News and Views

Mark Armbruster, CFA
Armbruster Capital Management, Inc.

GROWTH

Last year was a busy one, and this year is shaping up to be even busier. Armbruster Capital Management grew nicely in 2010, mostly because of referrals from all of you (thanks!!!), but also due to a rising stock market. A new sub-advisory relationship has pushed total assets under management and advisement to over $100 million, which is a significant milestone for us.

Looking to the New Year, we have plans to build a more robust technology infrastructure, add a staff member or two, and search for more permanent office space. I'll keep you posted as all of this unfolds. However, as things change and the firm continues to grow, you have my pledge that our focus on creative investment solutions and responsive client service will not change.

Thank you for your support in 2010. Without help from all of you, the firm would never be where it is today. I look forward to seeing you in the New Year.

IN THIS ISSUE

CAPITAL MARKETS YEAR IN REVIEW

In early 2010 there was much wringing of the hands by economists, politicians, and other "pundits". The economy, many believed, was headed for a double dip and the stock market was on its way to another steep decline. The usual suspects were at the heart of this thesis: stubborn unemployment, continued housing woes, and massive levels of government debt. In the end, things turned out just fine. The stock market added to its significant gains of 2009 by rising 15% in 2010. Of course, that presumes that you were invested only in large-cap, domestic stocks. Had you ventured into mid-cap, small-cap, emerging market, or real estate stocks, you would have done even better. Diversification, anyone?

Interestingly, despite the strong returns, the stock market was quite erratic during 2010. September was the best month, with the S&P 500 posting a return of 8.9%. May was the worst month, showing a decline of 8.0%. That is a significant spread. In fact, if you strip out the two best months, September and July, you would have lost a bit more than 1.0% during 2010. I believe this shows the fallacy of trying to time the market. You need a long-term perspective to harvest the market's returns. Of course, a naysayer might point out that were you smart enough to get out of the market during the two worst months, May and June, you would have ended up with a return of almost 32% for the year. Nevertheless, I'm sticking to my guns on the long-term perspective, perhaps because I am not smart enough to call market tops and bottoms.

As you may recall, we attempt to bias the portfolios we manage, on a very long term basis, toward parts of the market that are likely to outperform. This of course does not necessarily work in every market environment, but over longer time periods, there is a lot of evidence supporting this approach. One of the ways we do this is to overweight "value" stocks. In 2010 large-cap value stocks rose a little over 20%, as

measured by the mutual fund we favor. Another approach is to use "momentum" stocks. Large-cap momentum gained 18.6% during 2010, again measured by our favorite fund in this category. Both of these strategies outperformed the S&P 500. While a one-year period is a fairly short time slice, it is illustrative of what we hope to accomplish over time with a little bit of deliberate portfolio construction work.

