures and monetary stimulus will stabilize the system until the domestic economy shows gradual economic improvement.

Top Two 2012 Drivers to the US Financial Markets

European Sovereign Debt Yields

The fiscal issues being addressed in Europe are profound, as they involve basic philosophies of how disparate states can (and should) organize and govern. In addition, the current institutional tools to govern and finance budgets are long on accountability but short on authority. While new policies have not been fully hammered out, leadership is present, with Germany assuming the role of statesman. A solution will likely involve significant austerity measures, structural reform (tax and social services) and concessions on sovereign decision making. This process is guaranteed to have major setbacks, stemming from the politically unpopular set of choices offered as solutions. However, we believe that Europe is at the endpoint, as the bond market declines (and spiking yields on sovereign debt) will dictate that public policy must change. On this score, we predict a Greek default sometime in 2012 (or as soon as the European financial system is stable enough to absorb the default in an orderly manner). We believe Greece is a manageable risk, but it is the yield on Italian and Spanish debt that bears watching. On this point, Italy appears to be making more near term progress, and Spain less so. A prolonged collapse of the bond markets of either country would be catastrophic and highly negative for most categories of risk assets, and is represented in our most bearish scenario (5% probability).

Figure 2: Spanish 10 Year Notes Reflect Nervousness

Source: Bloomberg[iii]

Southern Europe Watch

Spain and Italy will be our focus (rather than Greece, Ireland or Portugal) due to the size of these large bond markets. Italy is the world's third largest bond market, behind the United States and Japan. Long term disruption of either of these two European markets would have a profound negative implication for the world economy.

- **Spain Near Term Focus** – The Spanish market will become the focus in the Spring 2012, as austerity programs are not faring well politically in this country. We believe bond market realities will dictate public policy and public acceptance.

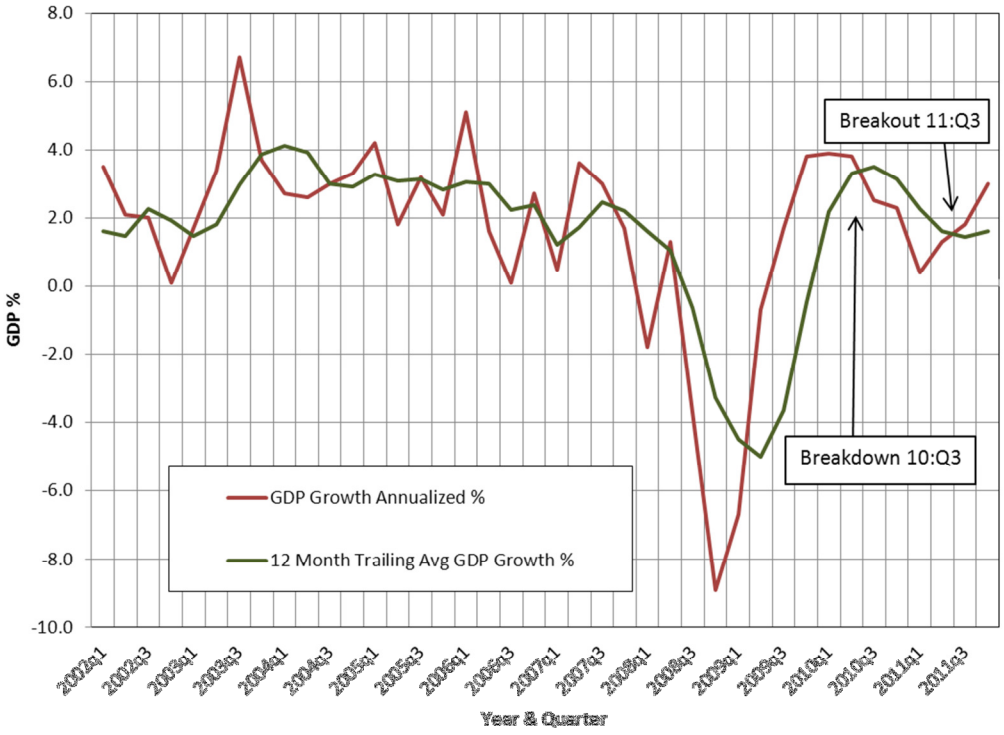
Odds of Undisciplined Financial Shock Low

We do not believe the market will retest the October 2011 lows (S&P 500 1099) and will be limited to 8-12% downside on the sovereign debt issue. The markets now have credible fundamental economic support mechanisms – such as Long Term Refinancing Operations (LTRO), European Stability Fund (ESF), International Monetary Fund (IMF) financing and budget agreements and treaties – that did not exist in Fall 2011. Importantly, Germany has appeared to back off of its hawkish position on monetary easing. In our eyes, the navigation of this thorny political situation should earn Angela Merkel the "Statesman of the Decade" award.

