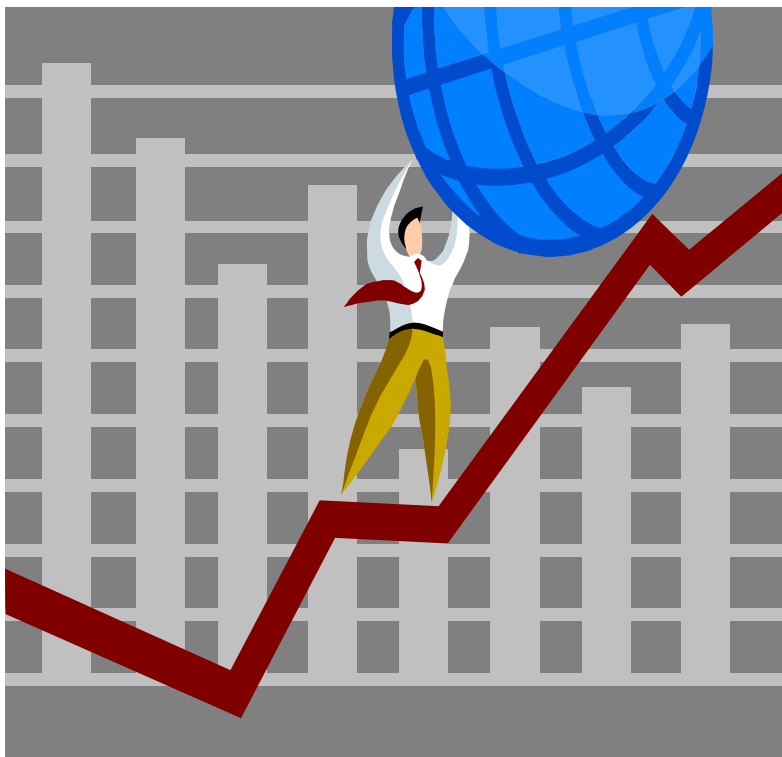


2012 Outlook & Investment Strategy



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2012 Outlook and Strategy

Watching Sausage Being Made

Overview:

Like all years, 2012 will be one of successes and failures. The distinction this year will be that the consequences resulting from both the successes and failures will be significant. Political and financial systems will be tested with the Euro-Crisis taking center stage, but there will be plenty of other actors too. As events unfold, politicians will need to be smart, disciplined and creative – three adjectives rarely used to describe them. Should politicians surprise and exceed expectations, 2012 could be a very good year indeed for equities and commodities. Should they fail, it will not.

Summary:

Rarely in our lifetimes has the global political/economic environment been so fiercely challenging and intractable. Strategic issues confronting us right now include the Eurozone devolving, Washington stalling, Arab states collapsing, Pakistan teetering, Iran threatening, and China and India slowing.

While successful resolution of **all** of these problems is implausible, the world will go on, and markets do best not when times are good and getting better, but when times are dreadful but get just a little bit better. It's at these times when a door opens – a door to optimism – a door that wasn't there before. But we're not there yet.

The biggest problem is of course Europe. No one knows how it will play out, but this is what we think: Market volatility will continue in the early part of the year while Europe attempts to rollover a large chunk of debt that's coming due. Germany will likely continue to preach austerity up to the point of something really bad happening. Angela Merkel will bet that this will be the precise time when Germany will get the best possible deal with its Euro-partners. Part of this deal must include starting the ECB money pump, which would be a relief to markets worldwide - at least for the intermediate term.

If the U.S. economy fails to improve, the Fed will most likely introduce another quantitative easing program (QE3). This too would be warmly welcomed by equity and commodity investors.

So it will be another tricky year with elevated volatility likely. Keep those seat belts fastened - AGAIN!

Stocks vs. Bonds:

Given the current dynamics of global markets, a conservative positioning going into 2012 – an underweighting of stocks and overweighting of bonds and cash – should be rewarded while waiting for markets to wring out their reactions to developments in Europe. Bonds should be of high quality and low duration (less than five year maturity). Stocks that are owned should be high quality as well.

Then, when sufficient policy actions are introduced that do more than simply “kick the can down the road”, allocations to equities can be increased.

Style Selection:

Of the nine U.S. equity styles, large cap growth contains the highest quality stocks: big, profitable multinationals like Apple, IBM, Coca-Cola and McDonalds dominate the index. This is the style that performs best when times are tough. Further, U.S. large cap growth is relatively cheap compared to the other styles, so that even when markets normalize again, U.S. large cap growth should continue to perform well over the intermediate term.

Stocks: U.S. vs. International:

As long as markets remain nervous, the U.S. dollar will be strong and likely build on its 2011 gains. Because a rising dollar introduces headwinds to investing in international stocks, we recommend stocks “made in the USA”. Resolution of global financial issues would present the best buying opportunity for emerging market equities since 2009 and 2003.

Commodities:

Despite sharp pullbacks in latter 2011, gold remains in a bull market. In the first half of 2012, gold should be able to dust itself off and resume its bull run. Appreciation could be large with the re-emergence of quantitative easing in the U.S. and other liquidity measures taken in Europe. However, should Germany insist on austerity for the Eurozone, gold (and other risk assets) will be challenged. Like equities, other non-gold commodities positions should be added with positive European developments.