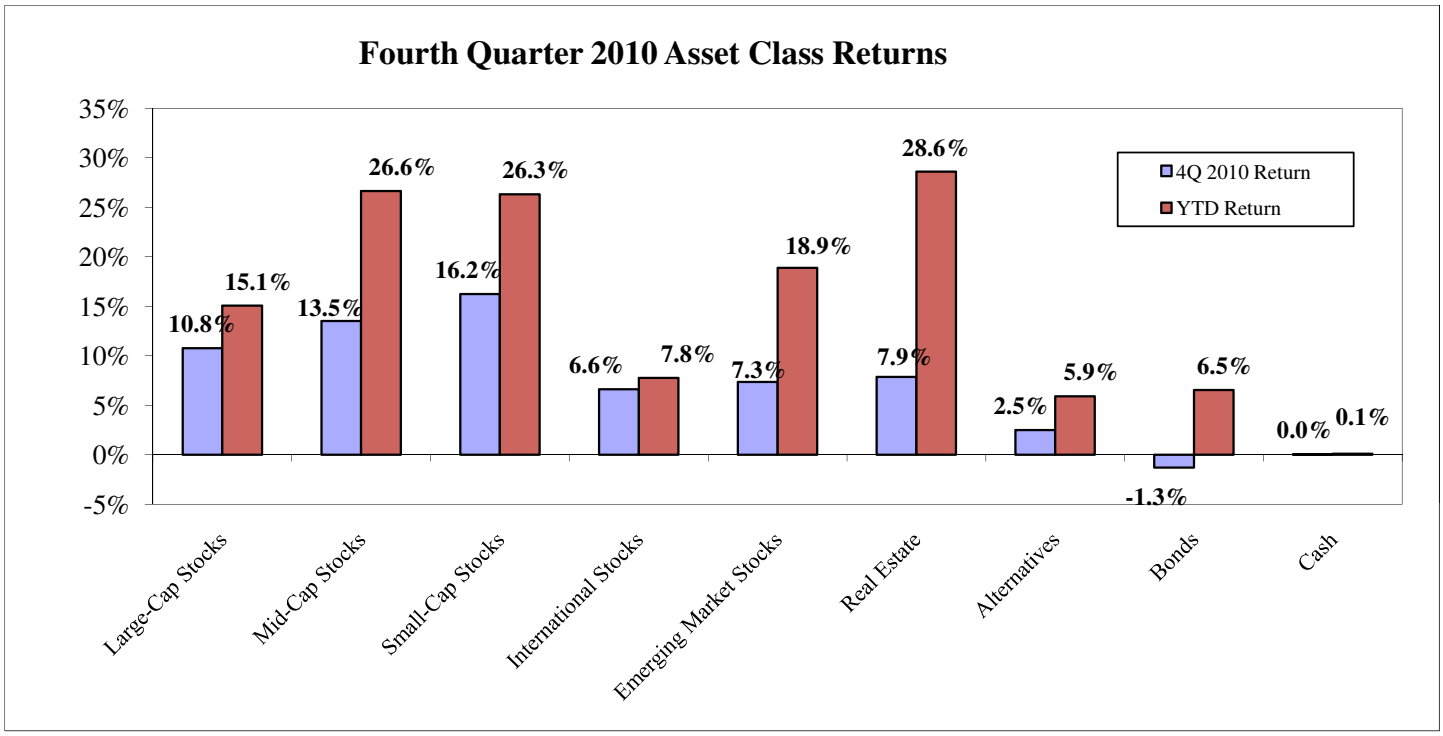
Mid and Small-Cap Stocks Soar

If large-cap stocks had a good year, mid-cap and small-cap stocks were phenomenal. Both categories rose more than 26% last year. There were a number of factors contributing to this performance, among them were strong merger and acquisition activity, superior earnings growth, and the timing of the economic recovery cycle.

While merger and acquisition activity has yet to resume pre-recession levels in the overall stock market, small-cap deal activity had its best year since 1997. Typically larger firms buy smaller companies and the acquired firms are purchased for a premium, giving a boost to smaller caps. However, the merger effect reaches even further as firms that are not acquired often see stock price appreciation as investors speculate on who the next target will be.

Additionally, earnings growth was quite strong for smaller firms. Larger companies posted nice earnings gains, but the magnitude and quality was superior for smaller companies. Larger companies goosed their earnings mostly by reducing expenses. It is no surprise that headcount is down at many firms, which results in a lower cost structure. For many large companies, sales growth showed anemic gains but earnings rose significantly just through expense reduction. Obviously this strategy can't persist forever. For smaller companies there were certainly cost cuts that helped boost earnings, but sales growth was also significant. The low interest rate environment offered attractive financing rates for smaller firms to take on new projects.

Finally, smaller stocks benefited from the timing of the economic cycle. Historically, smaller stocks



have outperformed during the first two years of an economic and stock market recovery. That appears to be the case this time as well. Some of this has to do with stronger fundamentals, like sales and earnings growth, but investor sentiment also comes into play. The appetite for risk generally resumes as it becomes clear that the economic decline won't last forever. Investors are eager to recoup losses from the downturn and are willing to search out superior returns, even in riskier market segments.

Small-cap stocks also play into our portfolio construction work. Using really small stocks, micro-caps, has historically resulted in higher returns than just using the typical small-cap stocks in the popular indexes. The micro-cap fund we use was up over 31% in 2010 versus a 26% gain for the S&P 600 Small-Cap index.

