DISCIPLINE • BALANCE • PERSPECTIVE

INVESTMENT COMMENT **January 6, 2013**
4th Quarter Review and Strategy Update

Global capital market performance during the 4th Quarter was marked by solid returns overall. US politics – the November election and year-end, self-imposed fiscal policy brinksmanship – created investor uncertainty in US markets, even as the economy and global financial markets performed reasonably well. The non-US portion of our globally-balanced portfolios performed particularly well this past quarter (see Table 1). In the first few trading days of 2013, global stock markets continued to strengthen after the US Congress passed a modified extension of Bush-era tax cuts.

Political uncertainties still remain as US policymakers did not resolve an important element of the so-called Fiscal Cliff – US Budget sequestration, which has merely been delayed for two months[1].

Table 1: Selected Asset Classes December 31, 2012	Third Quarter	YTD Return
SELECTED RISK ASSET CLASS SEGMENTS		
US Large Cap	**+0.26%**	**+16.50%**
US Large Cap Value	**+1.60%**	**+17.46%**
US Small Cap	**+1.93%**	**+16.69%**
US Small Cap Value	**+3.18%**	**+18.05%**
International Large Cap	**+8.44%**	**+18.82%**
Emerging Markets	**+8.00%**	**+19.10%**
International Real Estate	**+9.46%**	**+39.12%**
US Real Estate Investment Trusts	**+1.69%**	**+18.21%**
SELECTED LOW RISK ASSET CLASS SEGMENTS		
US Treasury 1-3yr Notes	**+0.01%**	**+0.28%**
US Treasury 7-10yr Notes	**-0.37%**	**+3.66%**
US Treasury 20-30yr Bonds	**-1.62%**	**+2.63%**
US Treasury Inflation-Protected	**+0.57%**	**+6.78%**
Inv Grade Short Duration	**+0.53%**	**+4.50%**
Inv Grade Intermediate Duration	**+0.86%**	**+9.10%**
Inv Grade Long Duration	**+0.57%**	**+11.60%**
Mortgage-Backed Securities	**-0.41%**	**+2.32%**
International (Non-US Dollar)	**-0.04%**	**+6.09%**
EQUITY INDICES		
MSCI All-Country World Index	**+3.05%**	**+16.85%**
S&P 500 Index	**-1.01%**	**+16.00%**
BALANCED PORTFOLIOS		
Vanguard 60/40 Fund	**+0.16%**	**+11.33%**
DFA 60/40 Fund	**+2.57%**	**+13.05%**
DFA 25/75 Fund	**+1.17%**	**+7.00%**

Source: Bloomberg Professional
Note: Returns include reinvested dividends.

4th Quarter Highlights

Risk Assets

- Developed International (+8.4%) and Emerging Markets (+8.0%) solidly beat US Risk returns.
- Best performing Asset Class segment was International Real Estate (Q4 +9.5%, 2012 +39.1%).
- The "Apple Effect". Apple (AAPL) stock returned -19.8% in Q4 and +32.6% in 2012. It is interesting to note that this impact was felt to a greater degree by investors holding index funds based on the S&P 500 Index. *Although we often make reference to performance of the popular S&P 500 Index, we prefer to construct the US Large Cap portion of portfolios using fund investments that have greater diversity and less single-company concentration risk (see Table 2).*

Low Risk Assets

- Interest-Rate risk was a negative contributor (note negative returns on long-maturity US Treasury segments). Our Low Risk exposures have, on average, low interest-rate risk.

[1] See our December 13, 2012 Economic Update "A Look at the Fiscal Cliff: Does it Mean Much for Investors?", under the Library tab at www.marylandcap.com

- Credit risk. High Yield and Emerging markets bonds generated solid returns (we characterize these riskier bonds as Risk Assets). Investment Grade bonds were positive contributors as investors continued to "reach" for yield beyond low-yielding US treasuries. Our Low Risk holdings include an important allocation to Investment Grade bonds, but 2012 has been a most challenging period to find attractively-priced bonds for reinvestment.

Table 2: "Apple Effect" December 31, 2012	AAPL Weight	Stock Holdings	Return Q4
Apple Inc. (Symbol: AAPL)	-	-	-19.8%
SELECTED US LARGE CAP INVESTMENTS			
Vanguard S&P 500 Index	4.8%	500	-0.39%
Vanguard Total Stock Market*	3.9%	3,306	+0.23%
DFA Core Equity 1*	2.4%	3,060	+1.34%
DFA Core Equity 2*	0.9%	3,093	+2.26%

** Funds we use for US Large Cap exposure*
Source: Bloomberg Professional, Dimensional Funds, Vanguard

Update on our Asset Allocation Strategy

As risk-balanced investors, we are continuing to follow fiscal and monetary policy events closely with an eye toward a timely and prudent rebalancing of portfolio exposures back to each client's targeted levels. During the 4th Quarter we nearly executed such rebalancing transactions, but the brief post-election drop in Risk assets delayed that action – we are likely to rebalance very soon.

As investors were reminded during the tumult of the past 5 years, it is best to adhere to an investment strategy that "budgets" exposure to Risk and Low-Risk assets, rather than an approach that attempts to "market-time" events. We are currently in a similar test of our tolerance for incredibly low yields on high-quality, low interest-rate-sensitive bonds. The lesson learned in the 4th Quarter is that "reaching" for higher yields with longer bond maturities (note -1.62% return on US Treasury 20-30yr Bonds) bears risk.

Similarly, high credit-quality bonds have performed so well that the minimal yield compensation offered when compared with risk-free US government obligations is now quite small – the chase for yield has little room to continue. *We are sticking to our discipline: Low-Risk holdings remain constrained to high-quality (i.e. BBB- rated or better) and have average interest-rate sensitivities equivalent to shorter-term (less than 5 year) bonds. When interest- and inflation- rates rise, the Low Risk portion of our portfolios is well-positioned to preserve capital in our risk-balanced portfolios.*