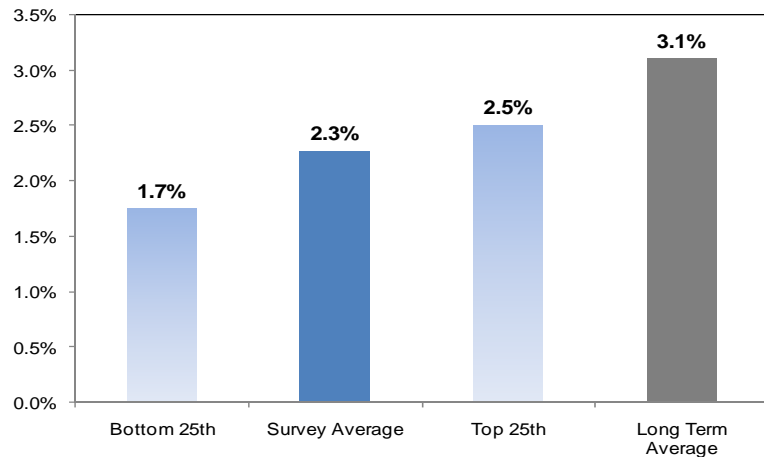
Review of 2011 Outlook and Strategy

Last Year's Prediction	Result
<p>Overview: “Good Year – But Stay Buckled Up”. 2011 will reflect improving economic conditions, some of which have been already discounted by the market. Even so, we believe the S&P 500 will show an average to good year due to additional stimulus and some progress being made on the long-term deficit issue. But there is likely to be some market volatility along the way, possibly in the first half of the year. And unlike in 2010, bonds, on average, won't be as attractive a place to hide out in 2011 as they'll be hard pressed to earn mid-single digit returns.</p>	<p>“Stay Buckled Up” was our best advice as 2011 was truly annus horribilis. Like a cheap disaster movie with too many calamities, the year had earthquakes, a major tsunami, a nuclear meltdown, historic Middle East instability, a European debt crisis, not to mention the U.S. losing its AAA rating. From an investment perspective, the Wall Street Journal described 2011 best: “It was a year that made the smart money look dumb.”</p>
<p>Summary: In 2011, volatility will be served-up again by the European debt crisis. The main dish this time - which may prove to be a bit too rich for Germany and France to digest - will be Spain with its heavy financing requirements. China may add volatility to global markets by raising interest rates two or three more times. They're doing this in an attempt to cool their red hot real estate market. China also is struggling to hold down the price of food, particularly pork prices. Currently, it's not looking too good. Food inflation reached 11.7% year over year in November. When you figure that each of the 1.3 billion Chinese eats an average of nearly one-quarter pound of pork every day, you can see why the Chinese are worried. High food prices can easily lead to political unrest. Here in the United States, confidence is re-emerging – and is justified in our opinion. To begin with, we feel that the continuation of the Bush tax cuts and the payroll tax reduction that were passed in December helped put a floor under the market. Then, if a long-term deficit reduction package, along with an overhaul of the tax system similar to the recommendations put forward by the Simpson-Bowles commission, can be agreed to in 2011, the stock market should move higher, possibly significantly.</p>	<p>Volatility was served-up in heaping helpings and the Eurocrisis was the main cause. Italy edged-out Spain as the leading culprit, but by the end of the year, the Eurocrisis had impacted every Euro country including France and Germany.</p> <p>A pall of great disappointment fell over markets when it was confirmed that politicians in Europe, as well as the U.S., had become terminally intransigent. By the end of the year, there was no clear solution to the European crisis, and zero budget/entitlement/tax reform in the U.S. With hopes dashed, stock markets had little reason to thrive in 2011.</p>
<p>Stocks vs. Bonds: Last year we predicted that 2010 would be a challenging year for bonds. We were early. While the Barclays Aggregate Bond Index fell 3% from its high just after Election Day, the Euro-crisis helped it to soar during the first ten months of 2010. Now, even though Europe will remain on the front burner, we believe it is unlikely that bonds in general will reprise their strong showing. Like the past two years (and correctly forecasted), the place for bond investors will remain in lesser quality debt (Corporate BBB and High Yield bonds). Emerging market bonds should perform well in 2011 as well. Potential volatility in stocks leads us to maintain a neutral weighting between stocks and bonds - but only using the bonds above.</p>	<p>Nope - we should have been underweight stocks and overweight bonds, specifically, higher quality bonds like U.S. Treasuries. But that would have been a very hard call to get right. Even with a crystal ball (i.e. that the U.S. would suffer its first credit downgrade in history), we would have made precisely the same call! Beginning in June, we did reduce stock exposure, which, while not doing much to enhance return, did reduce risk.</p>
<p>Style Selection: In terms of equity style selection, small-cap value has been on a hot streak for over ten years and its valuation compared to other classes seems stretched. However, the proverbial “fat lady” probably won't “sing” for small-cap value until markets sense the Fed is getting serious about tightening. When that occurs, large-cap growth – the scourge of the past ten years – will begin to outperform. We believe that hand-off, although not near, is approaching. Therefore, we recommend a barbell strategy of 50% large-cap growth and 50% small-cap value for 2011.</p>	<p>Small cap value was even with large cap growth through the first 1/3 of the year, but then cooled with the Euro crisis. For the year, large cap growth outperformed all U.S. styles. While our recommendation was 50%/50% out of the gate in 2011, our actual allocation over the year was 70% large cap growth, 30% small cap value, which was good.</p>
<p>Stocks: U.S. vs. International: Similar to last year, we think investors should focus on emerging markets in their international portfolios with a 40% weighting. Generally speaking, buy U.S. and buy emerging markets, but forget Europe and Japan. Eventually, Europe will be a value play, but not yet.</p>	<p>Avoiding Europe and Japan was a good call. Emphasizing emerging markets was not, but we aggressively reduced exposure by mid-June, avoiding much of the downside.</p>
<p>Commodities: We expect commodities to go up in 2011 as the secular bull market in commodities continues intact. However, if China steps on the monetary brakes too hard, or if the Eurozone begins to truly melt down, expect weakness. Finally, gold is still attractive, as it is the investment least correlated with equities and should be up this year as well.</p>	<p>Unfortunately, true to prediction, the Euro crisis did hurt commodities. But gold remained resilient - up 10% on the year. Through some timely sales our clients were able to capture more return.</p>

Growth: Below Average. Recession Ahead?

Economic growth is expected to be tepid next year. The most optimistic forecasts of 2.5% don't seem that optimistic when compared to the 3.1% long-term real average growth since 1960.

