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## Running in Place



Any investor that peeked at the stock market on January 1, 2011 and then looked again on January 1, 2012 would have had the opinion that it must have been a very dull year. Since the S&P 500 ended the year almost exactly where it began, it might seem as if the market was “running in place” and going nowhere. That opinion would be understandable given a quick look but it could not be more wrong!

The markets went nowhere in a very frenetic manner.

**Of course, the mess in Washington did little to instill calm and confidence.** The ridiculous battle to increase the country’s debt limit made us the laughing stock of the world and did little to instill confidence in our government, giving the markets cause for concern. The debt downgrade from AAA to AA should have been a wake-up call but was not. And now our President is asking

**“The stock market remains an exceptionally efficient mechanism for the transfer of wealth from the impatient to the patient.”**

Warren Buffet

for another bump in the debt ceiling of \$1.2 trillion. How is this possible?? That is another 8% increase in our national debt. I can just hear our founding fathers screaming from their graves. I had hopes that the earthquake that rocked D.C. would knock some sense into our legislature but, alas, that was not to be. Are we on our way to mimicking European socialism? Is a sovereign debt crisis imminent for the U.S.? Let’s hope not!

### THE FRENETIC YEAR

The year 2011 was a pre-election year and, as such, is usually the strongest of the four-year presidential election cycle. The pre-election year has posted gains 73.5% of the time over the years and the last time a pre-election year posted a decline was in 1939. Although the loss during 2011 was minuscule it was still

### Improvement in Our Sentry Program

As you may already know, the Navigator Sentry Strategy is a program that attempts to limit downside loss in our portfolios during difficult market periods. The strategy was put in place in early 2003 and has been performing extremely well over the past nine years. This strategy gave our clients the peace of mind to stay the course during the very difficult bear market years of 2008-09. The strategy has utilized S&P 500 put options as the allocation to volatility since inception. While the put contracts do a very good job of limiting downside losses, there is a price to pay (in addition to the cost of the puts) in that there is a drag on upside moves in the market. We have been able to manage this drag to keep it to an acceptable level but even then there have been times when the drag became excessive.

During the past year we have been performing extensive research on other methods to hedge our portfolios from excessive loss while attempting to capture more of the upward market movement. In late December we sold all the S&P 500 put options and replaced them with two ETPs, (exchange traded products) which invest in volatility. These vehicles are relatively new but the underlying assets have been in the market for several years, are well proven, and are based on the CBOE Volatility Index (VIX). **The results of our research were very exciting to say the least. This method retains the downside limits that we have enjoyed but allows us to capture a far larger portion of the market while it is rising.**

There are several benefits to the new hedging strategy. This new method provides a more enhanced way to hedge. One of the problems with the put options is that they expire on a certain date and their value diminishes as that date approaches. Using volatility avoids the drag caused by the time decay of a put option. There are many other advantages to this new hedging method. Please look at your statements to see these new ETPs in action.

classified as a loss. The S&P 500 began the year at 1257.64 and finished at 1257.60 making it the first year since 1939 to post a loss. **In addition, the year was one of the most volatile on record.** The S&P 500 100-day volatility index finished the year at levels seen only three times since the great depression. Also, the S&P 500 had reversals of at least 5% on fourteen occasions which is more than double the average for such reversals. Another indication of the frenetic nature of the year was the Dow Jones fluctuating 400 points on four days, for the first time ever, in August. The daily price swings on the S&P 500 averaged 2.2% for that month which made August the wildest August since 1932. The rest of the year was no exception. Since the beginning of August, 60% of all trading days saw a daily move of 1% or greater. There were only four other times in history where there were more days with 1% fluctuations. To top it all off, the market proceeded to decline for seven straight days in November. The Index also had its second smallest annual change in history and it was only the fourth time that the S&P 500 had an annual gain or loss of less than 1%. As I mentioned earlier: “a very frenetic year!”

After a very sloppy January, the S&P 500 rose 8.4% to a three year high on April 29<sup>th</sup> of 1364. This was the pinnacle for the market move from the bottom in March 2009 and capped the 104% move of that bull market. This was followed by a decline of 19.4% on the S&P 500 into a bottom on October 3<sup>rd</sup>. **While this is a tad short of bear market territory, other indices did decline far more than 20% to allow the decline to be classified as an official cyclical bear market.** While these market movements may seem very clear, they were actually extremely choppy and ill-defined making it very difficult to react appropriately.

