WOODSTOCK

QUARTERLY NEWSLETTER

Winter, 2012

After another year in which the US and worldwide recovery from the terrible financial environment of 2008 and 2009 has been muted, we write to you not to pile on new sources of worry. Those sources are evident every day in the national and international news. We write to remind you of Woodstock's approach to these concerns.

The themes we use to protect and grow our clients assets under our care are established and useful. We understand that at the bottom of a market, particularly after a drawn out and muted response, people, fatigued, look for alternatives. The primary lesson that needs to be kept in mind is to stay invested. If you and your investment manager have correctly understood your short-term liquidity needs, the pressure to sell is a choice, not a necessity. The times when you must be invested to receive the benefits of an equity-like return are measured in days, not weeks or months, so decisions to be out of the market for even short periods can be devastating to long-term returns. The alternatives to owning high-quality, growth-oriented stocks or similar strategies, which alternatives might be hedge funds or strategies following the institutional model, go in and then out of favor once what they're missing is revealed. It may be the fact that fees do matter. Or that only the very best managers of hedge funds or asset class investment vehicles are worth the money, or get the results as advertised.

At Woodstock over the last few years and through challenging economic times, we've invested in the human, intellectual capacity to keep high quality companies in our clients' portfolios. We build in general portfolio diversification which helps to protect on the downside and reduces volatility while preserving an equity-like return. Beyond what we consider to be our in-house expertise, we're knowledgeable about the wider investment world and have the tools and knowledge to place investments anywhere. We choose what we and our clients believe is in their best interests.

We do believe that what we offer our clients at Woodstock is the best that the investment world offers its clients. Some of our new approaches to our traditional style are evident by reading our ADV but we'll be making them more explicit over the next few months. These new approaches to picking high quality companies in sectors where growth companies tend to develop and grow are exciting and showcase the in-house talent that we believe we have.

Of course, we understand there are alternatives to our approach. We know how to use them. If you have questions about other styles or about other vehicles you'd like to explore, talk to either of us or your investment manager. In these uncertain times we want to serve you as best we can.

We also know that you are the most valuable business development tool that we have. Your referral of a friend, colleague or family member to us is the most important way that we grow.

We thank you for your support and want you to know that we are dedicated to serving your best interest. ◆

Paul D. Simpson, President
William H. Darling, Chairman

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2011 in Review and 2012 Outlook

Thomas C. Stakem

At last 2011 is over. It was an emotional roller coaster year of political brinksmanship on both sides of the Atlantic. Many possible examples could be cited. Would Congress pass the debt ceiling increase legislation or the payroll deduction extension? Europe was a headache for investors in 2011 and this will linger into 2012. The Euro zone was the source of a lot of the bad news flow during the year. Would the European Union breakup as a result of Greece and southern Euro countries? Would Germany pull the plug on the one currency union concept? What would the collateral damage be to individual EU economies and how significant would the rub-off effect on the U.S. be? These were just some of the questions and concerns investors had to deal with in 2011.

The Euro was up ten percent through the first third of the year along with the EAFE index (which tracks Europe, Australasia & the Far East markets) and the S&P 500 was up 8%, while emerging markets were only up about 5%. Then, except for a robust October, it was downhill the balance of the year. Most observers think that a 2008-2009 TARP (Troubled Asset Relief Program) like program has to occur in Europe in 2012 for them to avoid an even greater calamity. Reflecting that optimism, short-term yields declined for some of the more troubled countries as 2011 came to an end. France and Germany do not appear to see eye to eye on a resolution to the crisis and France elects a new President in late April 2012. The incumbent, Nicolas Sarkozy, has been trailing his socialist rival (Francois Hollande) in recent polls. The French citizenry's view of the importance of Euro unity will undoubtedly be a factor in that election. (The next German election is not until Q3 2013). But if the question devolves into whether to print or not to print money, the answer will be to print. The TARP type alternative will be seized but it is hard to know if it will be the ECB, the IMF or some other "hedge fund" look-alike structure, with pledged sovereign EU country backing leveraged 5 or 10:1. Papering over the problem is normally the preferred solution by politicians the world over. No vote is presumed ever lost running the printing press in contrast to the fear of the backlash that austerity brings. Austerity may have therapeutic effects on economies and capital markets but it is bad for incumbent employment prospects. Witness Greece, Italy, Spain, and Ireland, all of whose governments were turned out of office last year.

The market experienced record volatility and very high correlations among individual stocks and stock indices but the S&P 500 was unchanged for 2011! (There is now a new correlation tracking index [JCJ] along with VIX that can objectively indicate if volatility and correlation levels are high.) Are high frequency traders, hedge funds, and conventional institutional investors possibly cancelling each other out? On a risk adjusted basis an unchanged S&P 500 seems like very good investment performance.