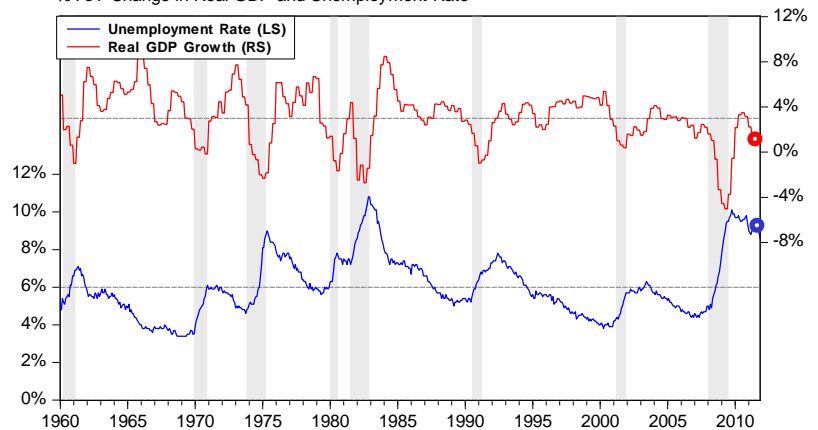
Consensus Economic Growth Forecast for 2012
GDP Real Growth Survey Forecast, WSJ Consensus Survey (11/2011)



Unemployment remains stubbornly high, which is a key drag on the economy, because consumer spending represents about 2/3rds of GDP.

Economic Growth and Unemployment

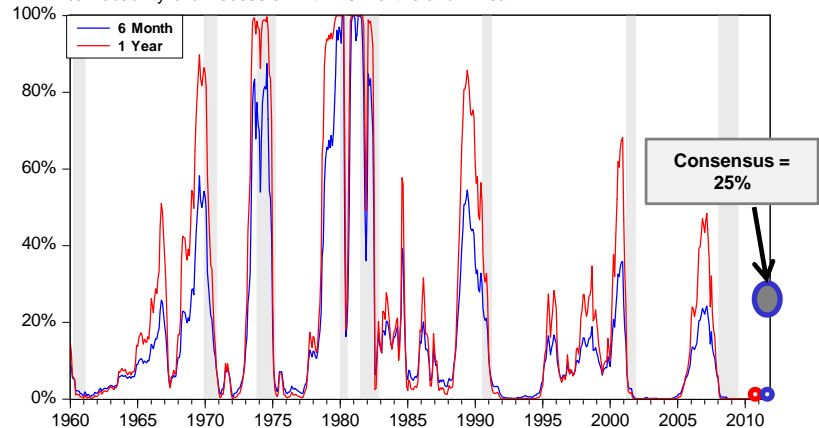
%YoY Change in Real GDP and Unemployment Rate



The consensus probability of recession is 25% for 2012. This is the number we should concentrate on as the quantitative forecast (which has historically been spot on and is currently close to zero) is possibly impaired due to central banks holding interest rates artificially low.

Recession Probability Forecast

%Probability of a Recession within 6 Months and 1 Year

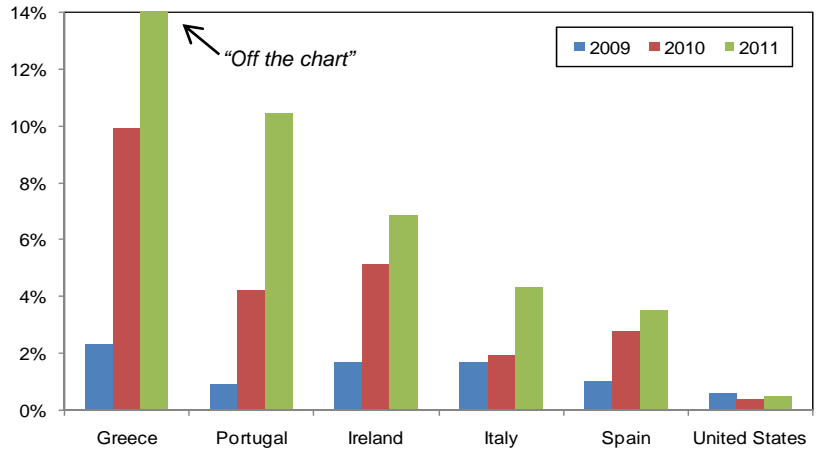


Data: Shaded areas are NBER defined recessions. Wall Street Journal and Federal Reserve. Recession Probability Forecast is based on internal Federal Reserve Staff Working Paper by Matthew Wright 2006 "Recession Probability Forecast Prediction".

Risk: Elevated, Historic and Unprecedented

European debt issues are the key risk factor in 2012. We were concerned in December 2010 when we saw smoke in the European credit markets. The smoke is now a fire, and we continue to maintain our zero exposure to European stocks and bonds.

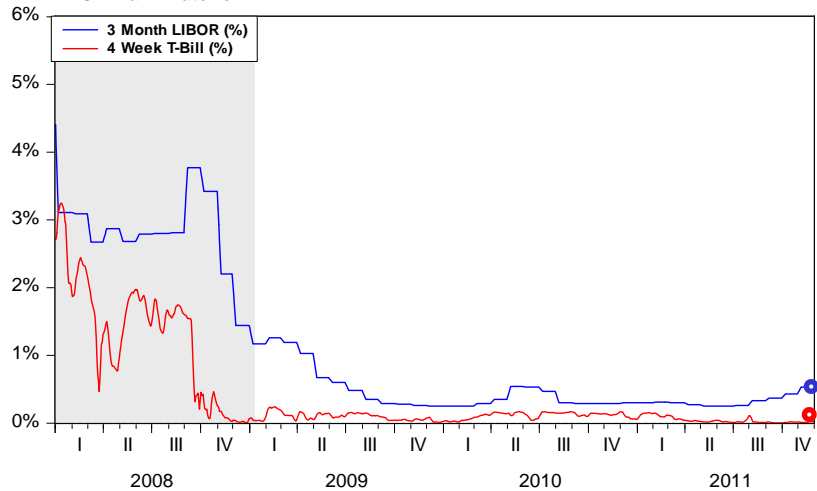
Global Sovereign Stress
Five Year Credit Default Spread, % Annual



Global contagion? The nightmare scenario is that Europe's problems could infect the global capital markets. We monitor bank lending rates on a daily basis. While not showing the market dysfunction of 2008, funding rates are rising, indicating some stress.

