



**4<sup>th</sup> Quarter Commentary**

January 1, 2012

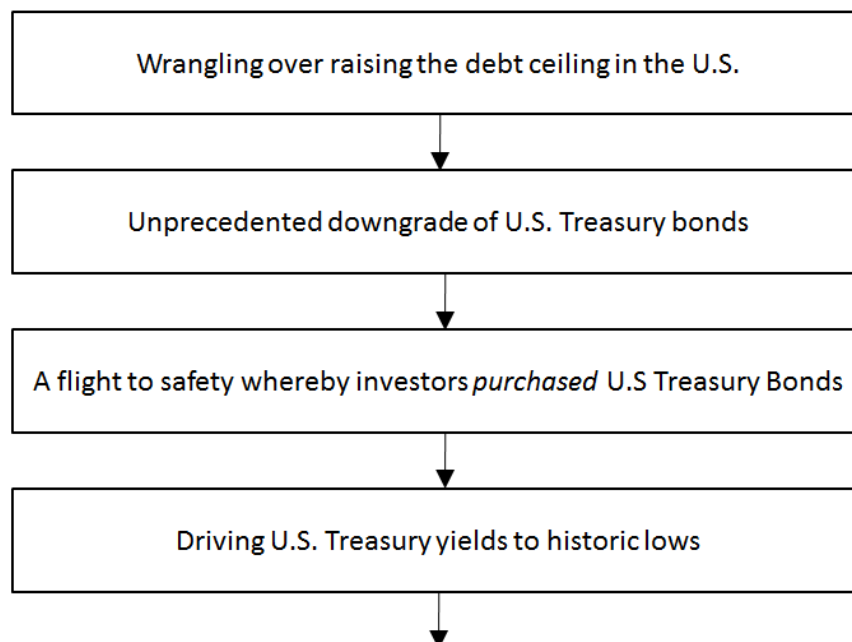
*“Things alter for the worse spontaneously, if they be not altered for the better designedly.”*  
Francis Bacon

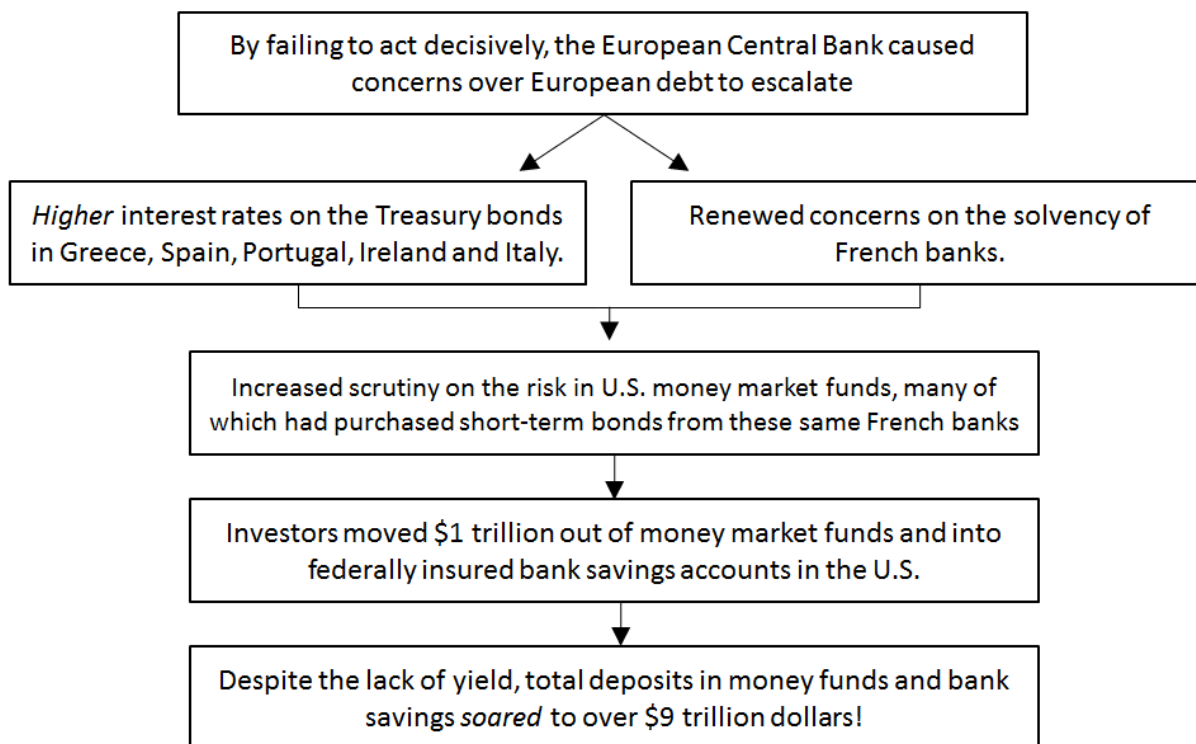
Dear Investor,

There is a type of cloud known as cumulonimbus that contains winds so intense and unpredictable, pilots never fly through them. However, even the most experienced aviators occasionally get caught in one. In 1959, Lt. Col. William Rankin was forced to bail out of his jet while above a cumulonimbus cloud. He spent 30 minutes bounced around inside the storm. Fortunately, he survived.

