

Year-End Review and 2012 Market Outlook



January 20, 2012

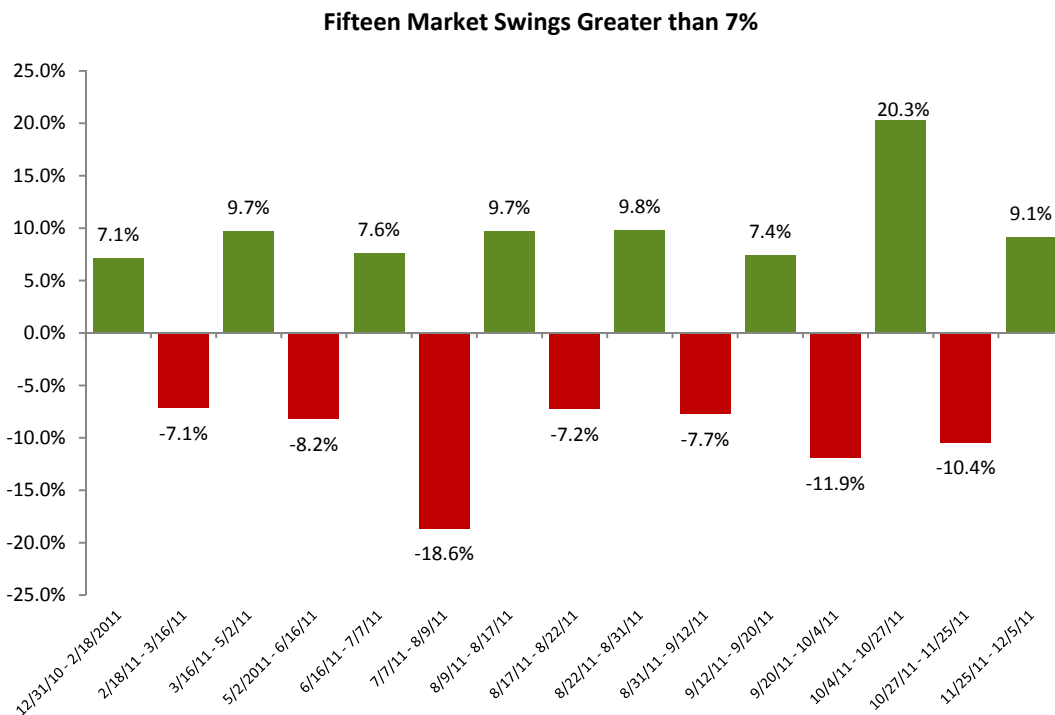
The Year in Review

The stock market repeated its roller coaster ride in 2011 violently jarring nerves and rattling the confidence of investors. It was one of the most volatile years for the stock market with stocks gyrating at a daily rate of twice the 50-year moving average. Despite the dizzying ups and downs, the ride ended right where it started. The S&P 500 was basically flat for the year, closing at 1,257.60, just 4 cents off the close of 1,257.64 in 2010, a change of only -0.003% excluding dividends! The year's move was the smallest since 1947 when the index closed exactly unchanged.

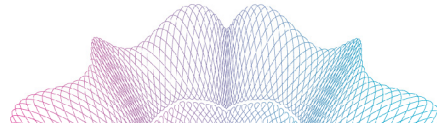
Nevertheless, the market's unyielding volatility due to the European debt crisis caused investors to continue their exodus out of equities. Investors pulled out an estimated \$70 billion from U.S. stock mutual funds during the year, exceeding the full-year total of \$49 billion in 2010. Most of these proceeds went into fixed income funds as investors sought safety of principal.

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Figure 1: Roller Coaster Ride of Volatility in 2011



Source: Bloomberg



Recalling the year’s events, the market’s volatility should not have been much of a surprise. After all, the market faced a number of potentially catastrophic risks that could have easily triggered another 2008 type panic when the market lost nearly 40% of its value. To put things in perspective, the market faced a litany of challenges which could have been catalysts for a significant market collapse:

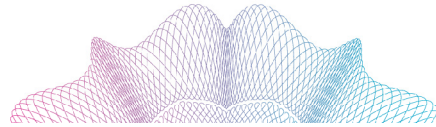
- Middle East political uprising that caused a rapid spike in energy prices due to supply concerns
- Concerns of rapidly rising global inflation that strained producers and consumers
- Japanese earthquake and tsunami that caused the worst nuclear disaster since Chernobyl
- Potential shutdown of the U.S. federal government due to a debt ceiling stalemate in Congress
- Historic downgrade of the U.S. credit rating by Standard & Poor’s
- Looming collapse of the European Union due to potential widespread default of sovereign debt

Given these possibly devastating risks, a focus on *capital preservation* should have been the primary objective of every investor in 2011. As shown in the table below, minimizing losses is a reliable way of achieving long-term investment success. In other words, if you can minimize the amount of money you lose in difficult markets, you don’t have to work as hard to earn it back in better market environments.

