Quarterly Update
4th Quarter 2011

Hi, this is Ed Green, and I want to wish you all a Happy New Year and thank you for joining me for Foster Group's update for the 4th quarter of 2011.

Well, those of you who listened to our last update may recall we talked about an anticipated change in the format of our updates going forward. We're beginning those changes this quarter, and the first change you'll notice is that I'm the only one in the studio today. We're also beginning to put some additional content up to our website, and I'll talk a little more about that later in the update. Right now, let's talk about the high-level view of last quarter and last year.

2011 began with a positive tone in markets and, for the most part, ended the same way. What happened in between, though, was frantic, noisy and worrisome.

Markets rallied through the first four months of the year, with the Dow Jones Industrial Average hitting its high for the year on April 29th. And then, the wheels fell off, or at least it seemed like they had. GDP growth slowed sharply, the unemployment rate edged higher and equities markets endured a major correction, with many indices declining 20% or more between May and September.

During that time, a number of events proved very unsettling to investors. A devastating earthquake and tsunami hit Japan, followed by a major nuclear event. Here in the US, massive tornadoes destroyed large portions of Tuscaloosa, AL and Joplin, MO. The European debt crisis re-emerged with a vengeance late in the spring while, on this side of the pond, politicians went to war over the Federal debt ceiling. When the dust settled on the argument, Standard & Poor's downgraded US Treasury debt for the first time in recent history, and the Super Committee later punted on their charge to find ways to reduce the federal deficit. Late in the fall, MF Global, a large financial derivatives broker headed by John Corzine, the former head of Goldman Sachs and ex-governor of New Jersey, filed for bankruptcy after disclosing what they described as a "material shortfall" of hundreds of millions of dollars in segregated customer funds. Another black eye for the financial industry, which is already short on investor trust.

After weak economic data last summer, Dr. Nouriel Roubini, who gained notoriety during the financial panic of 2008 and 2009 for apparently predicting the housing collapse, warned that, "We're going to a recession, we are at stall speed and we are running out of policy bullets." His prediction, so far, has turned out to be not quite on target, though, as the economy actually gathered momentum late in the year.

Equity markets gained momentum in the 4th quarter as well, on the strength of one of the strongest October's on record. In spite of a slightly negative November and a basically flat December, US markets were up well more than 10% for the quarter, while foreign markets continued to struggle with the Europe situation and finished the quarter closer to breakeven.

Index returns for US companies during the 4th quarter were roughly 12% to 13% for large companies and 15% to 16% for small companies. In foreign developed markets, large companies were close to 3% and small companies were 1% to 2% negative for the quarter. In emerging markets, large companies returned around 4% for the quarter, while small companies were slightly below flat. Real estate inside the US was up over 15% while foreign real estate was up just over 1%.

For the full year, US large companies were from flat to up 2% and small companies were down 4% to 6%. In foreign developed markets, large companies were down close to 12% and small companies were down 16% to 18%. In emerging markets, large companies were down around 18%, while small companies were significantly weaker, down about 27%. Real estate inside the US was up about 9% while foreign real estate was down by about the same amount.

Turning our attention to bond markets, the picture was generally positive for the 4th quarter and the year as a whole. Maturity risk was rewarded in 2011, so longer bonds typically outperformed shorter. At the short end of the maturity scale and the high end of the credit scale, instruments like 90-day US Treasury bills are generally considered to be the "risk-free asset," backed by the full faith and credit of the US government. Last year, investors in these instruments were basically willing to accept the return of their principal, with little or no interest, in exchange for the perceived security of this type of instrument. At the opposite end of the maturity scale are long-term government bonds, with maturities of twenty years or more. These had a remarkable 3rd quarter performance, as investors around the world flocked to the perceived safety of these instruments, and their prices rose to reflect both investors' desire for safety and their aversion to risk. To the amazement of many investors, including the manager of the world's largest bond mutual fund, who made large bets to the contrary with shareholder funds, long-maturity Treasuries turned in the performance of the year, rising almost 30%.

