INVESTOR NEWSLETTER Armbruster Capital Management, Inc. 4TH QUARTER 2011

The ACM Journal

THE GIFT OF MUSIC

It was a musical holiday at our house this year. We bought our son Amer an entirely-too-expensive electric piano in anticipation of his upcoming piano lessons. After all, every six-year-old needs a professional-quality instrument to learn how to play "Chopsticks" before giving up on the whole thing after three months. Otherwise the experience wouldn't be quite as culturally enriching (or as financially impoverishing).

Also, my wife and her parents chipped in to buy me that electric guitar I've been wanting (can you say "mid-life crisis"?). I've been taking lessons for the past few months and can actually play a few songs now. My musical ability is somewhere on the caliber of a junior high school band. But, now that I have an electric guitar, my not-so dulcet tones can reverberate through the house for the whole family to enjoy. Fortunately, we don't really have any neighbors.

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Capital Markets Year in Review

After posting strong gains in 2009 and 2010, the stock market embarked on 2011 in fine fashion. The S&P 500 index was up 9.0% by April and was still up over 8.0% in early July. The first half of the year brought several issues and uncertainties, such as the Arab Spring revolts, a brutal tsunami and nuclear meltdown in Japan, continued rising unemployment in the U.S., another round of "quantitative easing" from the Fed to help jump start our economic recovery, and the first Greek bailout. The stock market remained steadfast through it all.

Then the environment changed. Congress and the President sparred over whether to raise the national debt ceiling. They ultimately reached a compromise to allow the government access to additional debt funding, but the deal came too late. Standard & Poors decided that our elected officials' fiscal profligacy jeopardized the creditworthiness of U.S. Treasury bonds. In response, S&P downgraded the credit rating of the United States from AAA to AA+. Consequently, the stock market lost its former resiliency. Stocks dropped precipitously, losing just shy of 18.0% from their peak in late April to their low on October third.

Market Declines Hurt Sentiment

The carnage was widespread, impacting stocks across the market capitalization spectrum and around the world. Mid-cap and small-cap stocks fared worse than the S&P 500 as investors looked for safe havens and shunned the riskier parts of the stock market. Stocks did recover some by year-end (the S&P rose 2.1% for the full year) thanks to a late fourth quarter rally, but volatility persisted through year end. The VIX Index, which is a measure of stock market volatility, spiked in early August, but fortunately did not reach the levels seen in 2008. At year end, major economic catastrophe was largely avoided, but many were left wondering whether we were truly in a recovery phase and if so, whether it would continue.

The international picture was even worse. Greece was on the precipice for most of the year and any modicum of good news with respect to its stability was quickly offset by concerns in Spain, Portugal, Italy, and Ireland. The