Figure 2: Minimizing Losses Leads to Easier Recoveries

Portfolio Loss	Gain Needed to Breakeven
-10%	11%
-20%	25%
-30%	43%
-40%	67%
-50%	100%

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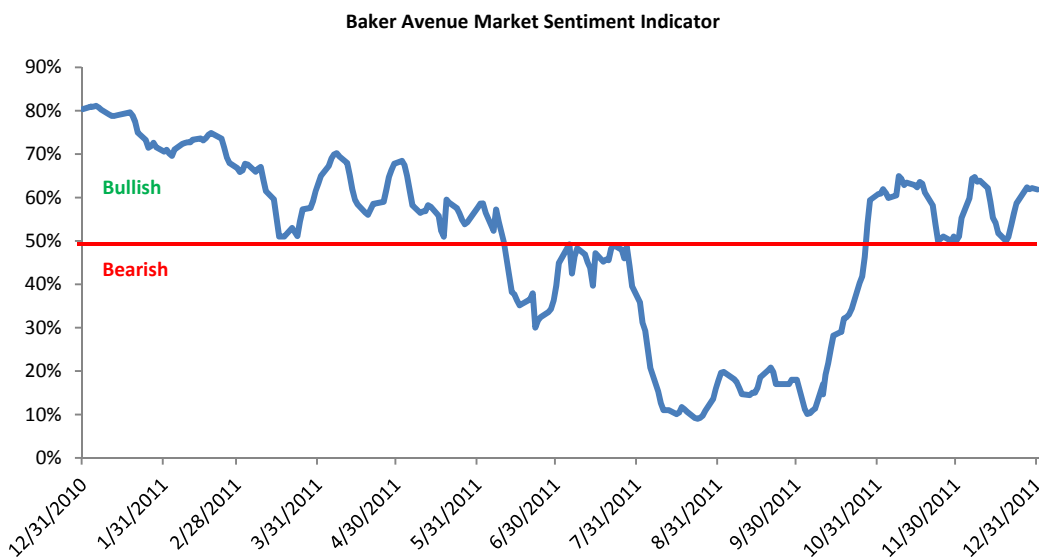


We use our proprietary *Baker Avenue Market Sentiment Indicator* (BAMSI) to gauge market risk and determine when it's an appropriate time to preserve capital. The BAMSI measures the overall bullishness or bearishness of the market on an index of over 4,000 stocks. When greater than 50% of stocks in the index are showing positive trends it indicates a positive market sentiment or said another way, the risk/reward of owning equities is favorable. In this environment, *capital appreciation* is our objective across all our investment strategies. When the BAMSI is negative (less than 50%) the risk/reward of owning equities is not favorable and higher levels of cash are warranted. In this environment, *capital preservation* becomes the main objective.

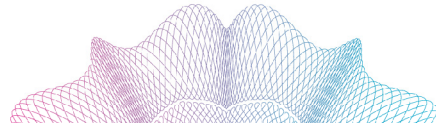
The BAMSI remained positive throughout the first quarter of the year, but turned negative late in the second quarter as concerns over Europe's debt crisis and stalemate in Congress unnerved investors. The BAMSI remained in negative territory throughout the third quarter while the market tumbled nearly 14%. Because of the negative market environment, we retained significant amounts of cash with the objective of capital preservation due to the unprecedented number of uncertainties that confronted the market. By doing so, we were able to considerably reduce risk and minimize the drawdowns in our investment strategies.