International Stocks Mixed

If there was any part of the capital markets that disappointed during 2010, it was large-cap, developed world, international stocks. They were up "only" 7.8%. That still isn't bad, but far below other stock market segments. Concerns over European economies and debt loads weighed on stock market returns throughout the year. There still is no clear resolution to the issues, but it seems unlikely any of the Euro zone countries will default on their debt.

Stocks in emerging market nations earned a solid 18.9% in 2010. Even as the world recovers from the economic slump of 2008 and 2009, growth is slow and unsteady in much of the developed world. It is the emerging markets that are growing at a fast clip and indeed, sometimes they are growing too fast. Countries such as China and Brazil raised interest rates during 2010 in an effort to slow growth to hopefully more sustainable levels. Strong economic growth doesn't always correlate with strong stock market returns, but the emerging markets have been a solid bet the past few years.

REITs: Expect Slower Returns

During the recent recession, businesses across the country vacated enough commercial office space to fill Chicago's main business district. Since then, vacancy rates have improved somewhat, but still hover near levels not seen since the early 1990s. Average rents remain below "normal" levels. In such an environment, you would not expect real estate investment trusts (REITs) to perform so well. Nevertheless, REITs have been, and continue to be, star performers. REITs turned in the best performance of any asset class we track for 2010 and returned an impressive 7.9% in the fourth quarter. What's the explanation? It is hard to say, but my best guess is that real estate valuations were driven down to such low levels during the bear market, that bottom fishers moved in. Additionally, many investors eagerly chase stocks with large yields which REITs usually provide.

Now that businesses are starting to show signs of life and have more of an appetite for commercial real estate, the picture is rosier for the real estate markets. However, gains in the stocks may subside. The bounce off the bottom is behind us, so now REIT gains will be based on operational gains and profitability. That's a tougher route to navigate.

Alternatives: Reducing Risk

The group of alternative investments we track, which includes commodity, currency, and hedge fund strategies, earned 2.5% in the fourth quarter and 5.9% for the full year. For those of you with alternative investment exposure, you know that this allocation was taken from the stock component of your portfolio. Given that stocks were up almost 15.0% in 2010 and alternatives were up just under 6.0%, you may be thinking, "thanks for nothing, Armbruster". However, I would note, in my defense, that the alternative investments performed exactly the way they should. Yes, they

underperformed, but that is inevitable during a stock market rally. After all, we invest in alternatives because of their low correlation with stocks. Unfortunately, low correlation works in up markets as well.

The main reason we invest in alternatives is for risk control. During 2010, the volatility of the alternative portfolio weighed in at an annualized 6.8% versus 19.3% for the S&P 500. So, even though the raw returns weren't as lofty as stocks, on a risk-adjusted basis the alternatives still look pretty attractive. Commodities, high-yield bonds, and emerging market bonds led the pack in the alternative space, all earning double-digit returns, above what the stock market provided. All the alternative components earned positive returns, but the hedge fund and currency strategies were much more modest.

Bonds: Signs of Stress

Bonds disappointed in the fourth quarter, posting a loss of 1.3%. However, they still earned an above-average gain of 6.5% for the full year. The fourth quarter, and especially December, was a nasty period for bonds because interest rates rose substantially (rising interest rates force bond prices down).

The riskier components of the bond market performed quite well. Ironically, it was the safer segments of the market, specifically Treasury bonds and municipal bonds, that bore the brunt of the late-year rout. Treasury yields had been at historic lows, but finally moved higher in reaction to the most recent Fed program dubbed QE2 (short for quantitative easing, round 2). The Fed bought billions of dollars worth of Treasury bonds on the open market and paid for them with newly printed dollars, thus flooding the economy with more liquidity. Normally, when there are bonds coming out of the market, reducing supply relative to demand, bond prices would rise. However, in this case bond investors collectively decided that the Fed was acting irresponsibly, potentially triggering future inflation by creating too many dollars, so they sold off Treasury bonds which caused prices to decline.