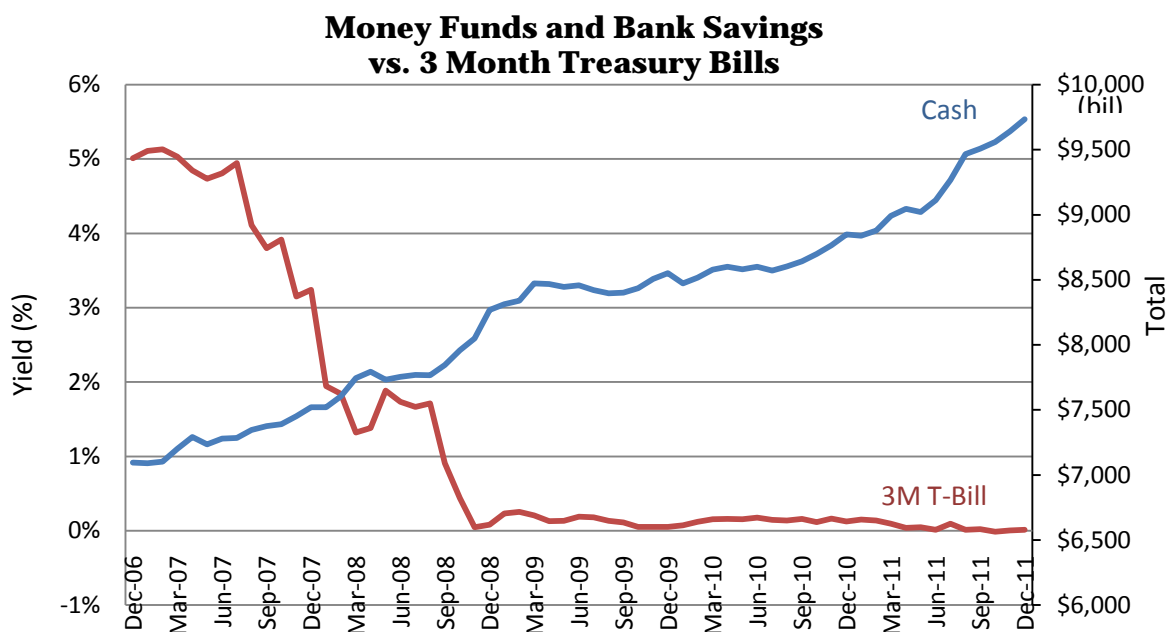
I think this is an apt analogy for the financial markets in 2011 as well. Despite experiencing the most volatile week *ever* in the history of the Dow Jones Industrial Average, we not only survived, in many cases we thrived as well.

Although the S&P 500 was little changed from where it began 2011, we begin 2012 with a landscape vastly different from a year ago. In particular, Treasury yields are at historical lows, short-term interest rates are hovering close to zero, and the price of gold is near an all-time high. The old rules no longer seem to apply. Consider the following sequence of events