With all this movement, the U.S. market still went nowhere, while most world markets took it on the chin in a very dramatic fashion. The MSCI EAFE (Europe, Asia, Far East) index declined 12.1%, Germany declined 17.4%, the MSCI Emerging Market Index lost 18.4%, MSCI Asia ex Japan fell 17.3% and Japan fell 20.5%. The biggest loser (besides Greece at 62%) was India losing 26.3%. Overall, not a rewarding year.

Mutual funds had their worst year since 1997 relative to their benchmarks as record high correlations and wild

price swings made stock picking extremely difficult. Some popular and highly ranked funds such as CGM Focus Fund lost 26.3% and Fairholme Fund declined 32.42%.

## HOW DID WE DO?

We also had a very difficult year. Overall a very frustrating year in which we underperformed the benchmark for our global allocation programs, the MSCI World index which itself was down 5.4%. These programs include our ETF Global Equity Hedged and Unhedged, the Navigator Global Hedged Fund, and the Navigator Unified Managed Accounts Hedged and Unhedged. All of these programs invest in Europe, Asia, and emerging markets in addition to the U.S. As mentioned above, these world markets were a large drag on performance. **There were, however, some bright spots, where we outperformed the relative benchmarks.**

**All of our fixed income strategys outperformed their relevant indices.** These include the *Fixed Income Total Return* program, discussed in detail in the last Navigator Report. In addition, our *Premier Tax Free Bond Income* program, which invests only in tax-free municipal bonds, also beat its index. *The Taxable Fixed Income Bond* program, which invests in government bonds and high grade corporate bonds, also exceeded its index.

**In the equity arena, our *Premier High Yield Equity* program performed very well, exceeding its index and returning over 7% before advisory fees.** This equity portfolio is managed by Maira Thompson, one of our Senior Portfolio Managers with 29 years experience. The portfolio invests only in U.S. large-cap high quality stocks with good dividend yields. This was the only equity area in which to get favorable returns last year and Maira did a splendid job.

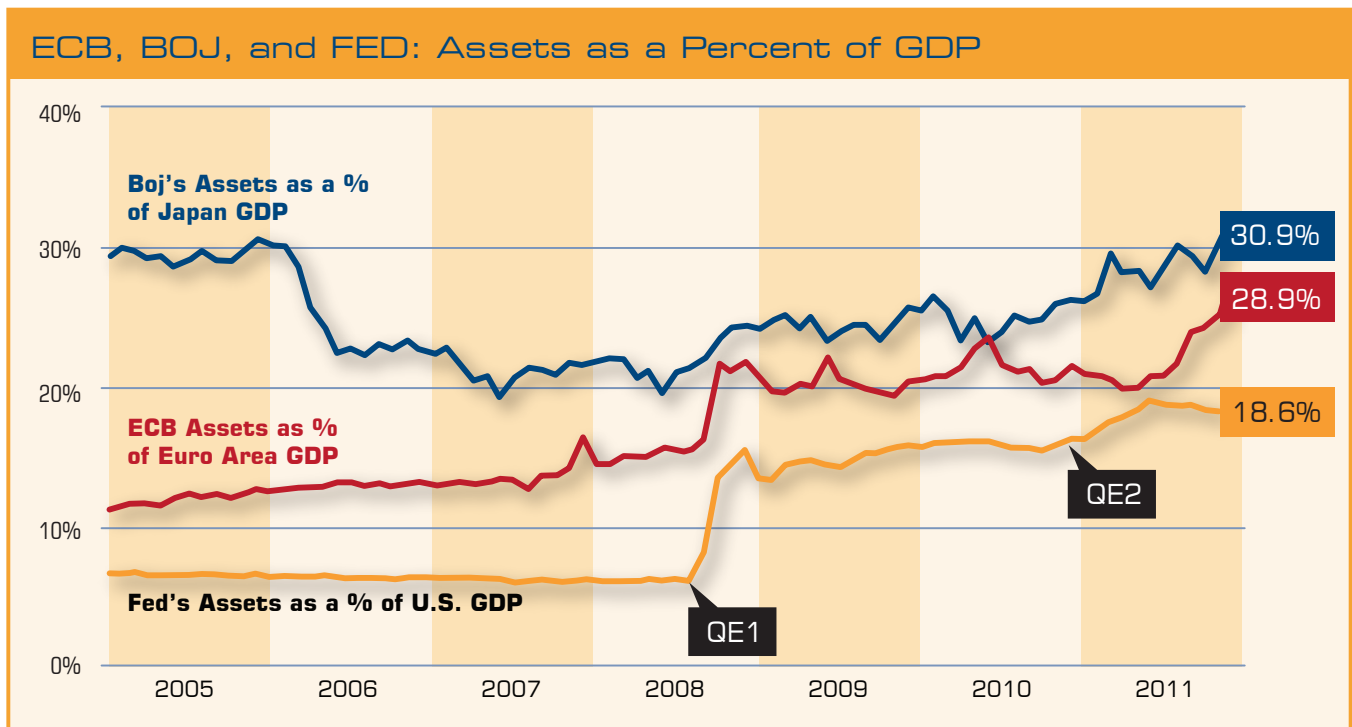
## HOW DO WE INVEST? OUR RELATIVE STRENGTH METHODS

