



2011 in Review: The Market

On its surface, the S&P 500 index clocked out on 2011 with a calming, peaceful, and serene annual return of 0.00 percent. In reality, what a cruel, torturing and painful 0.00 percent it was.

But so much is lost in translation when viewing markets through just two dates on a calendar. Banyan Partners is likely not alone when stating that 2011 *felt* worse than even, however like many situations in life, before you can fully understand where you've ended up, you have to first recognize how you got there:

- » 2011's flat market was as volatile as 2002's and 2008's infamous declines, measured by daily price swings of the S&P 500.¹
- » The year's outlier events include: unprecedented Japan tsunami, earthquake, nuclear disaster and Arab Spring turmoil.
- » Exogenous shocks in 2011 were mostly 2010 carry-overs: European debt crisis, Washington political circus.
- » Recessions fears sent the S&P 500 down -20 percent in a few short weeks between late July to early August.²
- » Through this all, investors added insult to injury by pulling \$75bb from US equity funds at the August 2011 lows — the highest degree of outflows since the depths of the 2008 market decline.³

And yet, even when acknowledging the events of 2011 in context of the 0.00 percent return, the angst and frustration which the year garnered still doesn't seem to fully reconcile. If someone had told you the above events would occur through the course of the year, without revealing the ultimate price action of the market, surely you'd expect a market correction of a far worse degree. While this didn't occur on the surface, the dislocations were fully evident upon deeper inspection — US financial index down 18 percent, materials sector off 11 percent, small

caps declined 6 percent, semiconductors fell 12 percent, China's indices lost nearly a third of their value and various European markets fell anywhere between 10 percent (Switzerland, Norway) to 25 percent (Finland, Austria, Italy, Czech, Hungary, Russia) culminating with Greece's main index losing over half its value.⁴

The stock market, it's said, doesn't have a memory. It acts today without regard or consideration to its deeds of yore. By its very nature, the market is a forward-looking discounting mechanism, constantly projecting, estimating and analyzing potential catalysts, risks and opportunities. This is not to say that the market is always efficient, nor is it always right — but the market does ultimately have the final say.

Therein lies a small problem. Participants of the market — us humans — are a rather reactive group, primarily looking backward at historical data to embark on what we determine to be the best path forward. While the market may operate today without appreciation for its prior actions, we remember all those gyrations, swings and swoons all too well. We market participants are not a cold, emotionless and detached accomplice. We remember all too well.

Now going on four years after the 2008 market crash, and over a decade since the Tech Bubble decline, investors can't be blamed for being fed up with the market's shenanigans. It's more than numbers, real money has been lost, regained and lost again. And though the pain from these events has diminished and the wounds have begun to heal, the scars — psychological, if nothing else — will always remain.

Banyan Partners in 2011

Along with many other investment firms, 2011 was not

a year which Banyan will look back upon fondly as it relates to how we performed for our clients. Ultimately, with hindsight, our shortcomings in 2011 can most directly be associated to decisions relating to poor timing and being hostage to the whims of the market's excessive and irrational volatility. A striking lesson from 2011 is that you can be proven right (Banyan expected continued economic and profit growth, no recession) but still wind up unprofitable.

At Banyan, we pride ourselves on being an unconventionally successful firm. This approach has generated for our longstanding clients over a decade of market-beating returns, though we've surely had a few slips and stumbles along the way, similar to 2011.

As a firm that is always looking to improve and progress in all aspects of our business, we look back at this difficult period as a time that has further enhanced Banyan Partners' competencies and expertise, building on a foundation for Banyan's aim of attaining great success for our clients over the coming decade and beyond. More importantly, we don't view these improvements as a one-off exercise, but as a continual effort to build one of the premiere investment firms for our clients and employees.

Looking Forward

About this time of year — each year — is where the prognosticators, soothsayers, visionaries and tea leaf readers parade around predicting the year to come. And while there is some usefulness to the exercise of surveying the landscape and penciling in a roadmap, the act of setting course and taking definitive action in response to these Nostradamus wanna-bes can be an expensive proposition.