US GDP Growth

The United States is slated to grow at a 2.0-2.5% rate in 2012, which is lower than needed, but in the right direction. We believe that a combination of slowly improving job market and pent up demand will provide legs to growth. We believe the recent reacceleration "breakout" GDP growth relative to the 12 month trailing average is encouraging and bodes well for equity performance in 2012.

Figure 3: Annualized Monthly GDP % Breaking Through 12 Month Avg



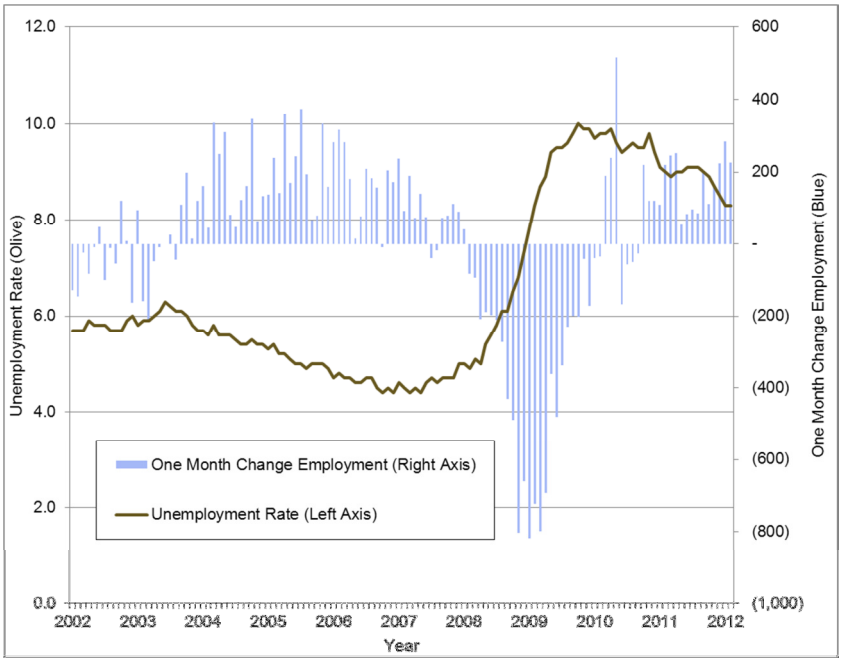
Source: US Bureau of Economic Analysis[iv], Sapling Wealth Management

US Employment Slowly Improving

The Federal Reserve cites the weaker than expected job growth as the single most important factor in its accommodative monetary policy. While the last few

months have tallied low +200,000 improvements in non-farm payroll jobs, March 2012 registered a disappointing +120,000. The US economy needs to generate at least +200,000-300,000 new jobs monthly to address the 13,747,000 estimated unemployed in the US in the near term. Any continued weakness in employment trends will be met with more accommodative monetary measures, providing a floor for equity valuations. In either case, we believe that slow, steady progression in this area will provide a baseline for GDP growth and domestic economic expansion.

Figure 4: Job Gains Gradually Changing Unemployment Rate



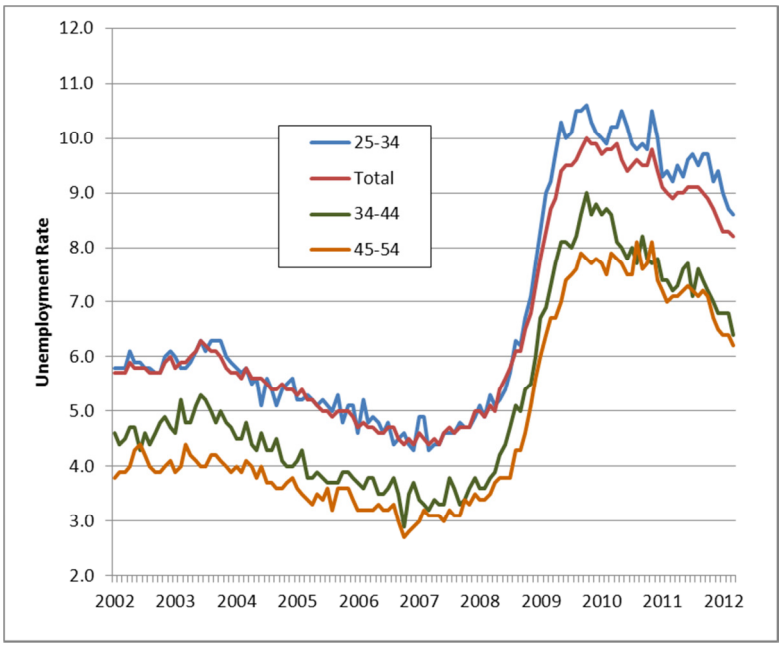
Source: Bureau of Labor Statistics[v]