Bank Lending Rates

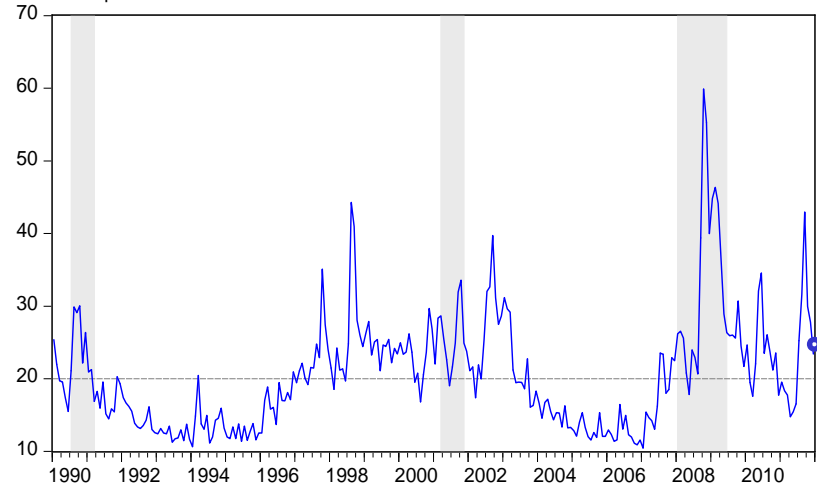
LIBOR Bank Rate vs T-Bill



The VIX Index (the market's perception of risk and future volatility), has hit extreme levels over the last three years. Its more moderate current level masks the recent spikes in volatility.

Implied Market Volatility (VIX)

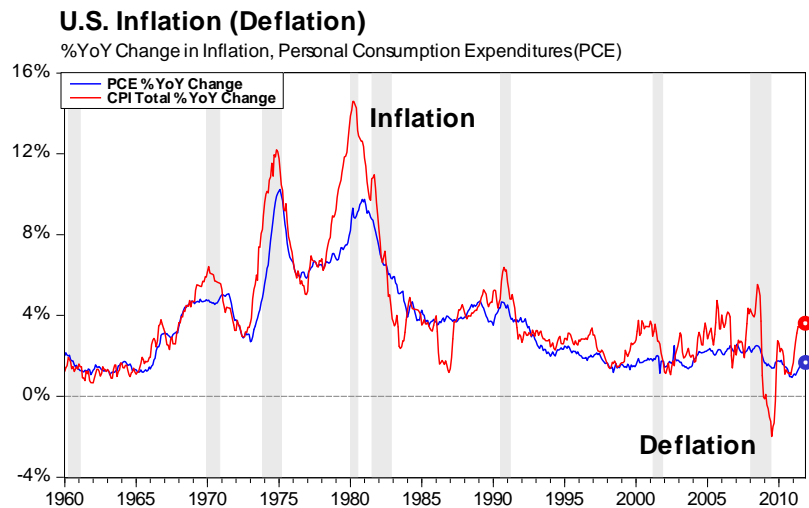
VIX Implied S&P 500 Standard Deviation



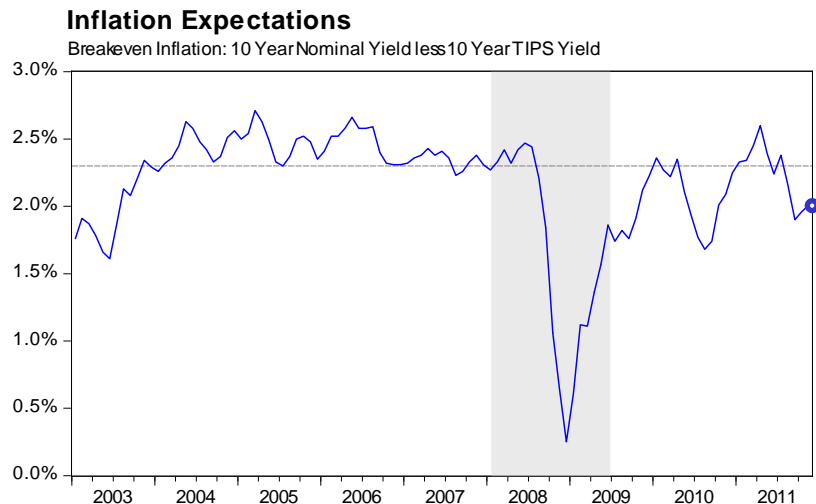
Data: Shaded areas are NBER defined recessions. The Economist, CMA Datavision, Yahoo Finance and Bloomberg.

Inflation or Deflation? No Deflation (for Now)

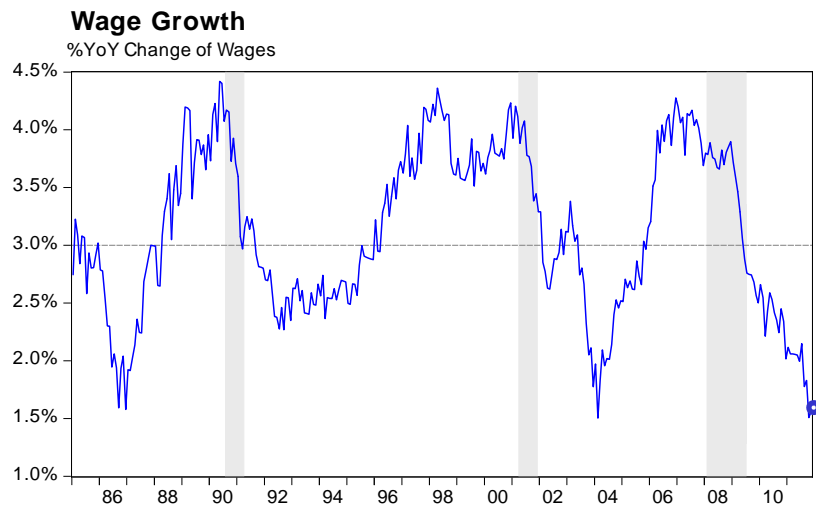
Prices are currently in a normal band which suggests Bernanke's policy actions are helping avoid deflation.



Inflation expectations remain contained. Keep in mind, though, a moderate increase in inflation would help repair U.S. consumers' personal balance sheets, as their fixed debts would become less expensive in "real" terms.