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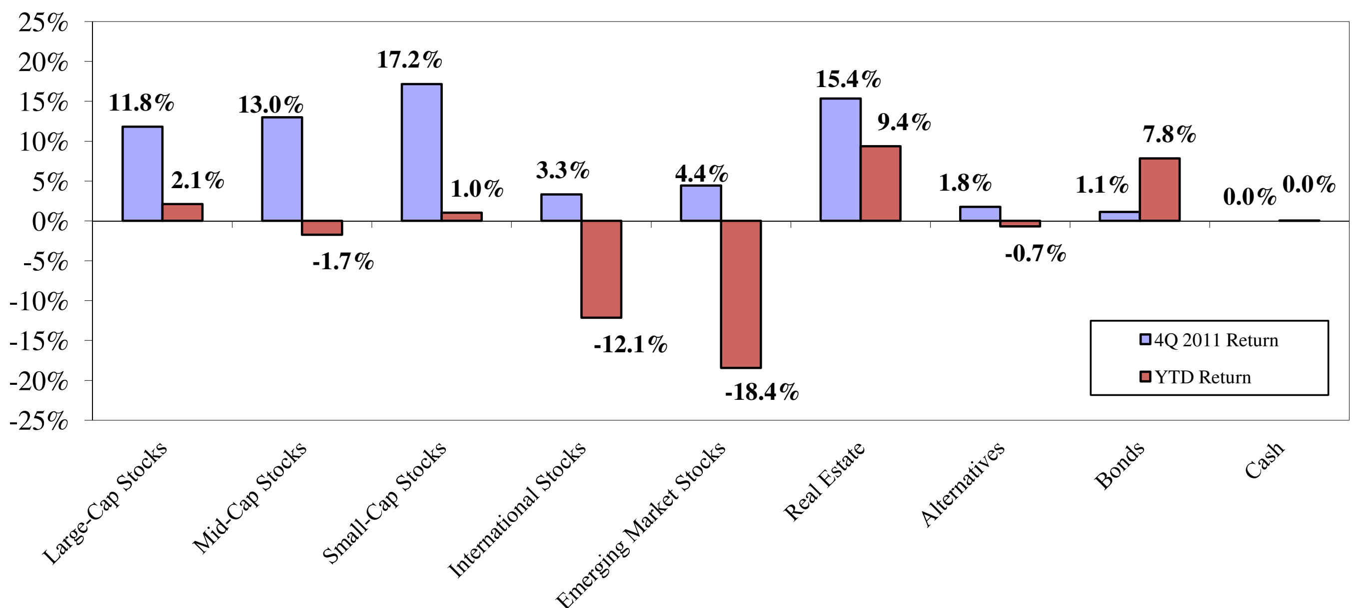
benchmark international stock market index, the MSCI EAFE, dropped over 24.0% peak-to-trough during the year, but ended the year down 12.1%. Surprisingly, the emerging markets were even bigger losers with the MSCI Emerging Market Index down 18.4% for 2011. Emerging nation economies are generally in much better shape than those of the U.S., Japan, and Europe. However, concerns over rising inflation, slowing economic growth, and a potential real estate bubble in China have caused many to wonder if the emerging markets will also fall on hard times in the near future. Probably the bigger issue is investor sentiment and risk aversion. Emerging market stocks have historically experienced boom and bust cycles, and a global recession could result in dramatic stock market losses (emerging market stocks lost over 65.0% in the 2008-2009 bear market) even if emerging nation economies hold up relatively well.

Throughout the year, investor sentiment remained low. Over the past decade, the U.S. experienced two major bear markets. This resulted in a "lost decade" in which stocks posted no returns with high volatility. These ten years, so different from the preceding two decades, made individuals and institutions question several traditional principles of investing. Many wonder if a buy-and-hold, long-term perspective is wise, whether highly correlated markets make asset allocation useless, or if stocks can still bring sufficient returns to justify their risk.

Déjà Vu

The era of the late 1970s was an analogous time period with respect to uncertainty and risk aversion. The stock market lost almost half its value between 1973 and 1974, the health of the economy was perilous, inflation was rampant, corporate tax laws were in dispute, and there was significant concern about the future of stock investing. Indeed, BusinessWeek famously wrote an article called "The Death of Equities" in August of 1979 that forecast the permanent demise of stock market investing. The article argued that investor sentiment at both the institutional and retail investor levels had shifted away from stocks and



likely would not return for many years. The article quoted experts who believed that gold was a better alternative and that the Japanese had policies that would ultimately make them more successful economic competitors. Interestingly, just two years later the stock market began the strongest bull market run it has ever experienced, rising at an 18.5% annualized rate over the next 18 years. Gold lost 2.7% per year over the same period and we all know what happened to Japan.

Investor sentiment was similarly bearish in the wake of the Great Depression. In speaking of the late 1930s, British author Piers Brendon wrote "In the United States, the most important commodity to be damaged was confidence. Not only was there disillusionment with Wall Street, but the prestige of business was shattered...Depression jokesters quipped, 'Don't tell my mother I'm a banker, she thinks I play the piano in a brothel.'" There is a similar backlash today with the rise of the Occupy Wall Street movement. The mood remained dour for some time; a public opinion survey commissioned by the New York Stock Exchange from the year 1954 found that only 10% of the adults surveyed would even consider investing in common stocks. From 1954 through the end of 1970, stocks earned an average return of 11.9% annually.