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Figure 3: Baker Avenue Market Sentiment Indicator (BAMSI) 2011



Source: Baker Avenue



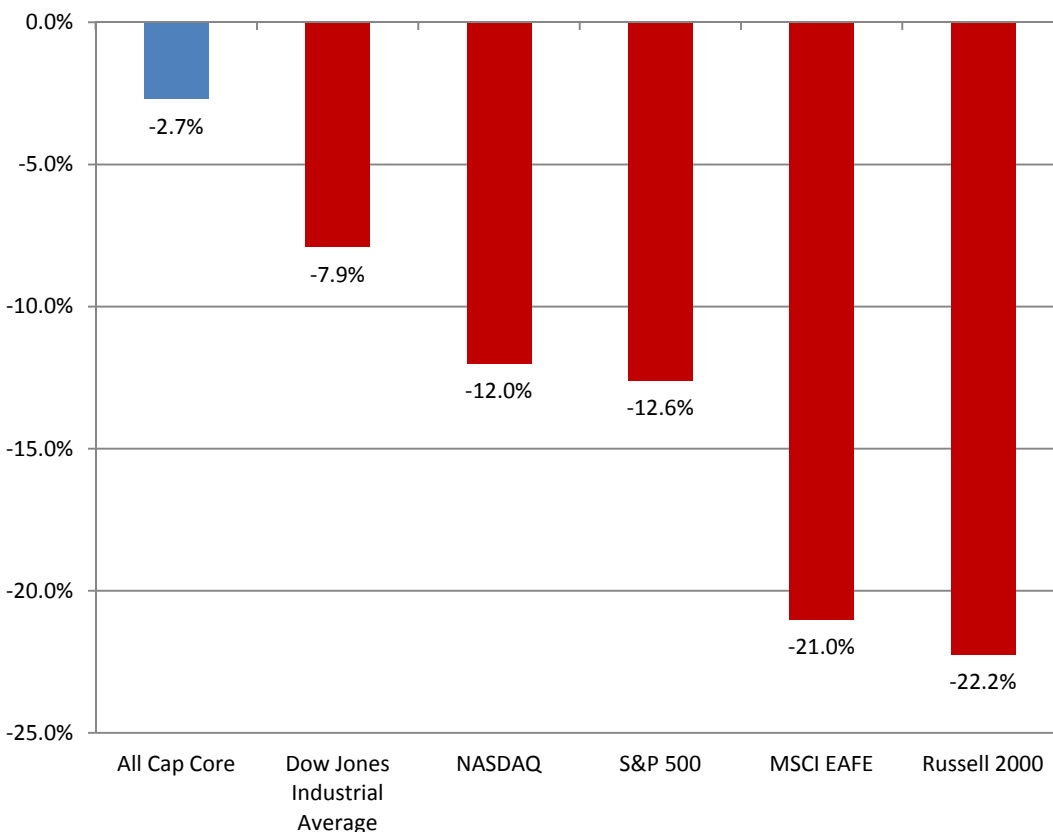
Investment Strategies

All Cap Core

In the All Cap Core strategy, we invest in stocks that are showing leadership on both fundamental and technical factors. When the BAMSI is positive (above 50) we invest in a basket of market leading stocks. When the BAMSI shows signs of deterioration we begin to raise cash and when the BAMSI drops below 50 we move 100% to cash. The All Cap Core strategy remained heavily in cash throughout the third quarter after having moved 100% to cash at the end of the second quarter when the BAMSI turned negative. By maintaining a focus on capital preservation in the third quarter, we were able to significantly reduce the downside volatility experienced in the strategy (Figure 4). When the BAMSI indicated that the market was very oversold, we began to add equity exposure and further increased our exposure to stocks when the BAMSI crossed into positive territory in November as U.S. economic data showed signs of improvement.

“By maintaining a focus on capital preservation in the third quarter, we were able to significantly reduce the downside volatility experienced in the strategy.”

Figure 4: Worst 2011 Return – Daily Observation



Global Tactical Indexing

In the Global Tactical Indexing strategy, we invest in a broadly diversified set of global asset classes. The strategy moves to cash when long-term market trends are negative. In the second quarter, the strategy was focused in precious metals and commodities as they benefitted from the effects of “QE 2” which caused the U.S. dollar to devalue and inflation pressures to increase. However, commodities faced a challenging environment in May and June as a stronger dollar and concerns about an overall global economic slowdown caused downward pressure on commodities and precious metals. We maintained a defensive posture with high levels of cash in the third quarter as the BAMSI indicated that market risks were high. Precious metals such as gold and silver also helped to hedge the portfolio against downside risk. Like the All Cap Core, it was successful in minimizing the drawdown experienced during high levels of market volatility.