2011 was striking in how risk aversion was rewarded and risk taking was punished. Long Treasuries returned 26% while the S&P 500 was +2%. International investing fared far worse than in the U.S. with the MSCI EAFE (a proxy for Europe) declining 12% while Emerging Markets dropped 19%. The big rout in global equity markets occurred in Q3 and the primary beneficiaries were intermediate and long term U.S. Government bonds.

For a lot of investors 2011 was the third year of remaining in the bunker until it was safe to step out into riskier assets. The following Federal Reserve of St. Louis graph shows how 3 month Treasury bill yields have been essentially zero since Q4 2008. This indicates that not only have investors talked but they've acted pessimistically. An estimated $8-$10 trillion of money market funds is "parked" at the 3 month Treasury bill rate, a favorite short-term cash investment vehicle.

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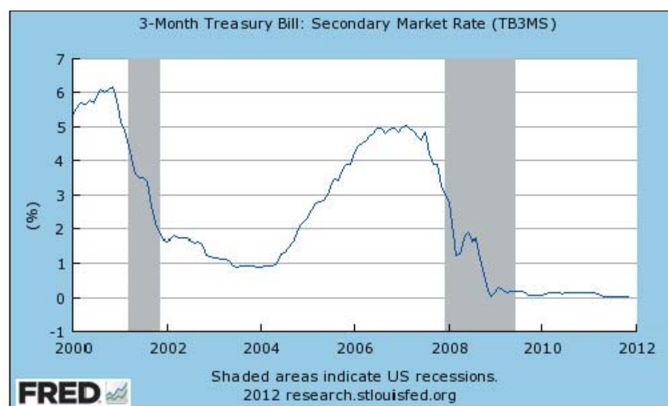
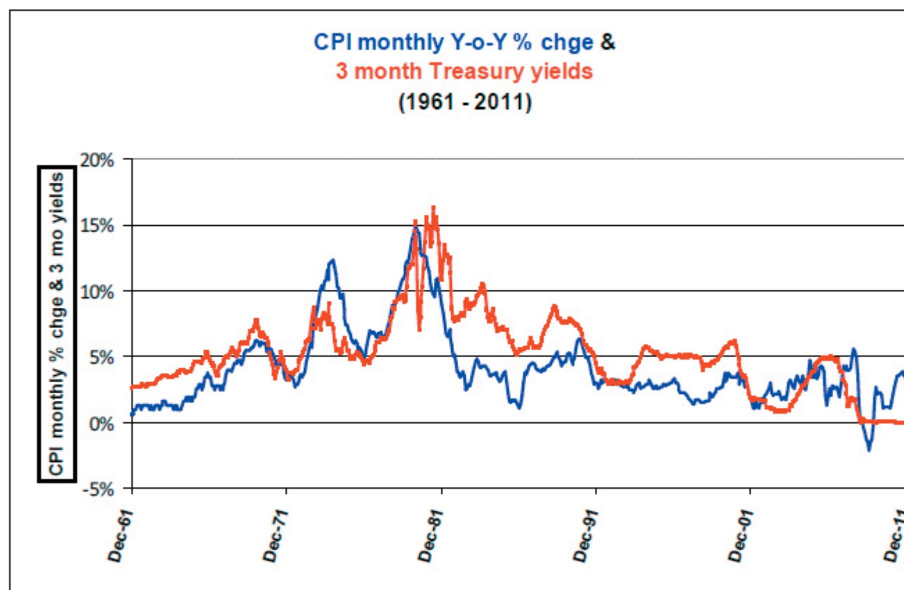


2011 in Review and 2012 Outlook (cont.)

Accepting a near zero rate of return will only continue if there is fear of a large capital losses in other assets, primarily stocks. For many investors this strategy is three years old and they must be itchy for good news. The combination of rising yields and increased confidence could eventually see this trend reverse pretty violently.

3 month Treasury bill yields have been essentially zero since Q4 2008 when "flight to safety" and risk aversion first received notoriety. Risk averse investors have earned nothing as can be seen in this Federal Reserve chart. This level of return lasted fromthe early 1930's to the 1940's. With about half of the S&P 500 constituent companies yielding over 2% how long will the trillions squirreled away in 3 month Treasury bills be content with their negative real returns? 2012 may provide important clues to answering that question.