While it isn't a perfect relationship, periods of negative investor sentiment generally correspond to periods of strong opportunity. Past periods bear this out, but so do some shorter term quantitative models. Richard Bernstein used to be the Chief Strategist at Merrill Lynch. At the time, he said the strongest statistical measure of stock market performance he had was one that measured the sentiment of his Wall Street peers. Interestingly, it was a contrary indicator. If strategists were wildly bullish, the market tended to go down. If they were wildly bearish, the market had a tendency to rise. The field of behavioral finance has shown the tendency of human beings to extrapolate the current environment into the future. However, this is an irrational response. The economy and the capital markets have always experienced cyclical movements. Cyclicality creates volatility, but it also creates opportunity. We're supposed to buy low and sell high. Bear market cycles create those buying opportunities.

When Opportunity Knocks

So, it is probably time to push the negative sentiment aside and start thinking about opportunities for the future. Stock valuations are at reasonable levels, interest rates are low, corporate earnings are strong, inflation is tame, and there are some macroeconomic trends that appear favorable.

The average price/earnings ratio for stocks in the U.S. is around 12, below the long-term average. International and emerging market stocks trade at P/E ratios of around 10. While these low valuations reflect real economic challenges, they largely ignore the nearly unprecedented strength of the corporate sector. Domestic corporations are experiencing record earnings and profit margins and have seen a dramatic improvement in their "fundamentals" the past couple years. In fact, there are currently four companies with higher credit ratings than the U.S. government: Exxon Mobil, Johnson & Johnson, Microsoft, and Automatic Data Processing. In addition to their profitability, these companies and others maintain very solid balance sheets with heaps of cash and low debt levels. Corporations are taking advantage of this strength and investing in capital spending, technology, and infrastructure. This behavior will be good for the overall economy, and it should also gear companies up for future growth and returns. The improvement in earnings and profit margins also bodes well for employment. Corporations are already starting to ramp up hiring and will have to do even more to maintain their recent momentum.

Housing statistics have been well below trend levels for the past three years. Historical economic recoveries have included rebounds in housing, which we have not

enjoyed during this cycle. Additionally, much of the jobs recovery in past recessions was attributable to a rebound in the construction sector. However, we are starting to see signs of stability as new construction projects are popping up even in severely depressed markets like Florida and Nevada. If housing simply stabilizes, rather than improving, economic growth should improve substantially. Now that there is a glimmer of hope that the housing sector is at least bottoming, if not improving, hiring could resume and unemployment could decline faster than expected.

Also positive, the U.S. dollar has been weak when measured against a basket of our trading partners' currencies. This allows for a recovery in manufacturing to unfold at a faster pace since domestic goods will appear more attractive to foreign buyers when our currency is weak. Additionally, there is evidence that foreign companies are looking at this currency effect and deciding to outsource jobs to the U.S. Given the volatility of global currencies, it is not surprising that companies would want to diversify their manufacturing footprints so they can be more nimble in responding to the changes in currency rates and global economic cycles. This all bodes well for further jobs creation and economic growth.

Finally, the U.S. has the potential to secure energy independence in the foreseeable future. We recently became net exporters of petroleum products, there is significant potential in offshore oil drilling, and we have a large untapped natural gas resource. There is a lot of controversy over how these resources should be accessed, but the potential for the country to free itself of Middle East energy dependence could be a huge driver of future economic growth.

Bottom Line

There is reason to be optimistic about the future of our country and our economy, and there are a host of positive economic drivers that could help us recover lost ground in industrial output and job creation. As a result of these drivers, the consumer sector should regain confidence, spending will resume, and stock market valuations will likely rebound to levels reflecting the improved environment. These factors will be offset to some degree by the macroeconomic problems we face here and in Europe. This will result in continued stock market volatility and an economic recovery that unfolds in fits and starts. Nevertheless, the long-term outlook is quite bright and opportunity abounds.