Blue Chip Core

While the third quarter marked a period where we progressively raised cash in our equity strategies, the fourth quarter proved to be exactly the opposite. As volatility subsided and the BAMSI increased, eventually rising above 50, we raised equity exposure in all strategies. This cash raise and subsequent deployment limited our declines in September but it also reduced participation in the gains of October. Limiting risk in the most volatile time periods is core to being in a position of strength when risk subsides. As we enter 2012, there are a host of quality companies at valuation discounts which could prove very attractive if the recent stability continues. Of course, if the trend shifts, we will be quick to turn back to the safety of cash.

Dividend Opportunities

The Dividend Opportunities strategy invests in a diversified portfolio of income generating ETFs to provide for current income and attempts to protect principal by moving toward high grade short-term fixed income instruments in long-term down markets. This strategy was especially relevant in 2011 as current dividend yields were often greater than those of most bonds. Dividends also helped to counteract the year’s volatility as yield provides defensive downside protection during equity market downturns. We continue to believe this strategy will perform well over the long-term as dividend paying stocks have historically had competitive returns versus the broad market and has outpaced inflation. Dividend paying stocks also provide the potential for income growth while most bonds have fixed interest payments.

Fixed Income

Fixed income returns were excellent in 2011 as bonds became a safe haven from stock market volatility. Longer duration bonds outperformed shorter duration bonds as investors priced in a high likelihood of a double-dip recession which drove down yields across the yield curve. Despite the decline in commodity prices, treasury inflation protected securities (TIPS) had strong gains as inflation expectations remained high. Although high yield bonds saw pressure earlier in the year, they rebounded in the latter half of the year as U.S. economic data showed improvement. We believe short to intermediate high quality corporate bonds remain the most attractive segment of the bond market in terms of risk and reward and continue to overweight this asset class. When the BAMSI turned positive, we added convertible bonds to the strategy as this asset class tends to do well in a bullish environment for equities. For 2012, we do not believe that the strong gains seen in long-dated treasuries will continue and are avoiding long this asset class as we believe they are extended and the risk versus reward is not compelling.

Market Outlook

The outlook for 2012 remains cautiously optimistic. A major market meltdown due to the European debt crisis continues to be the indeterminable “tail” risk – a risk that has a low probability of occurrence, but one that may have catastrophic consequences for global financial markets. The first test of this risk is the refinancing of European debt in the coming months. There is an estimated 537.2 billion Euros of PIIGS (Portugal, Italy, Ireland, Greece, and Spain) debt that needs to be refinanced during the year with Italy and Spain accounting for over 85% of the amount. Half of Italy’s debt needs to be refinanced in the first half of the year. If demand is weak for these refinancings and yields shoot higher, financial markets will likely react negatively. For these reasons, we can expect market volatility to be elevated at least for the next several months.

As we have learned time and time again however, the market is better at predicting the news than the news is at predicting the market’s ebb and flows. If concerns over European defaults mount, market breadth is likely to deteriorate triggering our BAMSI to turn negative *before* a potential precipitous market decline. We have confidence that the BAMSI will be able to help protect our clients against such a severe market decline should it arise.

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While it is still early in the year, the market is off to a good start with gains that have already eclipsed 2011's modest returns. Market volatility continues to decline following the trend lower since peaking in August of last year.

Cash instruments are losing relative strength to the equity market, meaning that market participants are rotating out of risk-free assets into riskier assets. Small and middle capitalization stocks which typically carry higher risk premiums are outperforming large cap stocks which are considered lower risk due to larger balance sheets and more stable businesses. Cyclical sectors of the economy like energy, financials, and industrials are outperforming the less economically sensitive sectors like consumer staples and utilities which outperformed the market last year due to high economic uncertainty.

2012 being an election year may also bode well for the stock market. Since 1926, election year market returns have averaged 10.9% versus an average of 8.1% in the first year of a presidential term and an average of 8.9% in the second. The third year of a presidential term ranks the highest with average returns of 19.3% (Figure 5). The logic behind this market phenomenon is that in the interest of retaining power, the current presidential administration does everything in its authority to make the economy look its best come election time in November. "It's the economy, stupid.", was the phrase widely used by Bill Clinton's successful 1992 presidential campaign against George H.W. Bush who lost due to an economic recession in the U.S.

The so called "January Barometer" may also be an important market phenomenon to keep an eye on. It purports that January's returns, be it positive or negative, have a high correlation to the market's returns for the full year. A positive January in an election year appears to be even more significant for the market. Since 1945, a positive January in an election year has never failed to predict a positive year for the stock market with an average gain of 16%. With January off to a good start, there may be reason to be optimistic about market gains this year.

