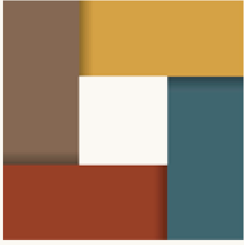


GHP Investment Advisors, Inc.

INVESTMENT INSIGHT

Fourth Quarter 2011

Foreign Stocks Hurt Us in 2011.
Is International Diversification Still Worthwhile?

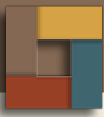
Brian J. Friedman, CFA

One of the hallmarks of our investment philosophy at GHP Investment Advisors, Inc. is that diversification mitigates risk. Our portfolios are diversified in a variety of ways depending upon each client's particular circumstances, but almost all of our equity portfolios are invested in foreign markets to some degree. Unfortunately, foreign markets tumbled in 2011 causing our globally diversified stock portfolios to under perform the major U.S. indexes such as the S & P 500 and the Dow Jones Industrial Average. This raises the obvious question whether international investments continue to make sense for the long term.

For a number of years prior to 2011 some investment gurus advocated for large foreign market allocations. Convinced that America was in decline and that the dollar would collapse, they repeatedly chastised myopic Americans for failing to notice that the $15 trillion U.S. stock market was now only 1/3 of the $49 trillion in publicly traded equities worldwide (down from 2/3 20 years ago). Some suggested that portfolio allocations should reflect these global ratios, with around 2/3 of a properly allocated stock portfolio invested outside of the United States. Of particular interest were developing economies such as China, India and Brazil which not only sported increasingly large stock markets, but rapid economic growth as well.

Until 2011, this hyper-global investment philosophy seemed to work well since foreign markets – particularly in developing countries such as China, India and Brazil – significantly outperformed the U.S. stock market. All of this reversed in 2011 as foreign markets plunged. The MSCI Europe, Africa and Far East Index fell 11.7% in 2011 and the MSCI Emerging Markets Index declined 18.4%.

We did not subscribe to the hyper-global point of view during the boom for the simple reason that most of our clients live in the United States and conduct their affairs in dollars rather than Euros, Yen or Yuan. Moreover, the United States continues to offer the widest array of investment possibilities relative to other countries while providing the best legal protection for our capital. Many foreign countries are just now starting to



develop an appropriate rule of law to protect investors. This statement applies to some developed countries such as Italy, not just low income emerging markets like China.

While we do not believe a majority of our clients' stock portfolios should be invested abroad, we continue to believe a modest foreign allocation is an appropriate diversification. Our rough target for most equity portfolios is 17%. If the legal protections for investors improve and the Euro Zone countries address their fiscal problems, then we could raise this allocation over time. At the moment, however, not all countries are facing impending collapse but are nonetheless attractively valued given the prevailing pessimism in the world today. One of these countries is, in fact, the United States.

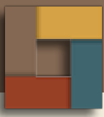
The United States is Slowly Picking Up Steam

Worries about an escalating European financial crisis exacerbated stock market volatility in the U.S., but our fears exceeded reality by a wide margin. The facts on the ground continued to improve slowly in America, further extending the economic recovery that began nearly three years ago. Even though indicators are moving higher in the United States, it will take many years before the U.S. economy returns to the levels of employment, lending and construction achieved prior to the "Great Recession" of 2008-2009.

To put the recovery into perspective, we aggregated data (displayed in tables below) for key problem areas in the U.S. economy. **The general picture conveyed is an economy moving away from financial crisis lows but still quite far from full recovery.** The tables also provides forecasts for the next several years. Like all forecasts, they are likely to be wrong in the specifics but we hope they communicate our more nuanced view of America's economic future. Investor psychology remains fearful of further crisis and potential collapse. As time passes and the U.S. economy continues to heal, market psychology should better reflect economic reality. The convalescence may be long and arduous, but the following data demonstrate that the patient's condition is improving.

Employment

In 2008 and 2009 8.6 million people lost their jobs. On top of this are 5 million recent graduates also competing for very scarce employment opportunities. This group of nearly 14 million people cannot be faulted for failing to notice that companies actually started hiring again in 2010. Over the past two years 2.5 million jobs have returned in the United States, and the pace is gradually accelerating. Nonetheless, the U.S. has only absorbed a small fraction of the unemployed because the economy is barely creating enough jobs to offset the 1.2 million first timers entering the work force each year.



U.S. government statistics indicate that hiring is picking up in most areas of the economy with three notable exceptions: construction, finance and government. Unfortunately these three areas were large and growing employers prior to the financial crisis. Construction layoffs seem to have abated, but recovery is several years in the future. Most financial fields are shedding jobs as are state and local governments. Our prediction is for modest job market improvement in 2012, but the U.S. will only start to absorb the vast ranks of unemployed workers in 2013 or 2014 as financial and government layoffs taper off. Even bigger job gains will only come further in the future as construction starts to recover, perhaps in 2015 or 2016. As a result, the unemployment rate is unlikely to return to its pre-recession low of 5.0% anytime within the next five years.