Pent Up Demand In Key Sectors Will Eventually Be A Factor

We believe that the housing and automobile industries will recover to a more normalized level, providing a boost to the overall economy. We are now in the third year of significantly below normal production, and once this trend reverses it will provide a rapid kick start to the economy.

- **Housing Sector Poised to Rebound** – This sector has struggled from overcapacity and tightened lending standards. However, we believe the most important factors in preventing new demand for homes are employment and household formation trends, which have been lagging for younger generations. We believe that continued improvement of unemployment rates in the key 25-34 age segment will be a catalyst for household formation and new residential construction. Currently the 25-35 age sector is experiencing 8.6% unemployment rate, compared to 6.2-6.4% for the 35-44 and 45-55 age brackets.

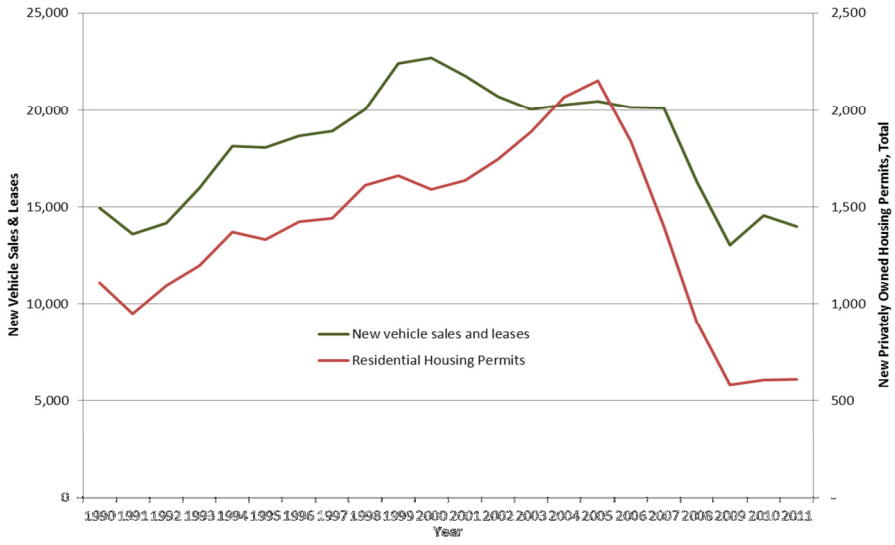
Figure 5: Unemployment Rate, by Age Group



Source: Bureau of Labor Statistics[vi]

- **Auto & Truck Sales** – A rapidly aging vehicle stock will likely begin to increase demand for new vehicles. According to R.L. Polk, the average age of light vehicle in the United States is 10.8 years (a record), +21.3% higher than 2000; the average age of a trade in vehicle is 6.5 years, +18% higher than 2007. In the next two years, we believe that obsolescence and attrition will start overwhelming the desire to put off this expenditure for another year. Recent pick up in used car prices supports our view.

Figure 6: Housing Permits & New Vehicle Sales Off Normalized Levels



Source: Bureau of Transportation Statistics[vii], United States Census Bureau[viii]

Front Page News Predictions in 2012

Presidential Race Will Be Tight Due To Economic Focus

A robust economy will take away Mitt Romney's best chance of election – dissatisfaction with the current state of the economy. Unfortunately for President Obama, we believe the economy will just be plodding along in November and provide ample ammunition for a challenger. In addition, Obama may face the prospect of having his landmark piece of legislation – The Patient Protection and Affordable Care Act (ObamaCare) - deemed unconstitutional by the US Supreme Court. This would be a major setback for Obama's Presidential legacy.