US broad-market bond indices were up around 1% for the 4th quarter and up close to 8% for the year. Short-term US Treasury indices were basically flat in the 4th quarter and up only fractions of 1% for the year. Intermediate-term government and corporate indices were up roughly 1% in the 4th quarter, finishing up 5% to 6% for the year. Long-term Treasury indices were up about 2% for the quarter, and nearly 30% for the year. High-yield bonds had a good 4th quarter at about 6%, but were weaker for the full year, at about 5%. Inflation-protected indices were up between 3% and 4% for the quarter and over 13% for the year, and municipal bonds indices ranged from up less than 1% for the quarter to almost 3%, and up from 3% to more than 10% for the full year, with longer-maturity indices showing higher returns.

With respect to municipals, it's very interesting that they did quite well in 2011, despite a noted analyst's prediction late in 2010 that there were likely to be 50 to 100 sizable municipal defaults in 2011, which could amount to hundreds of billions of dollars. That prediction threw the municipal market into a tailspin for the next few months, but it recovered nicely over the course of the year.

To be fair, 2011 did see the largest single municipal bankruptcy filing in US history when Jefferson County, Alabama filed for court protection after struggling under the debt load of a $3 billion sewer system project. Harrisburg, PA also sought court protection, but was denied by a federal judge who ruled that the move was not authorized.

Now, let me turn our attention to the performance on Foster Group's model portfolios. For the 4th quarter, returns in all the models were positive; for calendar year 2011, though, return in all model portfolios was negative. 4th quarter return ranged from about 1-1/2% to almost 10%, progressing from our most conservative portfolio to the most aggressive. Middle-of-the road allocations were up close to 5%. For the full year, returns ranged from down about 1-1/2% to down about 8-1/2%, again from most conservative to most aggressive, with middle-of-the-road allocations down 3% to 4%. These returns are all <u>after</u> deducting Foster Group's maximum management fee.

Now, it might seem strange, if you paid attention to market data last year, for all our model portfolios to be in negative territory for the year, when both the Dow Jones 30 Industrials and the S&P 500 indices finished in positive territory for the year. The explanation for this is that nearly all broad foreign equity indices had decidedly negative returns for the year. Small companies inside the US also had negative returns. So, in broadly-diversified portfolios like ours, the negative return of those components more than offset the positive return in large US companies.

Now, I'd like to give you some information about how you can get more detailed index and model return data than what we just covered. As we mentioned in our last update, we're intending to put more content on our website as part of our update process, and this quarter, there are two things available there that may be of interest to you.

First, there's a transcript of this audio update for those who may prefer to read information like this. Second, there are some charts that offer a visual of the return data we just covered. In these charts, we've also included some longer time periods to give historical context to the returns of the 4th quarter and the past calendar year. You'll find links to both of these items on our home page, www.fostergrp.com; simply click on the links and they'll take you directly to the transcript or the charts.

Well, earlier I mentioned a couple different instances where well-known and widely-respected individuals in the financial world made predictions about how they thought things were going to turn out. In both of these cases, things didn't go exactly the way they'd anticipated and investors who followed their recommendations ended up getting a very different outcome than what they probably expected.

I mention this not for the purpose of pointing fingers or poking fun at these individuals. For that reason, I intentionally did not mention their names. You may know who I'm referring to if you follow this kind of thing in the financial media, but who they are and what they predicted really isn't the point. My point in bringing it up is that we're at that time of year when there's going to be a lot of this sort of information making its way into the financial media. January is always the month for predictions, when the "experts," and I'm using that term in quotes, offer their view on what the coming year will be like and what we should all do with our investment portfolios in order to profit from it or, at the very least, to avoid big losses. This year, we'll probably see even more predictions through the first several months because 2012 is an election year.

These forecasts are often more entertaining than they are useful. They're even more entertaining if you save the predictions from this January and re-read them next January. If you do, chances are very good that you'll find most contain bits and pieces that pass as correct predictions along with a good share that are well off-the-mark. It's not that the folks doing the forecasting aren't intelligent, well-intentioned people. In many cases, they're some of the very brightest folks in the financial world, and most genuinely want to help investors. The problem, in the words of the immortal Casey Stengel, is that, "Forecasting is very difficult, especially if it involves the future."