	2007	2008	2009	2010	2011*	2012E	2013E	2014E	2015E	2016E
Employment										
Job Creation	1,092,000	-3,600,000	-5,063,000	940,000	1,568,000	1,650,000	2,100,000	2,300,000	2,300,000	2,300,000
Unemployment Rate	5.0%	7.3%	9.9%	9.4%	8.6%	8.5%	8.0%	7.5%	7.2%	6.8%

Source: Bureau of Labor Statistics, www.bls.gov

*For certain indicators data for December is unavailable and is estimated or based on the last 12 months of available data.

Housing

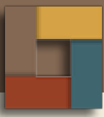
Home foreclosures may both accelerate and peak in 2012 as banks overcome the "robo-signing" controversy to push more foreclosures through the court system. Foreclosures could peak in late 2012 or early 2013 given greater job market stability, slowing home price declines, and limited lending to marginal borrowers in the aftermath of the financial crisis. Home prices should improve as foreclosure activity diminishes in late 2013 and 2014.

Home building will remain weak for years to come. In our view, home construction will only recover once foreclosures return to more normal levels and home prices stop falling. After that there could be a period where existing homes listed for sale surge as people can finally find a buyer for their house. A healthy home construction market is roughly 1.25 to 1.5 million units built per year, reflecting the demographics of new household formation in the United States. Although the construction market probably bottomed in 2009, activity may only return to normal levels after 2016.

	2007	2008	2009	2010	2011*	2012E	2013E	2014E	2015E	2016E
Housing										
Foreclosures	2,203,295	3,157,806	3,957,643	3,825,637	2,718,943	3,000,000	2,000,000	1,100,000	1,133,000	1,166,990
U.S. Home Prices	-9.07%	-18.64%	-3.10%	-2.39%	-3.62%	-3.00%	-1.00%	5.00%	3.00%	2.00%
Housing Starts	1,355,000	905,500	554,000	586,900	602,000	620,000	638,000	670,000	771,000	886,000

Source: The Census Bureau, www.census.gov; S & P Case Shiller Home Price Index, www.standardandpoors.com; Bloomberg, L.P.

*For certain indicators data for December is unavailable and is estimated or based on the last 12 months of available data.



Banks

U.S. banks wrote off an unprecedented $1.3 trillion in bad loans during the financial crisis. Ongoing foreclosures were fully accounted for by these large write offs, so banks actually returned to profitability two years ago. The problem is no longer the failure of banks on a large scale. Rather it is now the need to fully recapitalize bank balance sheets to reinvigorate lending.

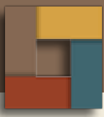
During the financial crisis banks raised $868 billion in fresh capital to prevent failure. Initially $330 billion of this money came from the federal government's Troubled Asset Relief Program (TARP), with the remainder coming from newly issued stock, asset sales and retained earnings in 2009, 2010 and 2011. Since 2009 the banks paid back $245 billion borrowed through TARP, with the outstanding balance of $81 billion likely to be paid back over the next several years. TARP is expected to cost the federal government very little and could perhaps net a small profit in coming years.

Banks will continue to retain earnings to further bolster their capital base. Nevertheless, it will take another several years of retained earnings before banks are fully recapitalized and ready to lend in greater volume. Even with improved balance sheets, however, most banks will keep mortgage credit tight until home prices stop falling.

	2007	2008	2009	2010	2011*
U.S. Banks					
Loan Write Offs	176.1	701.5	287.3	125.6	33.9
Bank Profits ($ Millions)	$101,662	-$12,928	-$18,166	$83,655	$114,411
Capital Raised ($ Billions)	$50.2	$478.8	$268.9	$35.9	$33.9
Failed Banks by Assets ($ Billions)	$2.6	$371.9	$169.7	$92.1	$40.5

Source: Bloomberg, L.P.; FDIC, www.fdic.gov

*For certain indicators data for December is unavailable and is estimated or based on the last 12 months of available data.



Stock Valuations Are Low...Meanwhile Bond and Real Estate Returns Are Abysmal

Stock market valuations reflect fears of another financial crisis and recession. For example, the Price-to-Earnings (P/E) ratio for the S & P 500 is similar to where it stood at the height of the financial panic in early 2009 just prior to gaining 97% over the subsequent three years. As outlined above, the U.S. economy will take a number of years to fully recover, but the job market and banking system are now healing. Housing remains the odd man out, but price declines are slowing and 2012 and 2013 may be the final years of the foreclosure mess.

Of course, current fears of another financial crisis do not emanate from the improving U.S. economy. This time our fears are imports from Europe. As we discussed in greater detail in last quarter's newsletter, we believe continued muddling through is much more likely than simultaneous currency, bank and economic collapse.

While predicting the future direction of stock prices is extremely difficult, particularly over the course of a few months or a year, we believe stocks will appreciate substantially in coming years. Given the combination of attractive valuations, improving earnings and ebbing fears of global meltdown, stocks have plenty of room for growth. In contrast, other major investment categories such as bonds or real estate offer abysmal yields. We believe rational investors will eventually realize that paltry 1% - 2% treasury yields pale in comparison to potential stock returns in excess of 10% based on current valuation arithmetic. Commercial real estate looks somewhat more attractive than bonds, but low interest rates, declining rents and high vacancy rates will keep yields on Real Estate Investment Trusts (REITs) low for several more years as well.