Wage growth is a key inflation ingredient. Its downward trend suggests that inflation will have a hard time coming back. This is a big-picture negative as improvement in the housing crisis will be difficult without wage growth.

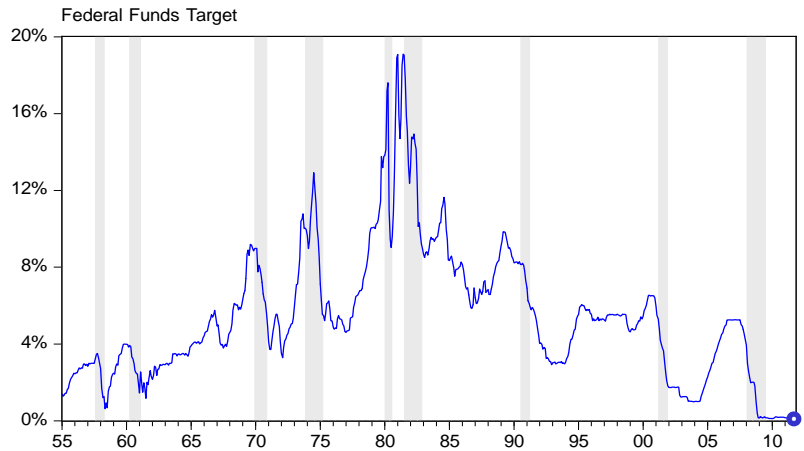


Data: Shaded areas are NBER defined recessions. Federal Reserve.

Stimulus: Pushing on a String?

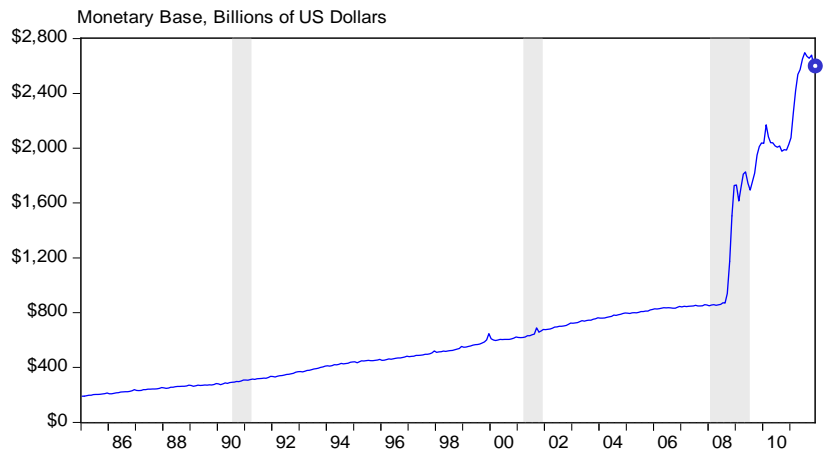
Low borrowing costs can be stimulative—no question. But for cheap money to really stimulate the economy, it needs to do more than lower costs of debt through refinancing. It needs to lead to new investment and spending.

Short Term Interest Rates



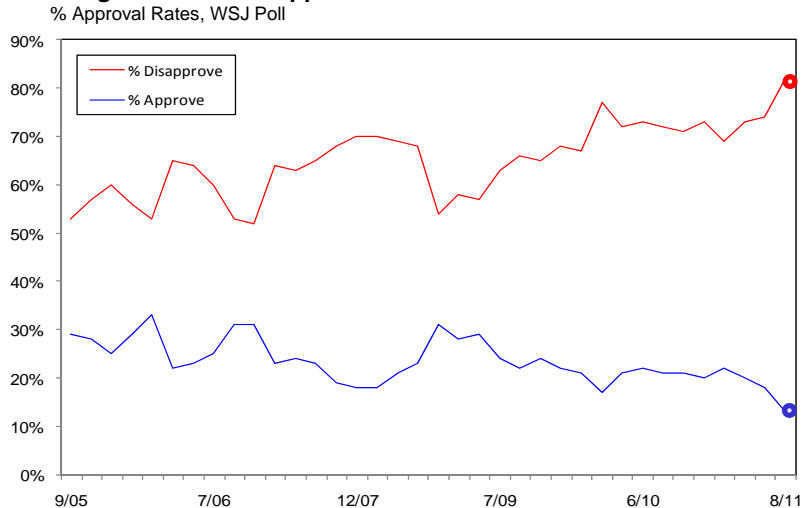
The Federal Reserve is doing everything it can. The Fed purchases assets, adding to its balance sheet, in an effort to lower interest rates. The degree of its purchases is unprecedented, tripling the U.S. monetary base over the past three years.

US Balance Sheet



With low approval ratings for Congress (as well as the Obama administration), there is great uncertainty regarding what U.S. fiscal policy will look like - and uncertainty is very bad for the economy.