Thing is, we — as humans more so than investors — like to hear people tell us what's going to happen. This not only applies to market action, but books, movies and other stories as well:

Nicholas Christenfeld, a University of California, San Diego professor of social psychology, along with Jonathan Leavitt, a PhD candidate at UC San Diego studying psychology, organized an experiment where volunteers were given three stories of different genres, written by well-known authors such as John

Updike and Anton Chekhov. One of those stories had a spoiler in a separate paragraph, another had the spoiler worked into the opening paragraph and a last one did not have any hint of the ending. Participants typically enjoyed the stories with the spoiler at the very beginning the most...⁵

There's something about an authoritatively narrated storyline that's comforting and reassuring. Never mind the track record of this "authoritative" figure, and forget questioning the data and source material which created the "storyline". What's important is that this individual, probably sharply dressed, well spoken and in possession of colorful charts, gives us something to grasp onto and understand, boiling nuanced complexities down to a purely linear, black and white portrait from which we can then absorb the contrasting tones and arrive at our own self-simulated outcome.

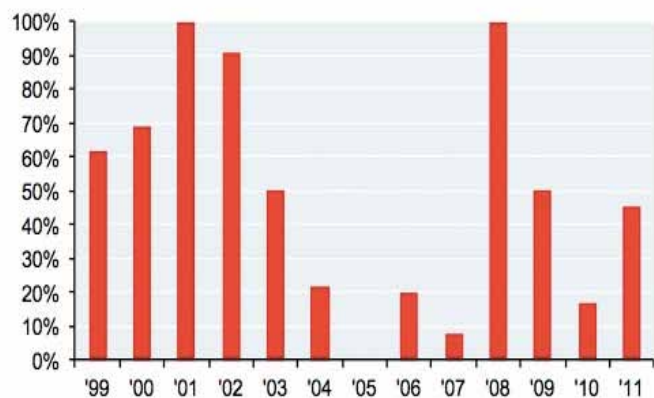
In fact, investors have come to expect annual market outlooks from their investment firms. Investment firms, on the other hand, have come to know that they're very rarely held accountable to those market outlooks. As previously mentioned, we pride ourselves at Banyan of being unconventionally successful. This reminds us of the following quote by John Maynard Keynes:

"It's better for one's reputation to fail conventionally than to succeed unconventionally."

Conventionally then, here's where an investment firm's year-end letter is supposed to give you a price target on the S&P for December 31st, 2012. Also, conventionally, this is about the point where a market letter would include some remarks about the uncertainty, risk and volatility that's likely to occur in 2012 — as if they've been conspicuously and eerily absent from the market in past months, quarters, years, decades and centuries.

Problem being, the espousal and recommendation of conventional action is one of the contributors to the situation our worldwide economy and many investors find themselves. Case in point, listening to the Wall Street "experts" annual forecasts for year-end S&P targets would have yielded results far removed from the intended bull's eye. On average, over the past 13 years, 50 percent of Wall Street firm's forecasts have been off by more than 10 percent on average, and many times they've erred far worse.⁶

Percent of Sell-Side Firms Whose S&P Forecasts Were Off by More Than 10%



Source: Bloomberg. 2011 est. is based upon S&P 500 value on 12/12/2011

In our mind, it's debatable who's at greater fault — the Wall Street Expert for thinking they could extrapolate a full forward year's market level based on the data available to the individual on one given day, or the investors that continually listen to them?

The best friend of the crystal ball wielding market prognosticator, it is said, is your short-term memory.

2012 and Beyond

What has us so angst ridden after 2011's conclusion is likely the psychological phenomenon called the "recency effect", which dictates that those events which occurred in the most immediate past are ones which we're prone to recall most vividly — i.e.; of the five visits you've made to a local restaurant, the service you received from the most recent patronage will have the most impact in defining your overall level of satisfaction.

The point from the beginning of the piece relating to the selling of equities by investors' at the market's August trough levels cannot be overstated, as it is this very action which illustrates the intersection of the market's forward looking vision, and the rearview-mirror-orientated "recency effect" of most investors.