The other segment of the bond market that took a beating was the municipal bond market. 60 Minutes aired an interview with a noted investment analyst who believes there will be many defaults and all manner of carnage in the municipal bond market over the next few years. Certainly many state and local governments are not in good shape, but I'm not ready to jump on the disaster bandwagon yet. Historically municipal bonds have been among the safest bonds available, with default rates of less than 1%. That is extremely low compared with corporate or mortgage bond default rates which historically have been in the low double digits. Additionally, when municipalities have defaulted in the past, they have almost always paid off their debt eventually through restructuring programs. This is a stark contrast with corporate bond defaults where you just lose your investment. It may be different this time, after all, some of the biggest states in the union are in unprecedented territory with respect to their budgets. However, the default picture has been getting better. In 2010, there were 72 defaults on municipal bonds, (mostly for riskier financings like hospital and housing projects) down significantly from 204 in 2009 and 162 in 2008.

I'm more of a free market proponent, but unfortunately, I have to agree with Warren Buffett when it comes to the likelihood of municipal defaults. Mr. Buffett noted that "It would be hard in the end for the federal government to turn away a state having extreme financial difficulty when they've gone to General Motors and other entities and saved them."

Conclusion

There were a lot of ups and downs during 2010, but in the end every segment of the capital markets posted gains, many of them quite

a bit above their historical averages. We still have a ways to go before returning to the stock market highs of 2007, but we've had a couple strong years and full recovery is now a likely scenario rather than an abstract notion. No one knows what 2011 has in store, but most economists are optimistic about global economic growth. There are signs of a brighter housing and employment picture, which hopefully bodes well for further gains in the capital markets.

THE VALUE OF FORECASTS

With 2010 being an election year and a transition point in the economy, there was no shortage of "experts" offering prognostications of every stripe. It is tempting to take these opinions of the future as the truth. After all, most of the forecasters are highly credentialed and have decades of experience in their respective fields. Also, their views are typically offered with some manner of statistical evidence as back up. Of course, you know what they say about statistics.

So, how have the forecasters fared? Philip Tetlock is a psychologist at the University of California, Berkeley who has spent 25 years studying the soothsayers' forecasts to answer that question. His study included 284 people, including journalists, economists, market watchers, and government policy experts. 96% of the forecasters had post-graduate education. Dr. Tetlcok asked them all manner of questions concerning their areas of expertise over a twenty year period and ended up with a dataset of 82,361 predictions.

Dr. Tetlock's conclusions were not flattering. He found that the majority of the forecasts were wrong. In fact, they were wrong more often that you would expect than if the forecasts were picked at random out of a hat. The study found no partisan bias. Liberals, moderates, and conservatives were all equally wrong in their forecasts. Interestingly, the more famous the forecaster, the more likely he or she was to be wrong. Additional levels of education also had no impact on the results. Journalists performed as well (or as badly) as PhDs.

Why the dismal performance? Dr. Tetlock believes it has to do with behavioral issues that human beings are subject to, primarily overconfidence. The experts were convinced that their opinions were right, so they only focused on evidence that confirmed their theories, while ignoring those that seemed to counter them.

The results were not that surprising to me since I have spent the last decade or more researching the investment industry and I have found data going back to 1903 showing that the active market participants are largely unable to outperform a basic, naïve index. This is despite impressive educational and professional pedigrees. It was interesting to read about Dr. Tetlock's study though to see that the inability to see the future isn't limited to the investment world. At least we have index funds that allow us to sidestep the behavioral biases and forecasting error that cloud most of the industry. If only there was a way to "index" the politicians.

WHAT IS ARMBRUSTER CAPITAL MANAGEMENT?

Armbruster Capital Management is an investment advisor to individuals, families, and smaller institutions. Because we don't sell any investment products, we remain unbiased in our selection of funds. We use index funds to drive down costs, manage the tax bite, and gain broad exposure to the various segments of the capital markets. Ongoing communication is the cornerstone of our service offering. You can reach us on our cell phones anytime.

Required Disclosures

The law requires us to furnish you with a statement of our privacy policy on an annual basis. Our relationship requires us to obtain sensitive personal and financial information about you. This information is treated with the highest level of confidentiality and will not be disclosed to any third party without your consent unless required by law.

All registered investment advisors are required to file Form ADV with the Securities and Exchange Commission or state securities regulators on an annual basis. A copy of our updated form ADV is available at any time. Please let us know if you would like us to send you a copy.

Mark Armbruster, CFA
(585) 469-5199
mark@armbrustercapital.com