Our primary investment philosophy uses Relative Strength to discern stocks, sectors, and countries that are displaying high strength relative to others, hence profit potential. When everything moves in lockstep, or in high correlation,

it makes it extremely difficult to find pockets of strength. The S&P 500 exhibited a correlation of .86 during a large part of the year. If the number was 1 that would mean that all stocks in the index moved exactly the same. In the international markets the swings were very wide and very short, driven by the massive uncertainty of the debt crisis gripping Europe and by fears of a hard landing in the Chinese economy.

Our performance during the year brings into question the efficacy of our relative strength methods. One of the chief proponents of relative strength is Ken French, from Dartmouth, who has been researching this method for many many years. There is a study which compared the total return of the S&P 500 and the return using Relative Strength to select the best stocks in the index on a rolling ten-year basis since 1940. **The average ten-year return was just under two times for the relative strength method. Most important is that the ten-year rolling returns of the relative strength method outperformed in 100% of the time periods.** This is but one study that shows that Relative Strength works consistently and these results provide the confidence to stick with this methodology through thick and thin.

Our Relative Strength studies are quantitatively based using computer models to generate the rankings. Our head of Research, David Rights, is in his 42<sup>nd</sup> year in the investment arena and all of his time is spent working with and researching the computer models we use in our rankings. We rank U.S. Sectors, International Countries and Regions, Equity Styles, Fixed Income vehicles and Alternative Investment vehicles. It requires several thousand computer models to rank all of these issues against all others to generate the strength rankings. *While we are disappointed about our performance over the past year we firmly believe that the key to good long term success in the equity markets is sticking to a strategy that has performed well over multiple market cycles even when it stops working for a short time.* Our strategy underperformed to almost the same degree during 2006 and the following four years experienced significant over performance. No strategy works 100% of the time but proven strategies work most of the time. Our professional portfolio management staff has over 275 years of combined experience and we promise to give our clients our very best efforts to obtain the best possible returns, with the lowest risk.



Source: Bloomberg, Guggenheim Investments. Data as of December 28, 2011

## THE EUROPEAN DEBT CRISIS AND THE EURO

The euro is the currency of seventeen nations in the European Zone. It was launched as a trading currency to facilitate trade between European member countries in 1999. **The initial peg to the dollar was €1.18/\$1.** Consumers began to use the euro on January 2, 2002, which was the first time that anyone could swap a member currency for the euro. There was quite a celebration at the time with fireworks over the European Central Bank headquarters in Frankfurt, Germany. Initially there were twelve countries that had access to the euro as symbolized by lighting the historic Pont Neuf bridge in Paris in European Blue with twelve rays of light to symbolize the twelve countries. Since the initial launch five more countries have adopted the currency.

There was less than universal acceptance of the new currency as prices rose dramatically. I can personally attest to that as I was in a German village shortly after the introduction of the euro and purchased a vase. When I peeled off the price sticker (in euros) there was the price in deutsch marks. The price had literally doubled overnight. It is true that the Germans (and other Europeans) still love their national currency. There is believed to still be over eight billion dollars in deutsch marks in the hands of German citizens “just in case” the euro fails.