In an indispensable study done every year by Dalbar Inc. tracking investor behavior, the Quantitative Analysis of Investor Behavior Study found that over the past 20 years, while the S&P 500 index returned 9.14 percent on an annualized basis through 2010,

individual investors returned just under 3.3 percent.⁷ That 6 percent annualized difference over 20 years equals almost \$385,000 in "missed opportunity" on a \$100,000 starting portfolio, as shown in the chart at the bottom of this page.

So while it's easy to look back at various market-impacting events of 2011 — disdain for our politicians' handling of the debt ceiling debate, confusion for how Europe's balance sheet got to be such a mess, shock at the turmoil and chaos of the Arab Spring — there's really only one controllable event an investor should focus on, and that's how they choose to react (or over-react) to the impact short-term market conditions have on their long-term investment portfolios.

Investors, it's said, are their own worst enemy, and that once again rang loud and clear in the third quarter of 2011.

While the term "past performance is no indication or guarantee of future results" is typically used by recently successful managers to tame the expectations of incoming wide-eyed investors, the same can most certainly be said in reverse. Just as investors in the late 1990s and early 2000s, greed-tinged recency effect in full regale, piled into equities without a thought or consideration to

Market vs. Investor Return



Source: Dalbar Inc. 2011 QAIB Study



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valuations or fundamental underpinnings, investors of today similarly disregard the historically attractive valuations and fundamentals out of fear and trepidation of what's already transpired.

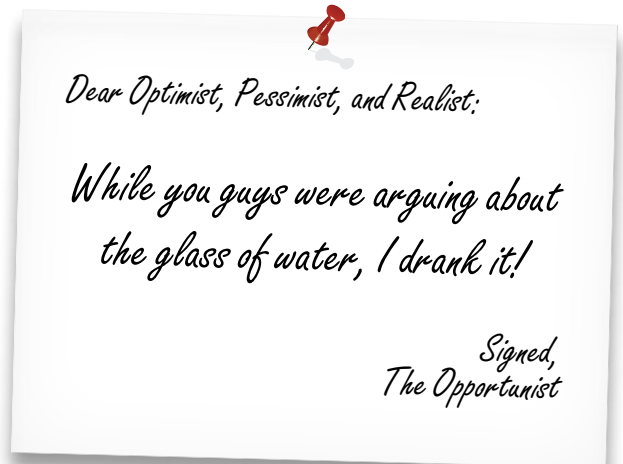
Heading into 2012, Banyan Partners is optimistic while tempered, opportunistic but perceptive, and focused though alert. The bottoms-up investment process and analytical framework which has worked so well for Banyan over the past decade has only been enhanced, and our level of awareness and sensitivity to the market's passing outside influences has been amplified.

In a vacuum, the fundamental and valuation underpinnings of the current market environment are as attractive and strong as they've been in well over a decade. Most conventional metrics — cash flow, earnings, revenue and earnings growth, balance sheet strength and liquidity — have many of the most seasoned investment veterans salivating at the opportunities in front of them. And while the good news is that valuations are the biggest determinate in long-term stock market performance, the bad news is that the "other" determinates will likely shake many investors out of their seats before the fundamentals are appropriately acknowledged by Mr. Market.

Our experience tells us that these attractive fundamental attributes, though, cannot be viewed in a vacuum. And though the collective angst, frustration and fear in the mar-

ketplace can be at times over-embellished, it is not without at least some basis and merit. As investment managers, our job is to navigate our clients' portfolios through these angst-inducing events, positioning the portfolios in the highest probability of success over the coming years using objective and thorough research and analysis.

It's in this context that Banyan Partners is implementing a tempered, but opportunistic approach within our client portfolios heading into 2012. A note hanging on our trading room wall sums up our sentiments well:



We'd like to thank all of our clients for their continued confidence and the ongoing trust they place in Banyan Partners. To each of you, we wish a happy, healthy, and prosperous 2012!

¹ Factset data, 12/31/2011.

² Ibid.

³ Ibid.

⁴ Ibid.

⁵ Time.com: Spoiler Alert! Knowing the End of a Story Makes It Better, Study Finds, 8/11/2011.

⁶ Bloomberg & JPMorgan Research, 12/12/2011.

⁷ Dalbar, Inc. 2011QAIB Study, March 2011

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