To capitalize on the opportunities available in today's environment, we will continue to rebalance portfolios. Generally this will involve trimming back bonds, which have performed quite well and making new commitments to international stocks with low valuations. Over longer time periods, the process of rebalancing has been shown to add significant incremental return potential because it instills the discipline of buying low and selling high.

We've come through a long period of subpar returns. Historically such periods have been followed by multi-year periods of stronger gains. It may be a bumpy ride, but we expect the next decade to provide significant returns for investors willing to ride out the market's ups and downs.

FIRM NEWS

2011 was a busy year for us. We built out our team, installed a new computer system that greatly increased our productivity and security, and introduced a couple new advertising initiatives. We launched a new web site and advertised in some new venues toward year-end. We also earned some good PR through a quote in the Wall Street Journal and some speaking engagements throughout the year. Hopefully this will result in new business in 2012. Despite an unfriendly economic environment, we were able to add more new accounts than ever during 2011 and we continued to grow our assets throughout the year. Thank you to all of you for the new client referrals you sent our way.

Also of note, we were able to negotiate a lower commission rate on mutual fund trades at Charles Schwab. This has been an issue for the past few years as mutual funds with lower expense ratios (the ones we use), incurred trading commissions of $49.95. That seemed steep in an era of low commissions on stock trades. Finally, we were able to gain some traction so that mutual fund trading commissions will be $30 going forward.

Looking ahead, we hope to continue to build on our past successes and keep the positive momentum going. We're still looking for a more permanent home for our business. Hopefully we will bring that process to a close this year with new office space. That should be the end of the larger, restructuring initiatives we've been undertaking. From there, we want to continue to focus on refining the investment portfolios we build. We're always on the lookout for opportunities to add new asset classes or improve upon the funds we're currently using. Additionally, we want to continue to build on our service model. We will likely conduct a client survey later this year, but we are open to your feedback, positive or negative, any time. Please let us know if there is something on your mind.

COMPLIANCE CORNER

We were blessed with a Yuletide caller just before the holidays. No, it wasn't the big man in the red suit, but rather the Securities and Exchange Commission. We were notified that we would be the subject of an SEC audit. This is not unusual, but does present challenges because of the time involved in responding to the request. As a registered investment advisor, we are subject to a number of rules and requirements from the SEC. They periodically conduct audits of registered firms and it apparently was our time.

Despite what we view as a disruption to our normal operations, the SEC and the audit process are actually positive. There are countless honest firms out there, but also a few bad apples. By conducting audits, and even through the ever-looming threat of an audit, the SEC is able to keep the vast majority of us honest and working hard on our clients' behalf. So, while it may be a bit of a hassle for us, you should be glad that there is someone looking over our shoulder periodically. SEC oversight and the separation of investment management from investment custody (using firms like Charles Schwab and Merrill Lynch) are the strongest tools out there to make sure advisors walk the "straight and narrow".

It is also that time of year again when we remind you of our privacy policy and offer to send you an updated version of our Form ADV, which we file annually

with the SEC. 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.

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 global capital markets. Ongoing communication is the cornerstone of our service offering. You can reach us on our cell phones anytime.

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I have this vision of Amer and I becoming proficient enough that we'll be able to play together someday. I mentioned the idea of starting an Armbruster family band and Amer thought it was a good idea. He did say though, that he just wanted to play for fun and that we shouldn't try to get famous. I've always tried to encourage the children to set achievable objectives.

It has been fun getting into music and hopefully over time it is something the whole family will embrace. Besides, if this investment thing doesn't work out, I can earn some extra income by playing on the street corner in front of an upturned hat.

Armbruster Capital Management, Inc.
(585) 469-5199
mark@armbrustercapital.com
www.armbrustercapital.com

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