There is no doubt that there has been, and still is, a massive amount of European sovereign debt to be refinanced. The chart on the previous page compares the Quantitative Easing that we have all experienced and heard about in our own country with that of Japan and the euro zone. You can see that over the recent six months there has been a massive effort to recapitalize European banks.

A large part of the turmoil in world markets over the past year has been due to the sovereign debt crisis in Europe. Poorer countries (Greece, Portugal, Ireland, etc.) have spent far too much to stay up with the wealthy countries (Germany, France, the Netherlands, etc.) and now they must pay the price. Greece will most likely default on its debt even though the debt has been reduced by 50%. Will there be others. We should pray there are not!

**Will Europe enter a recession?** Yes! It already is in one, in my opinion. Will this affect the U.S.? That is the biggest question of the coming year. Historically, recessions begin in the U.S. and spread to the euro zone. If a recession in Europe is mild then there is almost no chance that it spreads to the U.S. If it gets out of hand and is deeper than expected, then there may be some fallout in the U.S. Interestingly, only 10% to 12% of U.S. exports go to Europe. But many American companies have operations in Europe and a deep recession there could have adverse effects on corporate earnings.

**Will the euro survive?** Yes, because it would be an unmitigated disaster to go back to local currencies. This is a change of heart for me as until recently I did not believe the euro could survive. The European Central Bank will do just barely enough to keep the euro afloat. Survival might be in a little different form with potentially less countries participating but I believe it has to survive.

## CORPORATE EARNINGS AND ECONOMIC INDICATIONS

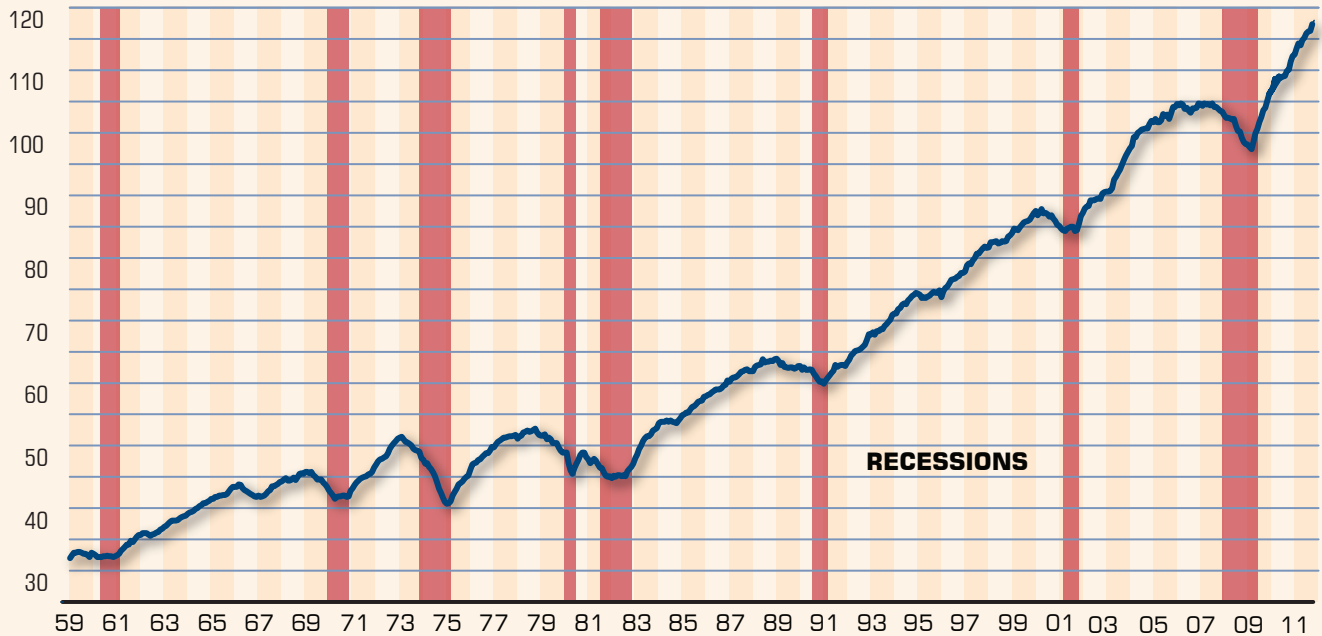
Corporate earnings have been a very bright spot on an otherwise lackluster economic backdrop. It is expected that when fourth quarter earnings are reported, the S&P 500 will show earning gains of 16% for the year. That would mean earnings of \$97.10 which would better the old record of \$87.70 from 2006. With earnings this great why is the market not soaring? With earnings of \$87.70 the earnings multiple is at only 13 times, a very cheap level historically. Earnings might not grow at the same level in 2011 but they are forecast to easily exceed \$100/share on the S&P 500. **If the earning multiples only expand to 15 times, then the S&P 500 could reach 1500 by late this year or early next year.**