With inflation ebbing in the mid 3% range and likely to trend down in 2012 any move up in short-term interest rates will cause real interest rates to become less negative and perhaps even turn positive, reversing the trend of the last four years as seen in this chart:



Source: FRED - Economic Data, Federal Reserve Bank of St. Louis, Woodstock

	2009	2010
Greece	13.5%	9.8%
Italy	5.2%	5.4%
Portugal	9.4%	7.6%
Ireland	14.3%	12.2%
Spain	11.2%	8.5%
U.S.	11.0%	10.7%
France	7.6%	8.6%
Germany	3.3%	5.3%
U.K.	11.3%	13.3%
Japan	7.2%	8.2%
Canada	5.1%	5.2%
Australia	3.9%	3.5%
Euro area	6.3%	6.7%
OECD	7.9%	8.3%

Source: OECD Economic Outlook 87 database, June 2010 & OECD projections

Evidence of progress in reducing the Euro zone's deficit spending problem would set the stage for improved economic fundamentals and investor sentiment. The debt markets would be also more hospitable as a result of some fiscal discipline being exhibited. Below are the budget deficit gaps as a percent of GDP for the key Euro and selected other countries.

The above revenue/expenditure deficits (gaps as percentages of GDP) can only be closed by having expenditures grow at rates lower than revenues for an extended period of time (a decade), with 0.5% to 1% being our preferred growth rate differential. Every country with a serious gap also has political leaders who have differing views on how to close that gap. For those who do not want to cut the growth rate of expenditures, higher tax rates are advocated to generate the revenue growth required.

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2011 in Review and 2012 Outlook (cont.)

Unfortunately, the feedback loop of higher taxes inevitably undermines the ability to achieve a targeted rate of growth. Formulating a set of policies that will foster a satisfactory rate of economic (& revenue) growth while restraining expenditure growth is what capital markets are awaiting. If and when such measures are proposed and enacted, the health of the long term capital markets (debt & equity) will improve markedly. Time and discipline are the answer. It took decades of fiscal irresponsibility to produce the strained financial picture of most countries today and it will take steadfast adherence to producinge a suitable outcome. Fragile capital markets would not believe five year timetables were realistic but ten year timetables for closing gaps might be considered more achievable and realistic. The below table illustrates the necessary spread between annual revenue and expenditure growth to close the gap.

So a 1% positive annual spread between revenue & expenditure growth in the U.S. for the next decade would close our 10% - 11% deficit gap percent of GDP. Greece and Ireland are in the same boat. While the U.S. would seem fairly assured of having 4%-5%-6% nominal revenue growth rates, expenditure growth rates of 1% less than each of those figures would do the job. Because of already implemented austerity measures, growth may be flat or negative in several European countries. That is where holding the line on expenditures or even absolute cuts of 1% - 2% would be required at least in the early years to close the deficit gap percent of GDP. But the payoff to the country would be significant as the capital markets could discount (look ahead) and see declining deficits, freeing up room for private sector activity and more self-sustaining economic activity. From a selfish equity market standpoint rising P/E ratios would also result. The economist, Herb Stein, is famous for several sayings one of which was "if a trend cannot continue it will end". That would describe many current country deficit gaps as percentages of GDP. Since they can't continue they have to end. Leaders around the world know they have to close the fiscal deficits, but it politics get in the way of solutions. Eventually a leader will emerge somewhere who will embrace expense reduction. When the citizens and the capital markets applaud such a move it will set a powerful precedent to others which will lead to success being emulated with benefits to equity owners around the globe.

Perhaps the one indicator to focus on in 2012 will be the Euro (FXE is the ETF symbol). Strength in the Euro will be a signal that the region's recession will be mild because of timely actions by policy makers on their structural budget deficits and their debt refinancing (a third of all outstanding Euro debt will roll over in the next 1-3 years). A Euro zone in economic and financial crisis will not be able to accommodate such a task. Since Europe has been the single largest depressant on U.S. equities in 2011, any resolution of Europe's problems will be very beneficial to U.S. domestic stock market sentiment. While the global financial crisis has gripped world markets, the U.S. has been improving its competitive position on the energy front in spite of unfriendly government policies. Amazing strides on the technology front (horizontal drilling and hydraulic fracturing) have enabled the exploration and discovery of large reserves, initially of natural gas but more recently of crude oil. The Bakken field, located largely in North Dakota, has been a gusher of new oil production volumes propelling the state to the #4 producer in the U.S. In the next few years production could double to ~800,000 b/d and positioning the state as the #2 or #3 producer. Reduced U.S. oil imports are a very real prospect going forward as is the citing of new manufacturing and chemical capacity in the U.S. to take advantage of the low cost, large reserves of natural gas that will be available. A growing industrial base would significantly improve the outlook for skilled employment in this country – a key to long term prosperity and rising real incomes.

Recently, both former ambassador Nicholas Burns (at a November energy conference) and Daniel Yergin (in a December WSJ editorial) expressed similar optimism on the U.S. economic outlook because of this new competitive advantage - increasing energy independence.