Sequestration Will Showcase US Leaders In Unflattering Light

Generally, presidential elections are a net positive for financial markets, as energies are focused on being accommodative. However, we believe the biggest risk regarding politics is not Obama vs. Romney (the most likely Republican nominee), but what will happen to the Bush Tax cuts on January 1, 2013. Unless a compromise measure is passed on these tax cuts, the current legal requirement of the 2011 Budget Control Act cause an automatic sequestration. Sequestration is an across-the-board reduction in government spending totaling $1.2 Trillion - $500 billion from defense and $700 billion from non-defense spending. We believe it is highly unlikely that a resolution will pass before the November elections. In fact, we believe that the politics will more closely resemble the debt ceiling showdown from the summer 2011, with the added complexity of a lame duck post-election Congress. This is another opportunity to be reminded how far apart elected officials are on major issues and will not play well with financial markets.

Federal vs. State & Taxes vs. Spending Will Frame Election Issues

Regardless of the outcome of the Supreme Court decision in June, we believe health care will evolve into a greater debate on who will provide the solutions to the domestic ills – Federal or State Governments. With reduced Federal support, by mid-2012 States will be forced to cut further in two areas of state spending, education and health & human services. We believe the tangible effects of the budget cuts will be felt in Fall 2012. For instance, in Washington State, the education budget will be cut 12-18% from the prior year, with many of the budgeted changes first taking effect in Fall 2012. US citizens can expect revenue boosters, lower spending and additional pressures on consumers to pay for uncovered services. We believe this will frame many of the election year issues and prove to be a major difference between the political parties.

Positive Effects of Shifting Commodity Prices

High oil prices will be pressured lower by increased production, reduced international demand and abatement of political hostilities. A major secular

trend in North America is the uptick in energy production, stemming from exploitation of new resources (Canadian oil sands, offshore) and more efficient extraction technology for existing fields (fracking for both oil and gas). The Keystone pipeline alone represents 1/3 of Iranian total oil exports; some analysts are predicting the United States will be a net exporter of energy by 2020. The boom in oil and gas production has also led to a precipitous drop in pricing of natural gas and some select grades of crude. We believe that an economic recession in Europe, less robust growth in China and modest US economic growth will keep worldwide demand for energy in check in 2012. Shifting prices will lead to infrastructure investments and valuable job creation aimed at capitalizing on regional disparities in pricing, as upstream energy sources are unbalanced with downstream market demand.

Other Headline News Items Manageable

Finally, we believe the odds are for political negotiation to prevail in Middle East hostilities, as major international players do not have the stomach for a major confrontational stance.

Valuations Are Reasonable, Particularly in US

Inexpensive Valuations and Lots of Room For Positive News

We believe investors are currently focused on the risks, rather than the opportunities, in the stock market. We believe that the current market P/E of 13-14 for 2012 and 12-13 for 2013 is not expensive, especially in relation to the 10-year Treasury Bond yield of 2.0-2.3%. Dividing Earnings by Price results in an "Earnings Yield" measure, which we believe is a useful valuation metric.

Figure 7: Earnings Yield Comparison

Valuation Metrics: S&P 500 vs. US Treasury Bonds

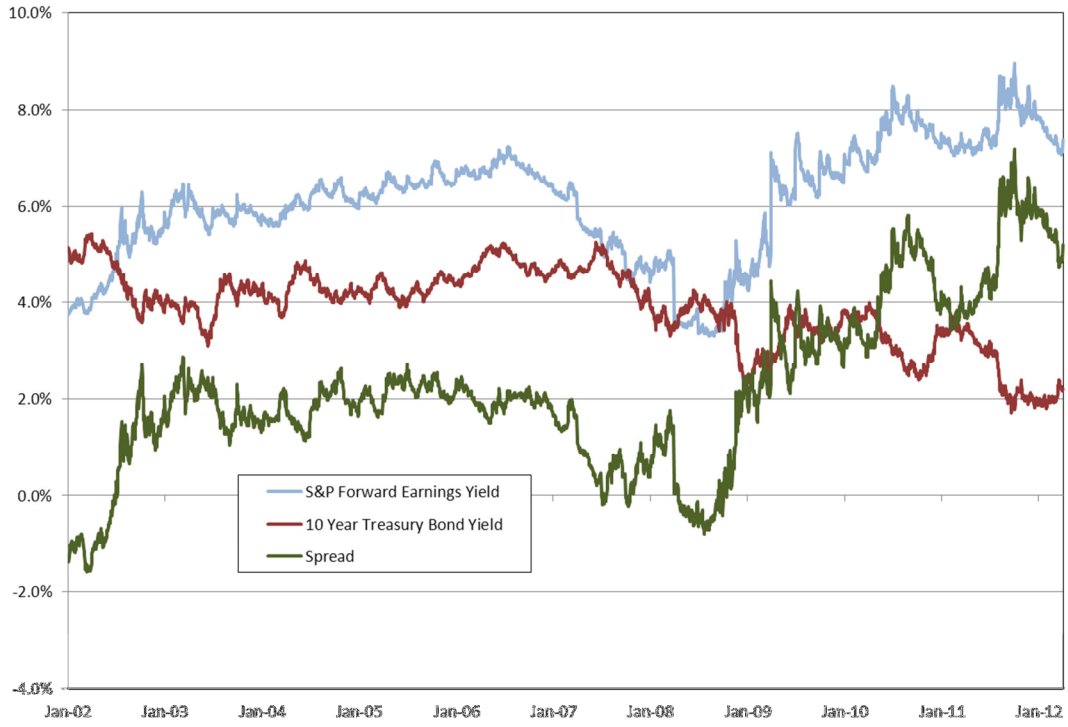
		Earnings Estimates		Price/Earnings		"Earnings Yield"	
	S&P 500	2012	2013	2012	2013	2012	2013
4/10/2012	1,369	$105	$118	13.0X	11.6X	7.7%	8.6%
10 Year T-Bond						2.0%	2.0%
Earning Yield "Spread"						5.6%	6.6%