In addition, the economy seems to be ticking right along. The chart on the next page shows that the Leading Economic Index is still accelerating. December was the seventh month that the Conference Board's Leading Economic Index has moved higher.

## PRESIDENTIAL CYCLE

We are all aware (maybe even painfully so with all the debates) that 2012 is an election year. The election year

## U.S. Leading Economic Index



Source: Conference Board

is usually the second strongest year of the four-year Presidential Election Cycle. The pattern is well established with the pre-election year being the strongest, except for 2011 which was an exception. We had cautioned that because of the strong gains in 2009 and 2010, 2011 might not be as strong as could be expected by the cycle.

Since 1928 the election year return has averaged 6.6% on the S&P 500. The chart to the right shows how most election years track with a low in the summer and then the election rally going forward.

Over the past 50 years, every time an incumbent president has run for re-election the market has had a positive return with an average of 13.6%. This is not a coincidence as any sitting president, usually, wants to be re-elected. Therefore he will do anything and everything he can to be re-elected. President Obama is no exception.

An incumbent has lost three times over this period: Ford, Carter, and H.W. Bush. Market return in these years was 19.1% when Ford defeated Carter, 25.8% when Carter lost to Reagan, 4.5% when H.W. Bush lost to Clinton.

### What Happens When a Sitting President Runs for a Second Term?

Sitting President	Year	S&P 500 Gain	Outcome
Lyndon Johnson	1964	+13.0%	Won by Landslide
Richard Nixon	1972	+15.6%	Won by Landslide
Gerald Ford	1976	+19.1%	Lost to Carter
Jimmy Carter	1980	+25.8%	Lost to Reagan
Ronald Reagan	1984	+1.4%	Won by Landslide
George H.W. Bush	1992	+4.5%	Lost to Clinton
Bill Clinton	1996	+20.3%	Won Easily
George W. Bush	2004	+9.0	Won Narrowly
Barack Obama	2012	???	

Source: Almanac Investor

### OUTLOOK 2012

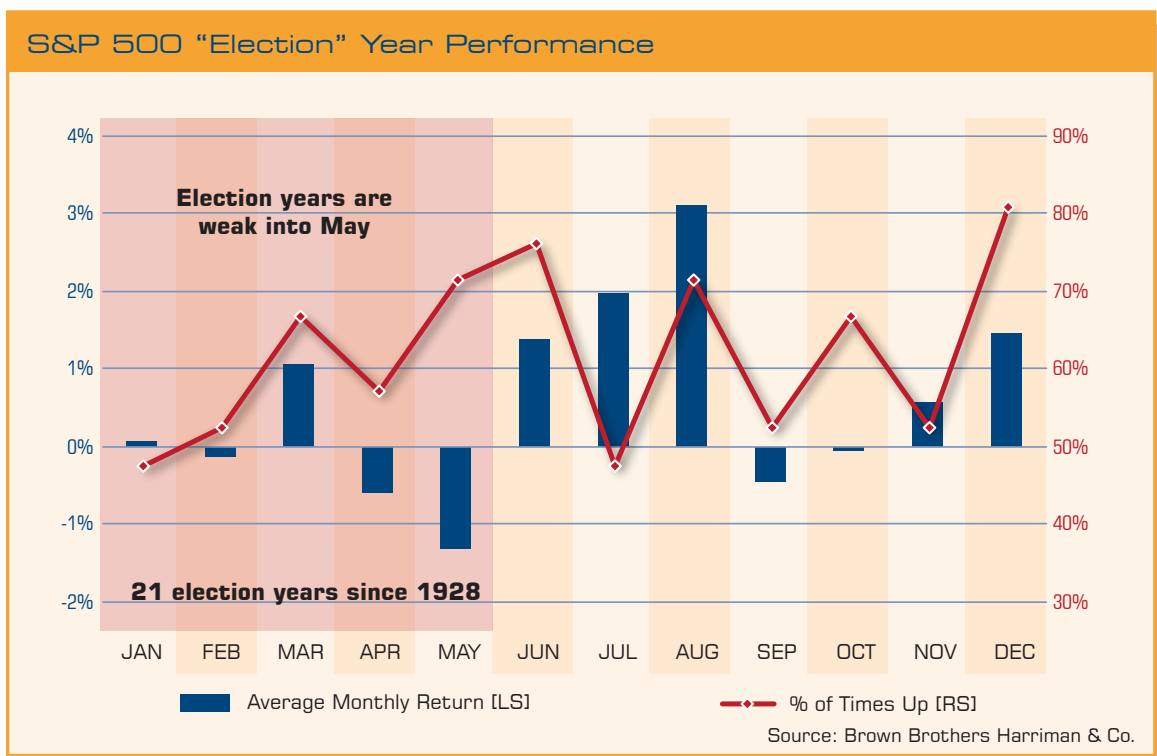
As mentioned by our Chief Investment Officer, K. Sean Clark, CFA® in his Market Outlook for 2012 “The range of potential outcomes in 2012 is very large.” There are so many items that can effect the markets this year that it will be difficult to use historic norms to discern a pattern for 2012. This being said, we will try to give an idea of what this year may bring.