You know, the global economy is a huge array of interconnected, moving parts. Each, in some large or small way, influences the others. And, in spite of armies of analysts with high-powered computers constantly combing through mountains of data, events have a way of creating unexpected outcomes that don't fit with the assumptions made from analyzing all the data. It's very tempting, perhaps even comforting, to believe that there's someone out there who's smart enough, or has a fast enough

computer or a large enough research staff that they can figure it all out and make consistently accurate predictions.

But, overwhelmingly, the evidence seems to show that there's no one like this out there. Sure, there are always folks who can claim to have gotten certain predictions right, but we need to recognize that with the sheer volume of forecasts made each year, simply by the laws of probability, some will be correct. So, the question to ask really isn't, "Don't correct forecasts occur?" The answer to that, certainly, is yes. The better question to ask is, "Among all the conflicting forecasts out there, can you identify the correct forecaster *in advance* of their prediction proving correct?" That's really what's required to profit from a correct forecast. Identifying that person after the fact is interesting, but it's of no value to you from an economic standpoint.

And, let me ask you to consider one more thought on this topic, acknowledging that I may seem very cynical in bringing it up. Let's assume for a moment that what I've just said is wrong. Let's assume there really is someone out there who's smart enough to figure it all out and make consistently correct predictions. Here's the question I'd ask you to consider: Why would that person be inclined to share that information with the rest of the world? Almost certainly they could make a lot more money by keeping the information to themselves and acting on it unilaterally. So, the assumption must be that the person is either tremendously philanthropic and simply wants to benefit society at large, or they're driven by a desire for recognition to the extent that notoriety for their predictive ability is of more value to them than sheer monetary reward. While both of these explanations are certainly "possible," I'm not sure either rise to the level of "probable."

So, with all that said, we're left with the question of, "So what?" What do we do with this view, if we accept it? How do we act in response to it? These are questions we wrestle with all the time as we think about building portfolios for our clients and help them with their financial planning decisions. So, let me try to frame this thought process for you in four broad ideas.

First, our experience serving clients over the past twenty years tells us that your financial planning requirements should drive your investment portfolio. You need to have a good idea what the portfolio is - and will be - required to do in order to adopt an allocation target that's capable of delivering that result. It also needs to be an allocation that you're comfortable enough to stay in through difficult market periods.

Now, a risk here is that there can be a false sense of security in creating a financial plan – the idea of, "OK, check that job off the list – got that done." Remember, a financial plan is a process, not an event. It's only as good as its assumptions, and a lot of assumptions go into any financial plan. So, back to the idea of events having a way of creating unexpected outcomes . . . . this is absolutely true of financial planning. What this says to us is that it's really important that we continually review the plan to see how unexpected circumstances may have altered the original assumptions and what course corrections may be required to keep you on track. This is one application of the concept of "vector change" that Jerry wrote about in his book a few years ago.

It's strange, but true for many individuals, that there can also be a sense of freedom that comes about by simply acknowledging the fact that we don't know with certainty what the future is going to look like. Accepting this idea allows us to let go of the anxiety many of us have around the thought that we should be able to know, or that we should be able to find someone who does to help us.

The second idea is that the inability to predict with consistent accuracy argues for a broadly-diversified, market-like investment portfolio. If the "experts," - and again, I'm using that term in quotes – have trouble getting even the movement of economies and broad asset classes right, what would lead us to think they, or we, have any better chance of predicting the outcome for individual companies? Our response to this is to build portfolios for our clients that are made up of multiple "asset-class" investment vehicles. Very simply, this means that each investment vehicle in the portfolio represents a distinct segment of the market by holding a wide portfolio of the companies that make up that particular segment. We believe you should be diversified both across asset classes and within asset classes.

So, why do we do this? Well, there are a lot of reasons, but the one I think is most compelling is that this a very effective method of reducing risk in the portfolio. Being diversified across multiple asset classes means your portfolio is never dominated by what happens in one particular segment of the market. As an example, think about equity investments during the financial panic of late 2008 and early 2009. They declined in value to varying degrees, but nearly all experienced significant loss. The effective diversifier was the fixed income asset class, particularly high-credit-quality issues like US Treasury securities. Holding a meaningful allocation of bonds didn't mean the investor avoided all losses, but it certainly reduced the amount of loss they experienced.