Source: Wall Street Journal, Sapling Wealth Management, S&P

Source: Sapling Wealth Management, Wall Street Journal[ix], S&P[x]

The recent earning yield "spread" of 4.0-7.0% is very high relative to historical trends, which trended in a 1:1 ratio from 1985-2003 and a 2.0% spread from 2003-2007. Our base case projections suggest an Earnings Yield of 7.1% at the end of 2012, which is in the middle of the trading range for this statistic in the last few years.

Figure 8: Larger Earnings Yield Spread Accounts For Most Market Risks



Source: S&P, Sapling Wealth Management, Yahoo! Finance[xi]

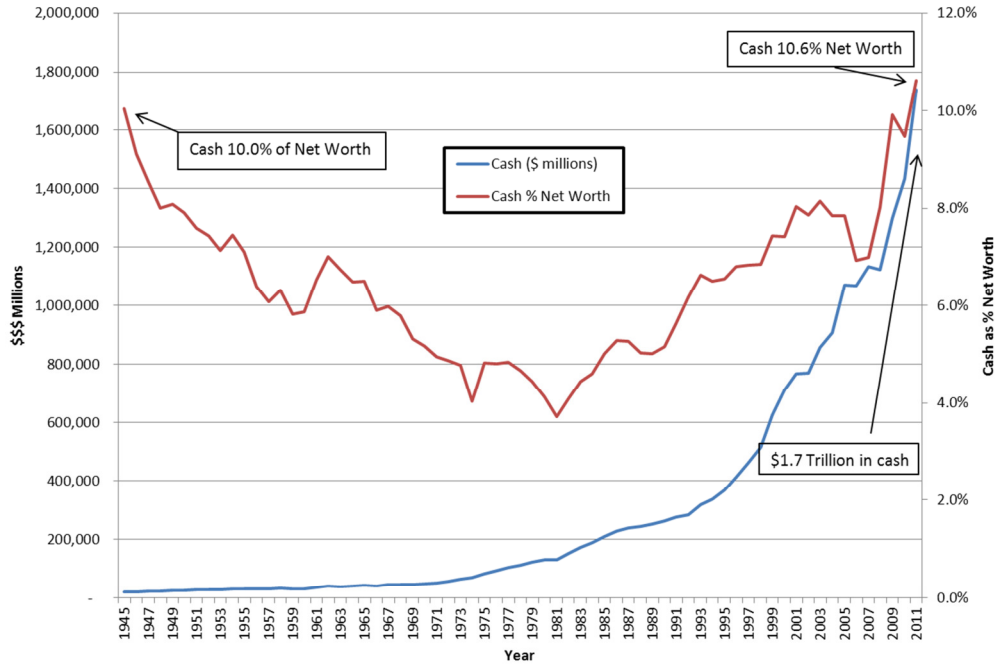
Most Risks Are Baked Into Valuations

Since 2007, the spreads have been much higher, reflecting the market's perception of earnings risk in the S&P 500 forward estimates. We believe this suggests that relative valuations for the S&P 500 are inexpensive vs. Treasury bonds; at bare minimum, a fair degree of economic risk is being baked into equity valuations. Another explanation of the "earnings yield" divergence is that the relationship between financial assets is changing – in anticipation of a "doomsday" event. This could take the shape of European financial meltdown, or heightened sensitivities to budgetary woes in the US or Japan. While these issues must be addressed, we believe that the day of reckoning on this issue is more than 24 months out, and there are many public policy levers (QE III, federal infrastructure spending, ECB monetary ease) to pull in the interim.