We have often shown work from Ned Davis Research and especially his cycle composite for the year. This composite combines several yearly composites with the Presidential Election Cycle and is a best guess for a roadmap of the year based on these historical cycle composites for the S&P 500. Ned Davis cautions that this is only a “best guess” but it is in line with election year patterns and other historic trends.



Source: Ned Davis Research

The chart depicts a sideways movement in the spring and then a decline to a bottom in mid-summer. This is consistent with a monthly seasonal pattern that has been in place since 1967 as shown in the next chart.



A strong January, which we are experiencing at the moment, usually gives way to a weak February where the markets move sideways. March and April are normally stronger months leading into a weak summer. The S&P 500 could challenge the April 2011 high of 1364 before the summer decline begins.

The decline of almost 20% from the peak on April 29<sup>th</sup> to the bottom on October 3<sup>rd</sup> during the second half of last year is called a “waterfall decline” because of the swiftness of one portion of the decline. These declines are unusual as there have only been eleven since 1929. It is unusual for a market to recoup all of a waterfall decline very quickly and the shortest recovery was during 1970 when it only took nine months to eclipse the pre-waterfall high. The high point prior to the waterfall decline of 2008 has still not been reached. Of the eleven declines, the four shortest recoveries averaged thirteen months. So, potentially we may have to wait for later in the year to surpass the April high of 2011.

As stated earlier, 2011 was only the fourth time in history that the S&P 500 had a gain or loss of less than 1%. Since 1929, the S&P 500 has only ended with a gain or loss of under 3% nine times. **This happens to be a good omen for 2012 because since 1950 the median gain, following these small movement years, has been 17.9%.** The average loss was 1.6% while the average gain was 20.9%.

There is an old stock market adage called the January Barometer which was developed by Yale Hirsch of Stock Market Almanac fame in 1972. It states, “So goes the first week of the new year, so goes the month and so goes the year.”

When the first five days of the year were positive, 33 of 38 occasions resulted in gains averaging 13.4%. That is an accuracy rate of 86.8%.

The January Barometer also extends to the first month of the year and says that as goes the S&P 500 in January so goes the year. This indicator has been accurate 88.5% of the time, only being wrong seven times. If you add in the seven times when the index was up or down less than 5%, then the accuracy goes to 77%. Of course the verdict is still out but this does bode well for this year.

There is another simple indicator that you can watch easily in conjunction with the January Barometer. It includes the low for the Dow during the month of December, which was 11766.26 on December 19, 2011. If that low is breached during the first quarter, extra caution is advised. This has only been wrong on two occasions since 1952. If the low is not penetrated, then the January indicator has been correct 100% of the time.