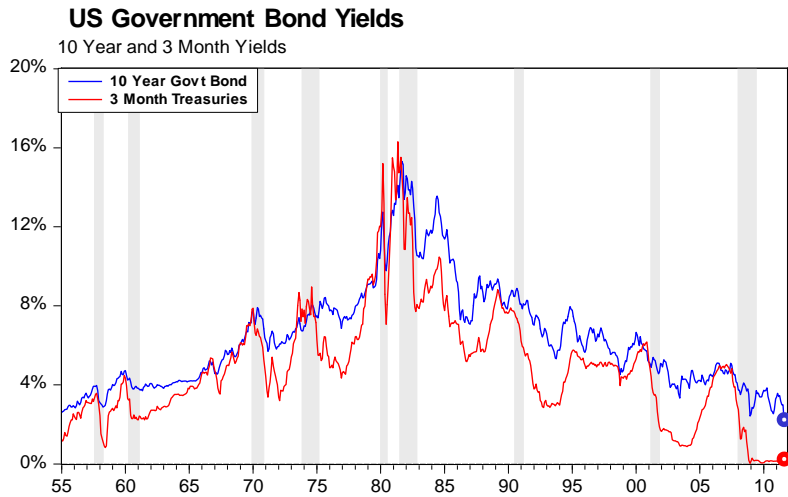
Congressional Job Approval



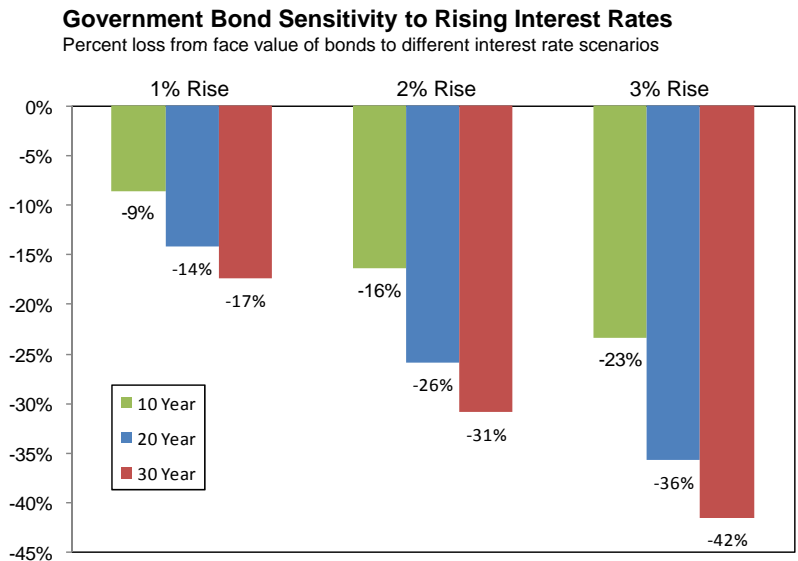
Data: Federal Reserve and Wall Street Journal.

Bond Valuations: Not Good

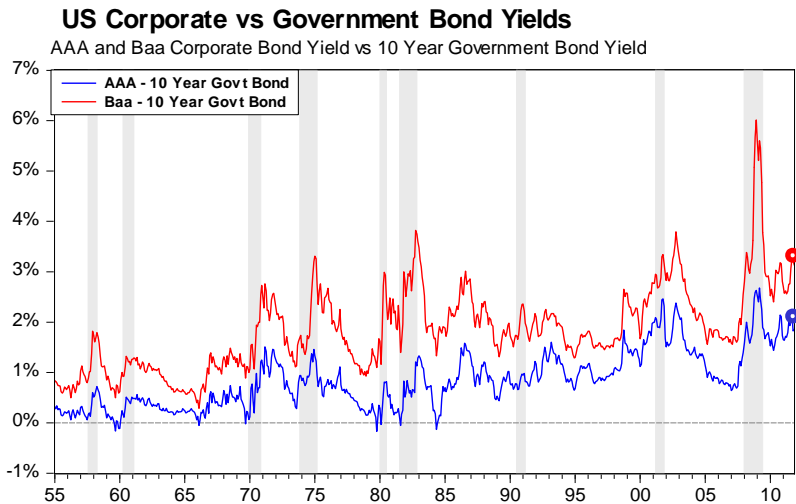
No juice in U.S. government bonds. With ten year Treasury bonds yielding below 2%, it's hard to see how these investments will do better than inflation - but easier to see how these bonds will lose value as rates go up.



U.S. government bonds, which many consider the "risk-free" option, are not riskless by any means. If interest rates snap back to pre-credit crisis (Dec-07) levels, prevailing rates would be higher by 2% and the value of government bonds would decline by 16 to 31%. The longer the maturity, the larger the loss.



U.S. corporate bonds look attractive versus government bonds. The premium for corporate bonds (both low and high quality) over government bonds is higher than average.

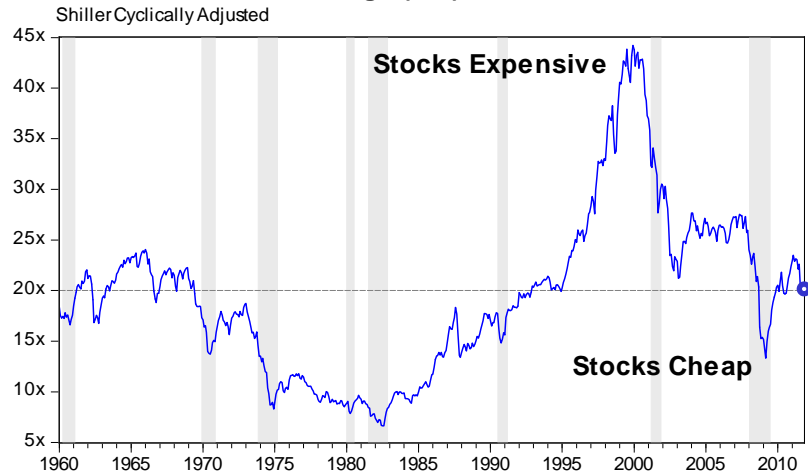


Data: Shaded areas are NBER defined recessions. Federal Reserve and WCM Estimates.

Stock Valuations: OK

Stocks are trading at historically average prices. While average valuations definitely provide some room for optimism, the risk that must be managed is that prices could “overshoot” to lower levels.

S&P 500 Price-to-Earnings (P/E)



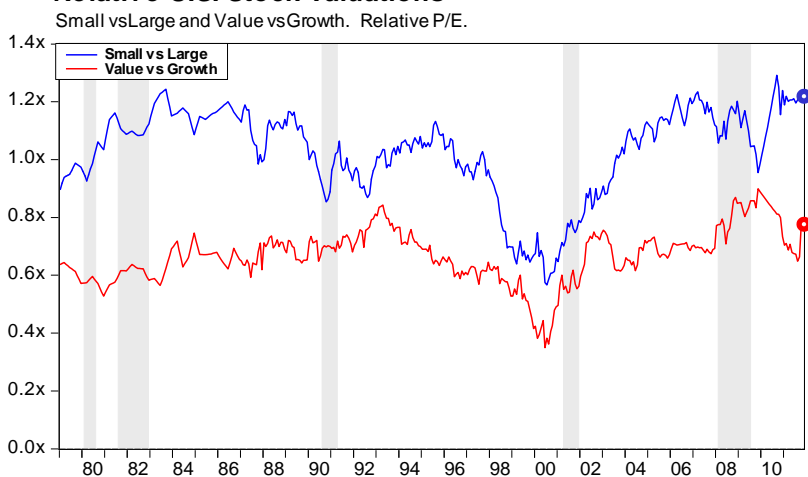
Stocks compare favorably to government bonds. The Earnings Yield is the inverse of the P/E chart above, and shows the yield per dollar invested in the S&P 500. The current 5% yield (Shiller long-term) compares favorably to the sub-2% 10 Year Treasury Bond yield.