Downside Also Mitigated By Strong Corporate Financial Position

Unlike the 2007-2008 financial crisis, US Corporations are much more prepared for a financial shock. In fact, the record amount of cash now exceeds 1945 wartime levels and is an indication of the level of uncertainty for operating companies. We believe absent a shock to the system, corporations will redeploy this cash in the 2012-2013 time frame via acquisitions, capital spending, increased dividends or share repurchases. All of this is a positive for the equity markets.

Figure 9: US Corporate Cash Balances as % of Net Worth At WWII Levels

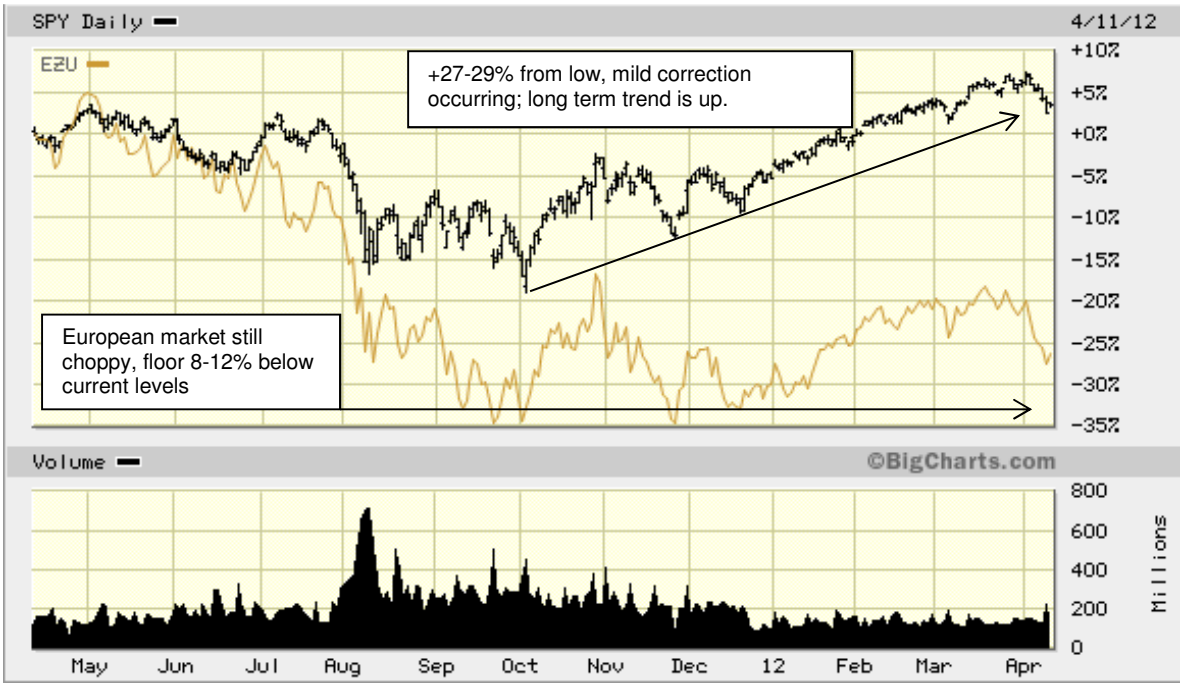


Source: Federal Reserve[xii]

More Likely Near Term Risk of a Pullback

Torrid +27-29% increase in equity valuations has caused the S&P to rise from a 10.4X P/E multiple from October to 13-14X today. We believe it is very likely that any one of the many risks previously mentioned could spook the market, which we would view as an opportunity to increase exposure to thoughtful risk taking. In particular, we see opportunities in midstream energy, technology, and capital goods. For investors with strong stomachs for volatility and risk, deep cyclical and financial stocks have long term appeal.

Figure 10: Divergence in S&P 500 (SPY) and European Markets (EZU)



Source: Big Charts[xiii]

European Weakness Will Present Future Opportunity

The SPY (an ETF representing the S&P 500) has outperformed the comparable European indices (EZU) by 25-30% in the last year. We believe that the European situation will remain choppy while the US equity markets will advance. However, there will be a time in the next 12-18 months where much of the European bad news will be accounted for in valuation, while the US equities will begin to wrestle with many similar issues that Europe is currently addressing, but without a comparable Angela Merkle statesman figure. There appears to be a base in European valuations at levels 8-12% below current market levels.