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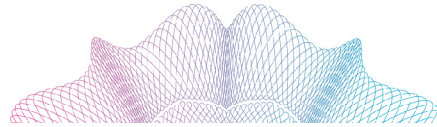
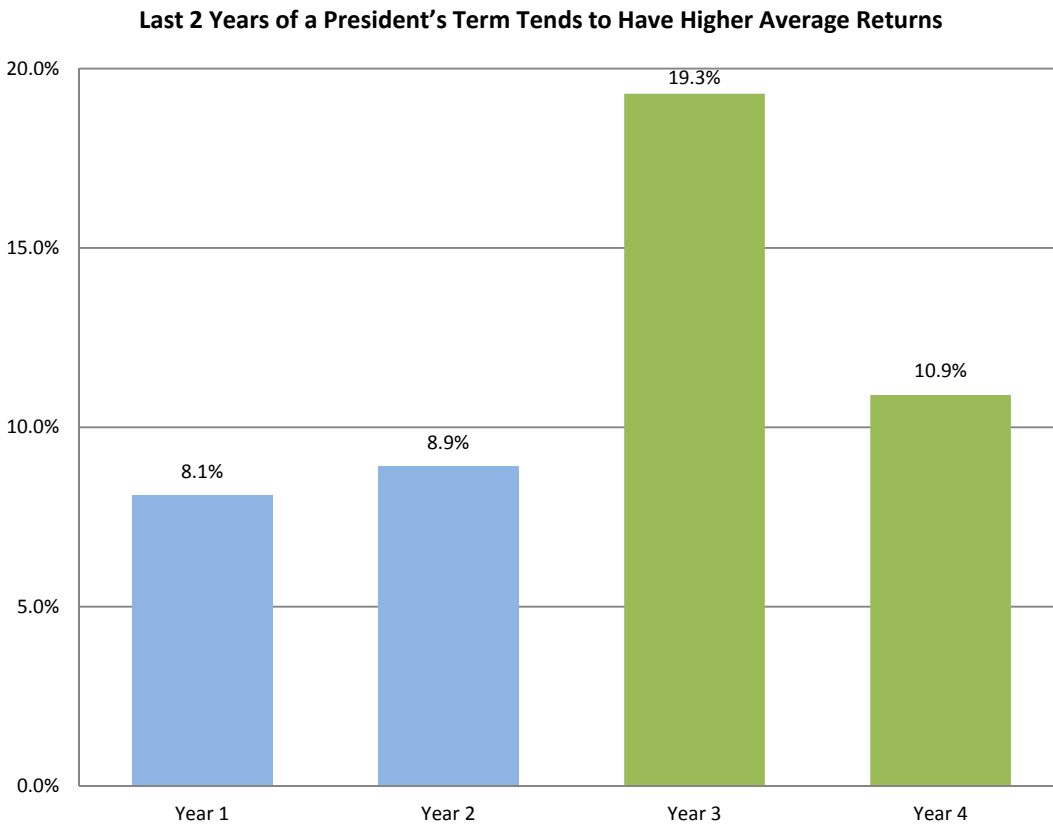


Figure 5: Presidential Term Year-by-Year Average Returns 1926-2010

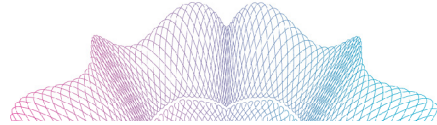


Source: Standard and Poor's

Conclusion

The market's roller coaster ride continued in 2011 as market uncertainty prevailed. With the number of potentially catastrophic risks that arose during the year that could have triggered another 2008 type market panic, the market's volatility should not have been much of a surprise. A focus on *capital preservation* should have been the primary objective of every investor in 2011 as minimizing losses is a reliable way of achieving long-term investment success.

To counteract the volatility and high risk market environment, we managed our investment strategies to focus on capital preservation by using our market sentiment indicator, the BAMSI. It remained in negative territory throughout the third quarter while the market tumbled nearly 14%.



We retained significant amounts of cash due to the unprecedented number of uncertainties that confronted the market. By doing so, we were able to considerably reduce risk and minimize the drawdowns in our investment strategies.