	2007	2008	2009	2010	2011*	2012E	2013E	2014E	2015E	2016E
Investment Yields										
Fed Funds Interest Rate	4.25%	0.00%	0.00%	0.00%	0.00%	0.00%	0.25%	0.75%	1.50%	2.50%
10 Year Treasury Bond	4.21%	2.18%	3.76%	3.38%	1.94%	2.50%	3.50%	4.00%	4.25%	4.50%
REIT Dividend Yields	4.9%	6.7%	3.0%	3.8%	4.5%	4.5%	5.5%	6.0%	6.3%	6.5%
S & P 500 P/E Ratio	17.0	12.2	23.9	14.9	13.3	14.0	14.7	15.4	16.2	17.0
S & P 500 Earnings per Share	$84.66	$60.54	$61.60	$84.51	$94.96	$106.81	$114.29	$122.29	$130.85	$140.01
S & P 500 Index Value	1,468.36	903.25	1,115.10	1,257.64	1,265.43	1,495.34	1,680.01	1,883.22	2,119.72	2,380.10

Source: www.federalreserve.gov; www.nareit.com; Bloomberg, L.P.

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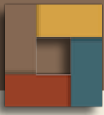

We Are Sober About the Current Environment…But Our Analysis Leads Us Toward Cautious Optimism

Clients often tell us we are optimistic. In truth, we recognize the problems confronting the U.S. and global economy. Employment, lending and construction will take many years to fully recover, but they are no longer declining. Europe is certainly an economic wild card, but renewed economic growth (albeit slow) in the United States will provide a fillip for our efforts to contain the fallout from their financial problems. As we discussed in our third quarter 2011 newsletter, Europe retains a variety of tools in their box to combat their mounting financial woes. The question is whether they will use them.

Our cautious optimism is based on our analysis that America faces continued economic problems, but our problems no longer threaten to renew a financial crisis. Stock prices, however, do reflect heightened fears of further crisis. **As our economic condition moves from terrible to bad and then to mediocre as it is now doing, we believe stocks will move higher despite continued volatility along the way.** Here's to a happy, healthy and prosperous 2012 for us all!

Market Summary

Key Financial Ratios for Domestic Asset Classes

Asset Class	Price/Earnings 2011:Q4	P/E Benchmark	Over/Under Valuation	Price/Book Value 2011:Q4	P/BV Benchmark	Over/Under Valuation
Large-Cap Growth Stocks	15.1	27.0	-44.1%	3.4	5.7	-40.4%
Large-Cap Value Stocks	11.5	20.2	-43.1%	1.4	2.5	-44.0%
Mid-Cap Growth Stocks	20.0	24.8	-19.4%	2.8	4.5	-37.8%
Mid-Cap Value Stocks	15.1	19.1	-20.9%	1.4	2.2	-36.4%
Small-Cap Growth Stocks	19.3	23.2	-16.8%	2.4	3.5	-31.4%
Small-Cap Value Stocks	22.4	18.2	23.1%	1.3	2.1	-38.1%

**Please note that the P/E data reported above are based on "as reported" earnings information rather than "operating" earnings. "As reported" earnings include one time write-offs whereas "operating" earnings reflect the profitability of a company as a going concern. We believe P/E's based on operating earnings are a better long-term valuation indicator, but Standard and Poor's does not report this information for the style indexes used in our calculations. Amid economic recession, declining earnings impact price-related ratios and "as reported" earnings can be significantly lower than "operating" earnings (particularly in the Value segment of the market) due to large write-offs. As a result, the P/E ratios listed above are higher than they would be using "operating" earnings for the denominator. To address this issue we have included Price to Book Value (P/BV) data, which are less affected by the impact of declining earnings and large write-offs.*

GHP Investment Advisors, Inc. benchmarks are based on proprietary discounted cash flow models. P/E and P/BV data provided by Bloomberg L.P. as of 12/31/11.

Returns by Index

Index	2011:Q4*	YTD*
DJIA Total Return	12.75%	8.34%
NASDAQ	8.21%	-0.79%
S&P 500	11.82%	2.11%
S&P 500/Value	12.98%	-0.48%
S&P 500/Growth	10.81%	4.65%
S&P MidCap 400/Value	15.88%	-2.43%
S&P MidCap 400/Growth	10.26%	-0.94%
S&P SmallCap 600/Value	18.58%	-1.38%
S&P SmallCap 600/Growth	15.85%	3.62%

DJIA & NASDAQ: Bloomberg L.P. as of 12/31/11.

S&P Returns: Standard & Poor's Financial Services LLC. (2011). S & P Indices. In Standard & Poor's/Americas. Retrieved January 3, 2012, from http://www.standardandpoors.com/home/en/us

*Dividends Reinvested.

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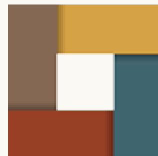

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