Signs of Health In Equity Sector Investment Performance

We welcome the return of more varied levels of industry sector returns, which we view as a sign of a much healthier market. In prior years, "risk off" assets (Gold, US Treasuries) traded in line with each other and "risk on" assets (Equities, High Yield Bonds, Commodities) were very highly correlated. We believe that decreased anxiety and increased focus on intrinsic company fundamentals will continue this year-to-date trend.

Table 1: S&P Index & Sector Returns

	2012 YTD %
S&P 500	+8.03%
Energy	-1.71%
Materials	+5.10%
Industrials	+5.28%
Consumer Discretionary	+11.46%
Consumer Staples	+2.73%
Health Care	+5.46%
Financials	+14.95%
Information Technology	+18.67%
Telecom Services	-2.88%
Utilities	-4.91%

Source: S&P[xiv]

Fixed Income: Meager Yields, Volatile Capital Fluctuations

Fixed income securities have done exceptionally well in the last 12 months, registering low double digit returns in many cases. Long term US Treasuries yields have dropped (prices rose) from a high of 4.37% to the current level of 2.34%. Due to this large upward price move, US Treasuries now offer little in the way of long term investment value and only serve to protect portfolios against the occurrence of an economic catastrophe. Other areas offer more interesting investment opportunities and the investment fund flow into the fixed income area continues to be robust. Timing in the last year has been critical, with current yields down (prices up) in many cases +20-58% from highs. We believe that intelligent risk taking the US Corporate, High Yield and Emerging Market debt markets will produce solid 8-12% returns in 2012-2013.

Figure 11: Volatility Marks Traditionally Stable Sector

Index (4/9/2012)	Yield (%), 52- Latest	Low	High	Move From High BPs	Move From High % High	Move From Low BPs	Move From Low % Low	52-wk % Chg
Broad Market Barclays Capital								
U.S. Government/Credit	**1.89**	1.80	2.79	0.90	32.3%	-0.09	-5.0%	9.6%
Barclays Aggregate	**2.12**	2.05	3.17	1.05	33.1%	-0.07	-3.4%	8.7%
Treasury Indexes Barclays Capital								
Composite (Total Return)	**1.12**	0.93	2.39	1.27	53.1%	-0.19	-20.4%	10.6%
Intermediate (Total Return)	**0.87**	0.68	2.11	1.24	58.8%	-0.19	-27.9%	7.6%
Long-Term (Total Return)	**2.70**	2.34	4.37	1.67	38.2%	-0.36	-15.4%	32.5%
U.S. Corporate Indexes Barclays Capital								
U.S. Corporate	**3.37**	3.27	4.10	0.73	17.8%	-0.10	-3.1%	10.3%
Intermediate	**2.77**	2.66	3.53	0.76	21.5%	-0.11	-4.1%	7.6%
Long-term	**5.01**	4.87	5.99	0.98	16.4%	-0.14	-2.9%	18.3%
Double-A-rated (AA)	**2.50**	2.47	3.35	0.85	25.4%	-0.03	-1.2%	9.0%
Triple-B-rated (Baa)	**3.94**	3.83	4.64	0.70	15.1%	-0.11	-2.9%	11.2%
High Yield Bonds Merrill Lynch								
High Yield 100	**6.80**	5.77	9.19	2.39	26.0%	-1.03	-17.9%	5.4%
Europe High Yield Constrained	**8.75**	7.53	12.13	3.37	27.8%	-1.23	-16.3%	3.4%
Global High Yield Constrained	**7.79**	6.84	10.45	2.65	25.4%	-0.95	-13.9%	4.9%
Tax-Exempt Merrill Lynch								
Bond Buyer 6% Muni	**4.55**	4.54	5.72	1.17	20.5%	-0.01	-0.2%	18.2%
Government Bonds J.P. Morgan†								
Canada	**2.18**	1.95	3.39	1.21	35.7%	-0.23	-11.8%	10.9%
France	**2.84**	2.52	3.67	0.83	22.6%	-0.32	-12.7%	9.0%
Germany	**1.73**	1.70	3.41	1.68	49.3%	-0.03	-1.8%	14.2%
Japan	**1.18**	1.15	1.44	0.26	18.1%	-0.03	-2.6%	3.6%
Netherlands	**2.08**	1.93	3.51	1.43	40.7%	-0.15	-7.8%	13.0%
U.K.	**2.68**	2.43	3.97	1.29	32.5%	-0.25	-10.3%	16.7%
Emerging Markets**	**5.62**	5.38	6.62	1.00	15.1%	-0.24	-4.4%	12.0%