## SUMMARY

While the past few weeks have been encouraging, there are many risks still facing the U.S. and global economies. Yes, U.S. corporations are enjoying record earnings, have record cash, and the low U.S. dollar is encouraging heavy exports. And while the European debt situation has been quiet for the time, the problem has not even remotely been solved. There is \$203 billion of European debt coming due early this year and that could pose a problem even though the recent debt auctions in Spain and Italy have seemed to go well. Thankfully, the European Central Bank and other world economic institutions remember the Lehman disaster and will do all in their power to make sure that experience is not repeated. There are solutions if the respective areas have the will to avert a disaster. Believe me, the European mess, if allowed to get worse, would spread to the global economy and cause massive dislocation in the U.S. and elsewhere.

The U.S. debt problem is another great concern. If this problem becomes a major discussion during the upcoming election battle it could derail the economy and investors renewed appetite for stocks. **And quite a problem that would be! Government spending represents 24.7% of the economy while tax revenues are only 16.9%. How long can this go on? The answer is: NOT MUCH LONGER!!**

The markets could enjoy an exceptional year this year propelled by a large underinvested position in stocks and massive cash on the sidelines. Bonds, except for high yield bonds, yield very little return and there is no doubt that rates will begin to rise at some point. Rising rates will not bode well for bond holders. On the other hand, there are wonderful companies with good growth prospects paying dividends far in excess of bond yields that are begging to be bought. As mentioned earlier, our best program last

year, Premier Portfolios, enjoyed a stellar year by staying invested in very high quality dividend paying stocks.

## POTENTIAL FOR THIS YEAR

**If the market remains on the bullish path, we expect a test of the old high on the S&P 500 in the 1500 area.** How is this possible you ask? We believe that the market began a new cyclical bull on October 3, 2011. A typical cyclical bull within a secular bear (we have discussed this before) has a life of six months to one year and a gain of 34% to 42% over that time. We discussed corporate earnings earlier and the possibility the earnings multiple could expand. A level of 1500 would give us an earnings multiple of only 15 to 16 times, which is well within historic norms. One of the problems from last year, as discussed earlier, was excess volatility. Volatility is mean reverting which means that it is very unlikely that we will see the same level as last year. With lower volatility, there will be trends that develop and the trendless market of last year will give way to defined trends for 2012.

What is the other side of the equation? If the potential risks mentioned earlier come to pass **then the downside to the**

**market is in the 1000 range which is the bottom of the July correction during 2010.** As mentioned by Sean in his 2011 Market Outlook, the possibilities for this year are very broad indeed. This is not our expected outcome but it is interesting to note that a decline of that magnitude would send the earnings multiple to the level of 2008 and would be a 50% retracement of the entire bull market from March 2009 through April 2011 which would be in the normal range of possibilities.

**How do we avoid this? We elect a legislature that will get a handle on our spending and debt problems before it is too late and we become another Greece, Spain or Italy, to name a few.**

While problems do remain, our overall view for 2012 is positive. While a level of 1500 might be a bit aggressive on the upside and a low of 1000 seems a bit much on the downside, we believe that a reasonable range would be between 1200 as a low and 1480 as the high with a year end goal of 1425. This would produce a gain of 13.3% on the S&P 500 which is in line with metrics that we believe are in place.

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The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 75% of U.S. equities.

The Dow Jones Industrial Average is a stock market index that shows how 30 large publicly owned companies based in the U.S. have traded during a standard trading session in the stock market.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performers of developed markets outside the U.S. and Canada.

The MSCI Emerging Markets Index is a freefloat-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. The Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

The VIX Index is a forward looking index of market risk which shows expectation of volatility over the coming 30 days.

Barclays Capital U.S. Government/Credit Bond Index measures the performance of U.S. dollar denominated U.S. Treasuries, government-related & investment grade U.S. Corporate securities that have a remaining maturity of the greater than one year.

The Barclays Capital U.S. Aggregate Bond Index covers the U.S. investment-grade fixed-rate bond market, including government and credit securities, agency mortgage pass-through securities, asset-backed securities and commercial mortgage-based securities. To qualify for inclusion, a bond or security must have at least one year to final maturity, and be rated investment grade Baa3 or better, dollar denominated, non-convertible, fixed rate and publicly issued.

The Barclays Capital U.S. Corporate High-Yield Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

Index returns include the reinvestment of income and dividends. The returns for these unmanaged indexes do not include any transaction costs, management fees or other costs. It is not possible to make an investment directly in any index.