

FIRST QUARTER 2012 NEWSLETTER

When the dust settles on 2011, we may ultimately conclude that it felt a lot worse than it really was. With the benefit of a nice fourth quarter rally, we finish the year with a mild positive return on the Dow, a flat result for the S&P 500 and a mild negative on the NASDAQ. The reason it all felt so bad was, of course, volatility. We experienced almost a 20% drop from high to low, and a record-setting 100 plus days where the Dow went up or down by more than 100 points.

Review of Previous Quarters:

	<u>12/31/10</u>	<u>09/30/11</u>	<u>12/31/2011</u>	<u>YTD Change as of 12/31/2011</u>
S&P 500	1,257.64	1,131.42	1,257.60	-.04%
Dow	11,577.51	10,913.38	12,217.56	+5.52%
NASDAQ Composite	2,652.87	2,415.40	2,605.15	-1.80%
MSCI EAFE	1,649.69	1,373.33	1,393.45	-15.53%
10-Year Treasury Note	3.29%	1.92%	1.88%	-141 basis points
3-Month T-Bill Rate	.13%	.015%	.02%	-11 basis points
Price of Gold (COMEX)	1,422.00	1,622.30	1,565.50	+10.09%
Crude Oil (NYMEX)	91.40	79.20	98.89	+8.19%

Inclusion of these indexes is for illustrative purposes only. Keep in mind that individuals cannot invest directly in any index, and index performance does not include transaction costs or other fees, which will affect actual investment performance. Individual investor's results will vary. Past performance does not guarantee future results.

- **Treasury Bills** are certificates reflecting short-term (under one year) obligations of the U.S. government.
- The **S&P 500** is an unmanaged index of 500 widely held stocks that's generally considered representative of the U.S. stock market.
- The **NASDAQ** composite is an unmanaged index of securities traded on the NASDAQ system.
- The **Dow Jones Industrial Average (DJIA)** commonly known as "the dow" is an index representing 30 stocks of companies maintained and reviewed by the editors of the Wall Street Journal.
- The **MSCI Europe, Australasia and Far East Index** is a market capitalization weighted selection of stocks from 21 developed nations excluding the US and Canada.

The second half of 2011 can be characterized as a period of high uncertainty and high volatility both in terms of economic data and price movement in the equity markets.

The weak economic data reported in July and August derailed what had been a consensus view of modest but steady growth in the US economy. Now, just a few short months after all the gnashing of teeth, it once again appears that recession will be avoided and that we are on track for modest economic growth in the US.

There was a time when Wall Street took comfort from political gridlock in Washington, believing that both sides kept one another in check. This view is beginning to change with the increased level of polarization and the incidences of political brinksmanship over even relatively minor issues. There now seems to be a desire for “general competency” in Washington and some progress on the major issues of revenues and spending.

Ultimately, the day of reckoning over US debt will come. It is unfortunate that we may have to wait until after the 2012 presidential election before we make any headway on this issue. In the meantime, businesses continue to postpone hiring and capital expenditures given the uncertain outlook.

The “tail risk” of a really bad outcome in Europe continues to weigh heavily on the markets. The term “tail risk” refers to the potential for a low probability but high impact event. A “worst outcome” for Europe would surely be quite severe but would seem unlikely given that memories of the post-Lehman environment in 2008 are still fresh in the minds of policymakers around the world. It could well be another 6-12 months, however, before markets will believe that the period of extreme stress has passed.

It may well be the case that we face more challenges than opportunities at this point in time. Even if this is the case, we should all derive some optimism from the chart below:

March 30, 1999		December 31, 2011
1300.75	S&P 500 Index Value	1257.64
3.47%	Earnings Yield	7.01%
28.9	Price to Earnings Ratio	14.27

Source: Standard & Poor's

The earnings yield measures the earnings a company generates as a percentage of its price. Higher yields represent lower prices.

Earnings have doubled in the past 12 years yet the S&P 500 has not made any progress. We believe the earnings yield on equities is quite attractive, especially given the low yields available on bonds. Historically, the returns experienced from valuation levels such as we have today have been well above long-term averages. Of course, past performance is no guarantee of future results.

In our view, Michael Santoli of *Barron's* summarized the current environment very well in his October 24, 2011 *Streetwise* column:

“It's not often that a major stock market trading in a place first hit a dozen years ago falls apart in a devastating way. Typically, when the past decade's equity returns were flat or negative, the following decade offers decent to above-average results, as valuation excesses have been ground down and the public has soured on stocks, both conceptually and in its actions. Note that even at the end of the panic lows of '98, stocks were about twice as expensive as they are now.

Other periods in which stocks in a prolonged ‘secular’ bear market sat at a level first reached 13 years earlier include the early 1940's and the late 1970's. These were not wonderful moments to gorge on

stocks for a short-term killing, and, like today, were periods cursed with daunting macro challenges (lots of wars, rampant inflation). But they were closer to the end of the asset class's long malaise than to the beginning. By those points, the earlier bear-market lows were never again approached, and the market ended up paying off pretty well for investors over the ensuing decade and more."

The past 11 years have certainly been tough on investors; however, our belief is that one must remain dedicated to the idea of a balanced portfolio if long-term goals are to be realized.

We can draw on the field of behavioral finance to help us in this endeavor. The concept of "mental accounting" suggests positioning assets in different baskets based on the time frame when the money will be needed. While just about everyone benefits from having a basket dedicated to safety and return of capital, most of us will also benefit from a basket of funds invested with a 10 year time horizon and perhaps a 15-20 year horizon as well. This is even true for an investor aged 65-70 who must account for the likelihood of a lifespan to 85-90 and beyond.

One's ability to weather the current market environment may well be enhanced by the knowledge that there are sufficient assets in the "safe" basket to allow time for the long-term assets to work despite near-term volatility.

MCM Notes

Congratulations to **Maureen Nyman** on celebrating her 5th anniversary with Mendham Capital! We cannot thank Maureen enough for her commitment, hard work and dedication to serving our clients.

In spite of all the volatility, Mendham Capital enjoyed its best year in 2011. We are greatly indebted to all of our loyal clients. Thank you! We are looking forward to celebrating our **15th anniversary** on June 1, 2012!

We will be launching a major, new financial planning initiative later in 2012. We are making a significant investment of money and time as part of this effort. All five of us will take part in training during the first quarter. It is a bit too soon to get into detail, however, we did want to make mention of it and give you a sense of our enthusiasm for this opportunity. More to follow.

Closing Thoughts

Investing is a challenging endeavor given that we have no control over the markets and world events. However, this is not an obstacle that should prevent us from positioning our assets in solid investments designed to achieve our long-term goals.

Let's instead focus on the factors we do control: the amount of funds we devote to savings; the time horizon for our investments; the asset allocation we select among cash, bonds, stocks and tangibles; the quality of the investments we select, and; tax efficiency in the choices we make.

Our belief is that sound decision making on the factors within our control is the greatest determinant of our long-term success.

We are very appreciative of your loyalty and referrals. Thank you for your continued trust and support.

Sincerely,



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