Source: Wall Street Journal[xv], Sapling Wealth Management

We Are Cautious On Commodities

We are near term bearish on industrial and economically sensitive commodities, due to a slowing Chinese export oriented infrastructure investment and less accommodative monetary & fiscal policies in the developed world. In 2011, the Chinese economy consumed 30-53% of certain industrial commodities yet represents only 9-10% of world GDP. A slow-down in this export driven economy, or even just a reorientation towards domestic consumption relative to export oriented capital investment, would lead to significantly reduced demand for certain types of materials. Faster growth in other developing markets, such as India (2% World GDP), may pick up some slack, but won't be enough to offset a Chinese slowdown. While precious metals (Gold, Silver) will do well during

periods of uncertainty and will be an important portfolio diversification asset class, we feel investment performance will be lackluster for the next 12-18 months as developed countries experiment with fiscal and monetary restraint. Agricultural commodities are an interesting play on the inexorable trend of population growth and increasing high end preferences in developing countries.

Table 2: China's Consumption of World Commodities 2010

Commodity	% of World
Cement	53.2%
Iron Ore	47.7%
Coal	46.9%
Pigs	46.4%
Steel	45.4%
Lead	44.6%
Zinc	41.3%
Aluminum	40.6%
Copper	38.9%
Eggs	37.2%
Nickel	36.3%
Rice	28.1%
Soybeans	24.6%
Wheat	16.6%
Chicken	15.6%
Oil	10.3%
Cattle	9.5%
China's % of World GDP	9.4%

Source: Barclays Capital, Credit Suisse, Goldman Sachs, US Geological Survey, BP Statistical Review of World Energy, Food and Agriculture Organization of the United Nations, International Monetary Fund, Paul Kedrosky[xvi]

Our Favorite Themes and Investment Strategies

We favor measured risk taking investment strategies. Our top themes, strategies and investments are as follows:

Table 3: Themes, Strategies and Investment Ideas

Themes	Strategy	Investment Ideas
Income Generation with Growth	Identify those areas of the economy which will have increased growth without additional capital	High Dividend Paying Stocks
Cloud Based Technologies	Research various companies poised to benefit directly and indirectly from new tech	Mobile computing, Software and Niche Technology Capital Plays
Government Spending Shifts	Target/avoid industries that will be winners/losers in shifts of government spending and increased taxation	Defense, Education, Health Care, State Provided Services, Business Services
Commodities	Take advantage of changing commodity prices	Utilities, Midstream Energy, US Energy Producers, Aerospace
Demographic Shifts	Invest where the inexorable demographic trends will benefit	Health Care Services, Medical Technology, Agriculture
Balance Sheet Trends	Identify companies with strong cash flow generation and redeployment opportunities	Tobacco, Consumer Staples, Telecom & Cable, Manufacturing
Trading Strategies	Track trading ranges of key indices and target <3 month opportunities	VIX, European Equities, US Treasury Bonds
Cost Reduction	Locate companies that will benefit from increased focus on costs	Human Resources, Outsourcing, Internet, Aerospace
Pent Up Demand	Distressed industry contrarian ideas	Housing, Autos, Financials

Source: Sapling Wealth Management

This report has changed since it was originally published on April 11, 2012. It now includes an endnote and reference section, which was added October 5th, 2012. For our analysis we select indexes and securities that represent the most widely regarded gauges to track capital markets. Those indexes are: S&P 500 & Sector Indexes as a proxy for large capitalization US Equity market & sectors; 10 Year US Treasury Bond for US Government borrowing cost; HG Corporate for investment grade US Corporate borrowing costs; HY Corporate for US non-investment grade borrowing costs; EZU for European large capitalization equity markets. No other items in the report have changed since the original publication.

ENDNOTES

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[x] Endnote i, ibid.

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[xii] "Flow of Funds Accounts of the United States (Z.1)", Federal Reserve, http://www.federalreserve.gov/releases/z1/ (March 8th, 2012).

[xiii] "SPY Daily as compared to EZU", Big Charts, http://www.bigcharts.marketwatch.com/advchart/ (April 4th, 2012).

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[xv] "Market Data Center – Tracking Bond Benchmarks", Wall Street Journal, http://online.wsj.com/mdc/public/page/2_3022-bondbnchmrk.html?mod=topnav_2_3010 (April 9th, 2012).

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