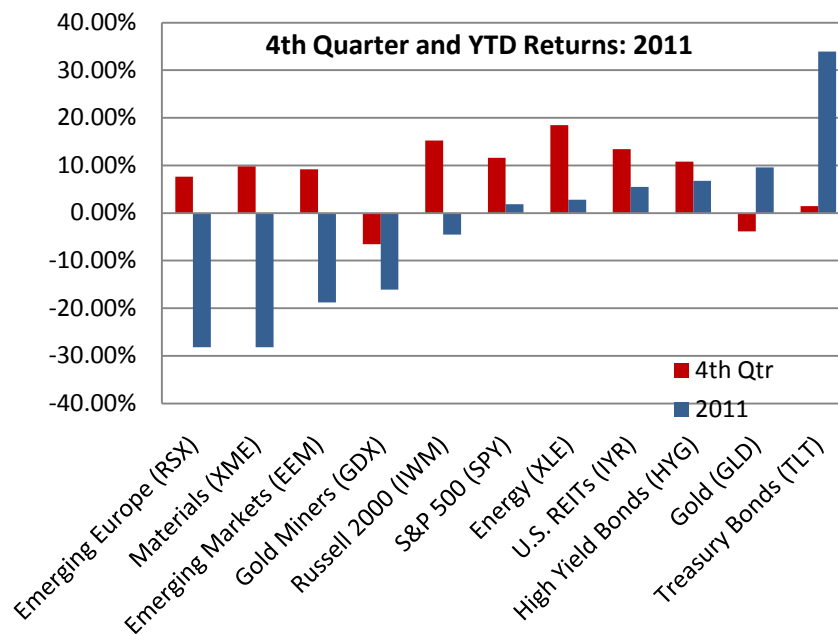




Let's think about that last point for a minute. In 2006 the average price of a loaf of bread was \$1.49. Today, that same loaf of bread sells for \$2.99 – *double* what it cost 5 years ago. By comparison, home prices in the U.S. have declined 31% over the last 5 years, while the yield on a 3 month Treasury Bill has declined from 3.5% to just 0.013%. In practical terms, this means your typical investor today is either eating half a sandwich or they are depleting their savings. And, going forward, what will happen to the real value of the \$9 trillion currently on the sidelines?



Storm clouds clear eventually, and I believe that is the case as we enter 2012. To be sure, concerns linger, and there are mines on the road ahead. But there is also cause for optimism. In particular, an improving U.S. economy, abating European debt concerns and compelling equity market valuations make the outlook for 2012 brighter, if not rosy.



Of critical importance will be integrating the changes that occurred in the investment climate last year into our investment approach going forward. While 2011 validated that the methodologies behind our investment strategies are sound, Partnervest has since made several modifications and improvements, and we are seeing signs that they are contributing towards improved performance and risk mitigation. I'll describe each in more detail below.

## STAR II

During the first quarter of 2012, Partnervest plans to incorporate additional features in the current STAR II portfolios. This should help further refine returns, and reduce correlations between different models.

Time has shown our security selection process is solid and adds significant value. Furthermore, we feel that over time, volatility can work in an investor's favor, if managed correctly. What is needed, and what we'll be adding, are different investments depending on the model. For instance, we'll be replacing "growth" investments, such as Emerging Market equities and High-Yield bonds in our Conservative model, with securities that exhibit less volatility. Along the same lines, we'll be reducing or replacing investments in income-producing investments in our Growth model with securities that come with higher potential returns, but exhibit greater price fluctuations.

In response to investor demand, in 2012, we are debuting a new model to our STAR II suite. Dubbed Conservative Income the strategy comprises an all-ETF portfolio which seeks to produce an attractive level of current income with preservation of capital as the primary objective. The strategy is currently yielding approximately 2.25% net of fees. Due to the low maturity of the securities in the component ETFs, The Conservative Income model should be very adaptive to an increase in interest rates in the future.

### **STAR III: VEGA**

In order to enable the *managed* strategy to more closely match the *model*, Partnervest made numerous modifications to VEGA in 2011. We implemented additional changes with the goal of further reducing the risk of the strategy as well. In summary, we<sup>1</sup>:

- Will be adding the protective puts to all VEGA accounts
- Incorporated the use of transactional shares which enabled us to more effectively rebalance accounts and capture earned option premium
- Streamlined the ETF portfolios, both reducing the number of different ETFs used and the volatility of the ETF portfolio as a whole
- Reduced the number of trades and transaction costs, especially for smaller accounts
- Changed the management of the Volatility Index ETF (VXX) from a permanent position to a tactical one

The benefits of these changes became evident as the 4<sup>th</sup> quarter brought significantly lowered volatility, improved performance and less disparity of returns between large and small accounts.

<sup>1</sup> For additional details, please consult your financial Advisor.

### **STAR III: Alpha**

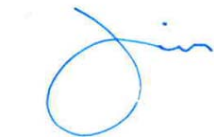
The large rally in U.S. Treasury bonds in 2011 meant that for most of the 3<sup>rd</sup> quarter and all of the 4<sup>th</sup>, the iShares Barclays 20+ year Treasury Bond ETF (TLT) was priced too high for inclusion in Alpha. This has occurred in the past, and we feel that stepping aside and waiting is a better proposition than owning Treasuries when they are trading at high premiums to par value. Such is the case at present. In those instances, cash serves as collateral, securing the eventual repurchase of the TLT at lower prices. Suffice to say, the Alpha strategy offers the potential for positive returns regardless of the current price of the TLT.

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## Summary

As I mentioned at the start of this letter, 2011 was a challenge for many, if not most, investors. Warren Buffet lost \$2 billion personally. MF Global became the 8<sup>th</sup> largest bankruptcy in U.S. history. John Paulson, who had successfully navigated his hedge fund through the Financial Crisis, finished the year down 46%. By comparison, I feel our returns held up rather well in 2011. The best investors learn from history, adapt, and emerge more resilient than before. That is how we approach investing at Partnervest. Figure out what works, and what doesn't. Focus on the first. Perhaps Buffet said it best: "I have no idea on timing. It's easier to tell what will happen than when it will happen."

Sincerely,



James Herrell, CFA

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