S&P 500 Earnings Yield



On a relative basis, small cap stocks and value stocks look expensive, as they are near the high-end of their long-term ranges. Over the intermediate-term, the best bet looks like large cap growth.

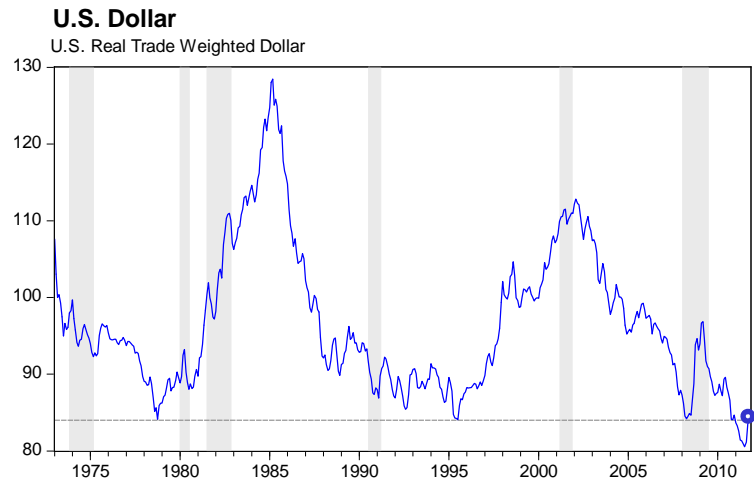
Relative U.S. Stock Valuations



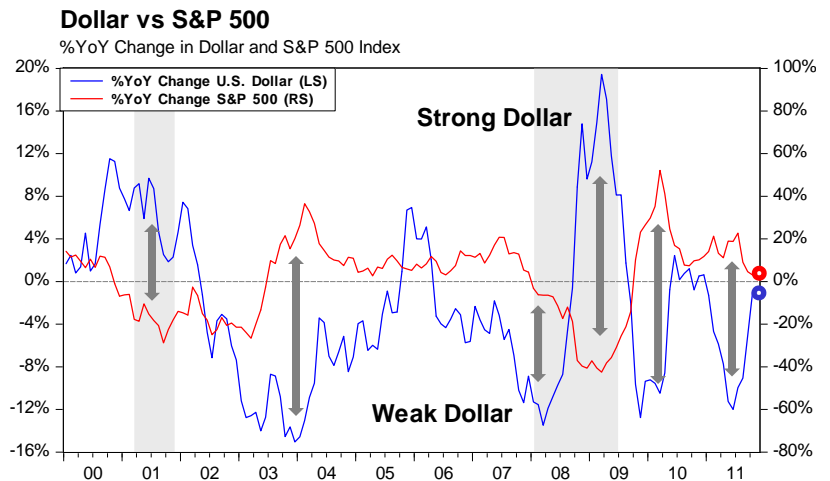
Data: Shaded areas are NBER defined recessions. Professor Robert Shiller and Russell Investment Group.

Dollar: Continuing the Trend or an Inflection Point?

The U.S. Dollar is weak, but has not decisively broken its long-term support line. While the global economy remains fragile, the dollar will remain resilient. But over the longer-term with likely massive government currency interventions, predictions are problematic.



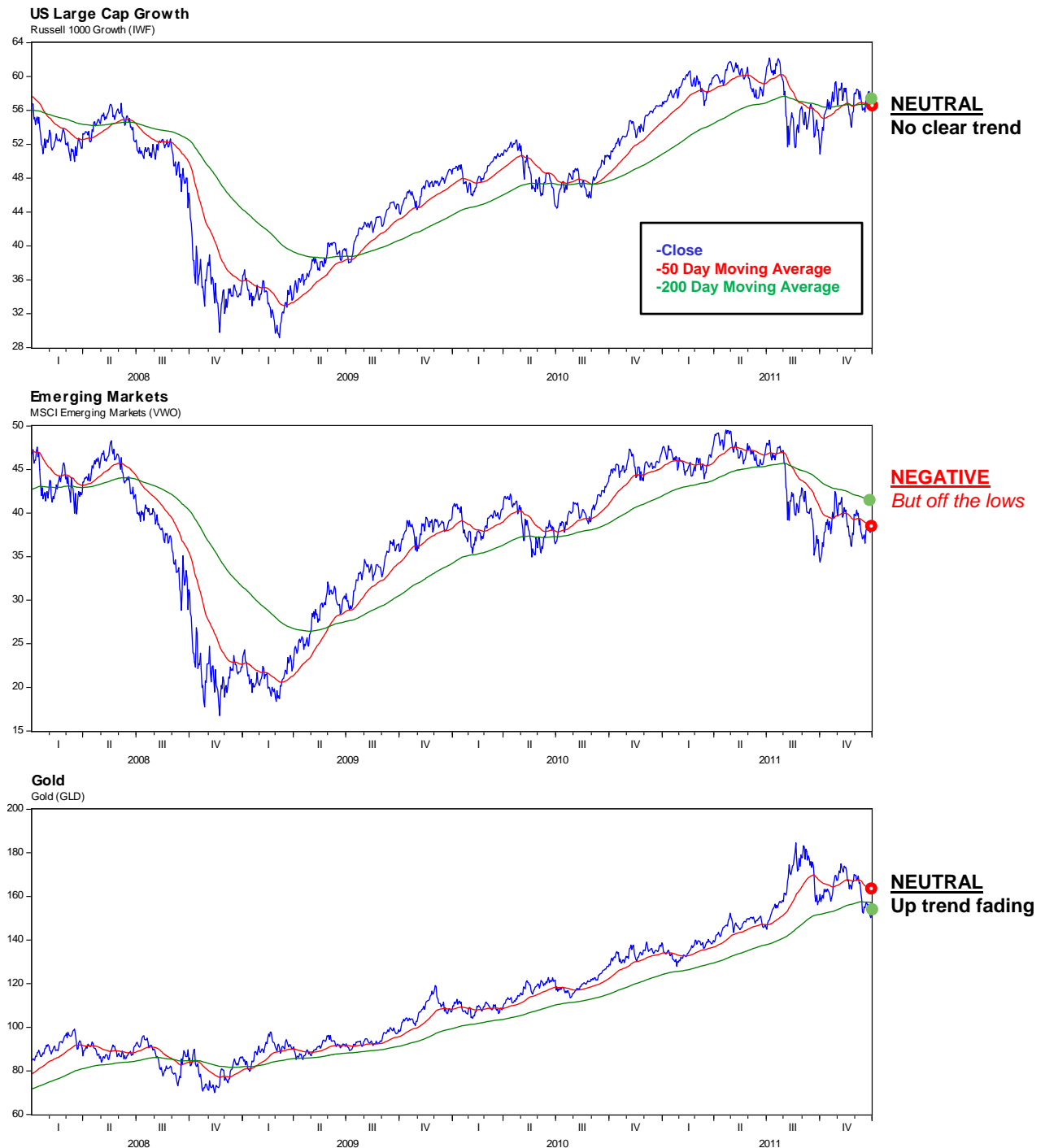
Since 2000, the relationship between the dollar and the S&P 500 has been negative. Further weakness in the dollar could be a plus for the market, as it would signal an improvement in the global financial crisis.