We start the year with cautious optimism as the U.S. economy shows signs of improvement, but we are aware of the potential risks that can continue to flare up in Europe. With that said, the market's best performing sectors and asset classes year-to-date are the cyclical sectors and asset classes that command higher risk premiums like small and middle capitalization stocks. This may bode well for the market as it suggests that investors are willing to take risk whereas 2011 was very much a "risk off" type environment. 2012 being an election year may also be a positive for the markets as historical market returns tend to be higher in election years. This may be due to the current presidential administration doing everything in its power to make the economy look its best come election time with stimulative fiscal and monetary policies.

We look forward to reporting positive news in our next quarterly letter. We wish you a very joyous and prosperous New Year.

Sincerely,

Baker Avenue Asset Management

The Baker Avenue Asset Management (“BAAM”) All Cap Core (“ACC”) Equity Composite is designed to generate a positive return over the medium to long term, with a focus on capital preservation. For comparison purposes, the composite is measured against the S&P 500. We believe the index that best replicates the market capitalization of securities we purchase for clients in the ACC are best represented by this index. The S&P 500 Index measures the performance of 500 leading companies in leading industries of the U.S. economy, which represents over 80% of the investable U.S. equity market. The index is presented as total return (reflect reinvestment of dividends, interest and other income) and is unmanaged, cannot be invested in directly and is never comprised of a cash allocation. BAAM may or may not trade in securities that are represented in this index. No representation is made that the performance or volatility of the ACC will track or otherwise reflect a particular index.

Past performance is not indicative of future results.

The minimum account size for inclusion in the composite is \$100,000. The U.S. Dollar is the currency used to express performance. Returns are presented net of a Model Advisory Fee and net of transaction costs. Returns are total return, i.e., they include the reinvestment of dividends, interest and other income. The composite includes both bundled-fee (wrap fee) and non-bundled fee portfolios. As a result, the returns presented are net of a model investment presented net of an annual fee of 1.25% per annum, charged quarterly in advance, which represents the highest annual fee currently paid by a portfolio in this composite. For bundled accounts in the composite, this fee includes management fees, brokerage commissions, portfolio monitoring, consulting services and in some cases custodial services. The composite includes accounts that did not pay an advisory fee; since the completion of the first year, less than 2% of assets in the composite have been from non-fee paying accounts. BAAM may waive or reduce the management fee with respect to one or more clients or agree to apply a different management fee for a client. Full details of the fees charged are available in our ADV Part 2, available upon request.

The BAAM All Cap Core Equity Composite was created on January 1, 2005. The annual composite dispersion is an asset-weighted standard deviation calculated for the accounts in the composite the entire year. The composite consists of fully discretionary fee paying accounts that invest in all cap equities and cash. Portfolios are included after one full calendar quarter under management; terminated accounts (those no longer with the firm) are included through the last full calendar quarter prior to termination. Carve-outs are included in this composite from inception on January 1, 2005 until March 31, 2009. After March 31, 2009, only pure accounts were included in the composite. The portfolio accounting system automatically allocates 100% of the total cash to the carve-out. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Additional information regarding policies for calculating and reporting returns and copies of prior verification reports are available upon request.

We may move to cash at times when the risk is not appropriate. However, there is significant dispersion between the performance of our composite and the index as the index is unmanaged and cannot move to 100% cash as we may do for our clients (and thus, this is reflected in our composite). For the time periods stated below, 1/1/05 through 9/30/11, the following time periods reflect when the Composite had a 100% cash allocation as a defensive component in the ACC. As a result, the negative performance of the S&P 500 is not reflected in our performance as we did not have the market exposure. Time periods are 27 days from 3/29/05 through 4/20/05, 49 days from 9/29/05 through 11/17/05, 27 days from 5/18/06 through 6/14/06, 30 days from 3/9/07 to 4/8/07, 23 days from 7/27/07 through 8/19/07, 62 days 11/8/07 to 1/10/08, 19 days from 6/19/08 through 7/09/08, 39 days from 2/20/09 through 4/1/09, 24 days from 5/20/10 through 6/13/10, 21 days from 7/13/10 through 8/3/10, 25 days from 8/26/10 through 9/20/10 and 60 days from 6/14/11 through 8/15/11. In total from 1/1/05 to 9/30/11 we were in 100% cash for 408 days.

Baker Avenue Asset Management, LP is an independent registered investment adviser. The firm maintains a complete list and description of composites and models, which are available upon request to info@bakerave.com.