A portfolio well-diversified within asset classes makes it likely that, over time, some companies in each asset class will do very well, others, probably not as well and some may fail altogether. Since we don't believe we can know in advance which is which, we think spreading the risk of which companies may not do well is a smart thing to do. This protects you from the possibility of serious portfolio damage from holding large amounts of a company that meets with unexpectedly poor results. As we look back on market history, it's littered with stories of companies which were once highly-respected - some thought to be virtually invincible - that ceased to exist for various reasons. On the other hand, there are no instances of entire asset classes ceasing to exist. For that to happen, the companies making up the asset class would all have to fail at precisely the same time, which is highly unlikely.

The third idea is to have a clearer understanding of the relationship between news, securities prices and expected returns. Very simply, the idea here is that while much of the investing world obsesses over the news of the day and forecasts of what might happen in the future, it's likely the majority of that information was already contained in market prices by the time the news hit the street. There's virtually no useful information regarding companies or economies that first comes to light when a journalist produces a story about it. Much of that information will have been circulating for some time in various forms, and prices will reflect any useful information it contains. What this means for us as investors is that while the news may seem gloomy or even frightening, prices already account for that sentiment.

More importantly, though, we need to understand what price movement means from an expected return standpoint. When investors perceive the risk of holding any particular investment to be high, the price of that investment will fall. Is this because they believe the investment is inherently worth less today than it was yesterday? Not necessarily. The price falls until it reaches the point where there's equilibrium between willing buyers and willing sellers – what's known as the "market-clearing" price. This decline in price compensates investors for the risk they accept if they purchase, or continue to hold, the investment. All else being equal, if two investments have the same expected future value but one has a lower price today than the other, the one with the lower price today has to have a higher rate of return to grow to the expected future value.

Framed this way, it's especially interesting to go back for a minute to the idea of a portfolio constructed of asset-class vehicles. If you remember, I said there were numerous instances of individual companies ceasing to exist in past market history, but no examples of asset classes ceasing to exist. This becomes crucially important as we think about the idea of rebalancing a portfolio during times of market uncertainty. If you have reason to believe the value of the entire asset class will not go to zero, you can be much more confident about buying more of that asset class if its value declines. What's implied by this action is that the expected return on the shares you just bought will be higher than what was expected before the price declined. Executing this same strategy using individual companies does not have the same expected outcome, because there's no reliable way to know if the company you're purchasing more of will be one that eventually ceases to exist, in which case all your shares, including the new ones, become worthless.

One final idea, and this one is very simple, but it's important. *Nothing lasts forever.* Assumptions in your financial plan don't remain static, bull markets don't go on indefinitely and recessions and market corrections ultimately end. The thing we can count on with certainty is that things will change. How and when that change takes place, and what its outcome will be is very uncertain.

We know these changes may require that we respond with some sort of change of our own in order to stay on track and meet our financial objectives. We also know that there are certain things within our control, but many others that are outside our control. When we think about responding with change of our own, we should focus our attention on the things we can control – how much we save, how much we spend, how long we choose to work, what allocation we hold in our portfolio – and try to avoid being consumed by the things we can't control – what markets will do next week, next month or next year, whether the Eurozone will be able to solve their debt issues, political change around the world - the list goes on and on.

Helping you deal with uncertainty and implement effective change is part of our role as your adviser. If you'd like to come in and visit about your portfolio or your financial plan, we're available and always welcome having those discussions with clients. Please give us a call or drop us an e-mail whenever we can be of help to you.

As we wrap up, I want to encourage you again to take a look at the charts or the transcript of the update that are posted on our website. Again, it's www.fostergrp.com and you'll find the links on our home page.

Well, I've enjoyed having the chance to visit with you today; I hope you've found the information useful and of interest. We look forward to seeing many of you in the coming weeks and visiting with you again in the near future with some new information. From all of us at Foster Group, our best wishes to you for a happy, healthy and prosperous 2012.

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Model portfolio returns provided by Morningstar and Dimensional Fund Advisors. Model portfolio returns are shown net of a 1% annual management fee, which is assessed quarterly. Model portfolios are rebalanced to target weights on an annual basis.