Data: Shaded areas are NBER defined recessions. Federal Reserve and Yahoo Finance.

Charts: Neutral to Negative

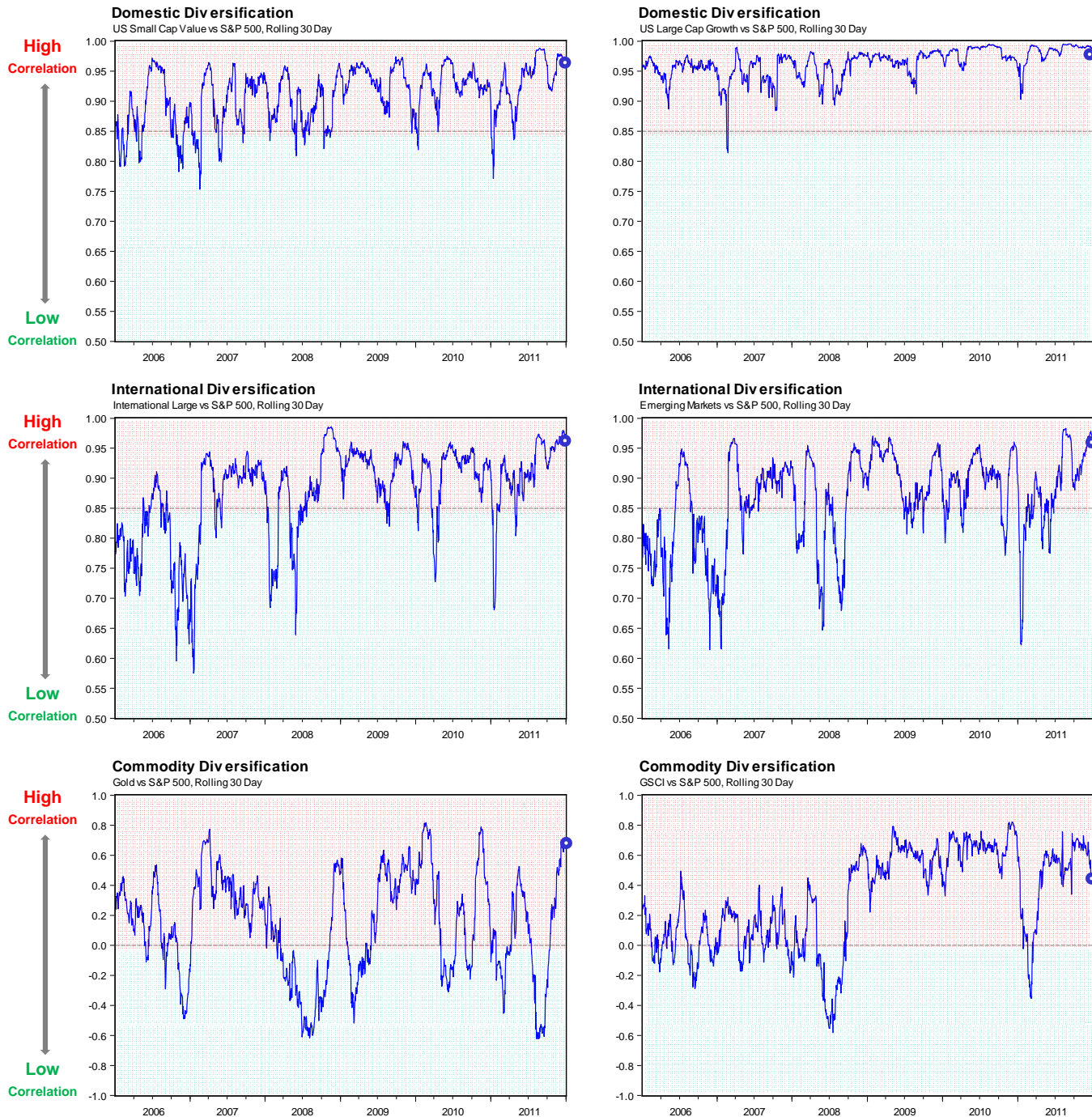
The charts are giving mixed messages. As the moving averages have merged for U.S. Large Cap Growth, neither an up trend nor down trend is indicated. Emerging Markets are off their lows but still in a negative trend while Gold is off the high but still in a long-term up trend.



Data: Yahoo Finance.

Correlations: Highly Elevated = Negative

Correlations are highly elevated. And they are high across all the major asset classes. As a result, the ability to reduce risk/volatility through a diversified portfolio is reduced. With correlations this high, going to cash becomes the default risk reduction option.



Data: Yahoo Finance.

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