In addition to low relative valuation being a powerful argument for the U.S. equities outlook, the brightening competitive outlook for the U.S. is perhaps the most enduring reason one should be bullish on the U.S. stock market. On all the important factor inputs for a thriving economy – labor, capital, regulatory/political environment

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Spread between Revenue & Expenditure growth required to close deficit: GDP gap of:

5%	6%	7%	8%	9%	10%	11%	12%	13%
0.5%	0.6%	0.7%	0.8%	0.9%	1.0%	1.0%	1.1%	1.2%

2011 in Review and 2012 Outlook (cont.)

& energy – the U. S. appears to have or be establishing some material and sustainable competitive advantages. Labor is abundant and the country is eager to see the unemployment rate retreat to 5%. Capital is abundant and scared as reflected in the near zero 3 month Treasury bill rate that has persisted since Q4 2008. The regulatory/political environment is more controversial (and blamed for a lot of the uncertainty among corporate leaders in the U.S.) but would still have to be put in the positive column relative to anywhere else in the world today. Lastly, energy is becoming a potentially serious competitive advantage that could really help employment, balance of payments and balance of trade relationships.

U.S. equities are attractive, trading at 12-13x forward earnings which implies a 6% earnings yield advantage over 2% 10 year Treasury yields. Although the immediate economic outlook is murky, particularly for Europe, the value proposition for the S&P 500 is exceptional as reflation and growth become investment themes in 2012.

U.S. stocks have significant catch-up potential relative to bonds because of their under-performance during the bond bull market of the last decade. Probabilities of reversion to the mean, competitive dividend yields

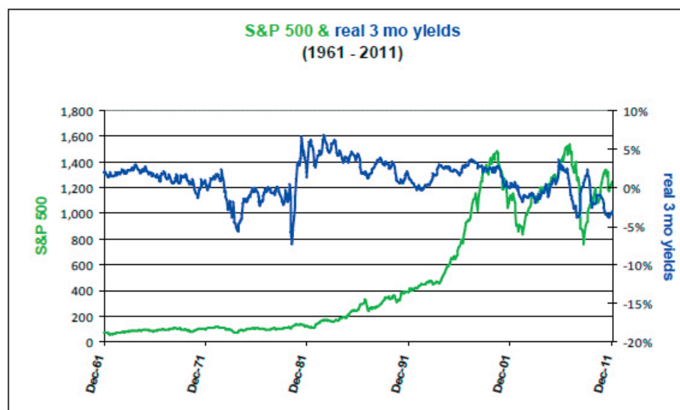
Compound Annual Total Return
to 12/31/2011

	1 yr	3 yrs	5 yrs	10 yrs	30 yrs
S&P 500	2.6%	14.3%	-0.1%	3.0%	11.0%
EAFE ($)	-12.5%	6.5%	-4.8%	4.6%	6.6%
EAFE (L)	-10.1%	9.0%	-4.0%	1.2%	5.2%
Fx	*-2.4%*	*-2.4%*	*-0.7%*	*3.5%*	*1.4%*
L/T Gov'ts	25.9%	5.8%	10.4%	8.8%	11.0%
L/T Corp Bonds	14.4%	10.6%	5.4%	6.6%	10.3%

Source: Ibbotson, Woodstock estimates
(L) in Local currency terms
(Fx) is the impact of foreign currency - whether dollar helped or hurt return

The 10 and 30 year US Treasury yields are now 2.02% and 3.06%, respectively. Increases of only 22 and 15 basis points (a basis point is one-hundredth of one percent) are required to produce a zero total return over the next year. Moves of 66 and 45 basis points over the next three years would assure zero total returns over the next three years. Is it any wonder many consider the bond market extremely overvalued?

The return of positive real short-term yields (3 month Treasury bills) would not only be greeted favorably by savers who have been hammered over the last three years but equity investors would also likely benefit. Historically, stocks have risen along with short term rates, as this chart attests.◆



Tom Stakem is a Portfolio Manager at Woodstock Corporation. You may contact him at tstakem@woodstockcorp.com.

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2011 Tax Update

Matthew G. Flynn

The 2010 Tax Relief Act

Jeanne M. FitzGerald

The 2010 Tax Relief Act retroactively reinstated the estate tax and generation-skipping transfer tax for decedents dying and transfers made after December 31, 2009. The maximum estate tax is 35% with an exclusion amount of $5 million. The applicable exclusion amount is indexed to inflation in 2012. The exclusion amount is $5,120,000 for 2012. These changes for the estate tax and generation-skipping transfer tax allowing for an increased exemption amount and reduced tax rate of 35% are available only for individuals dying prior to January 1, 2013. After that date the estate tax and generation-transfer exemption amount returns to $1 million with a maximum tax rate of 55%. The gift tax has been reunified with the estate tax for gifts made after December 31, 2010. The current $5,120,000 exemption is scheduled to decrease to $1 million for 2013. The current 35% gift tax rate is scheduled to increase to 55% for 2013.

The 2010 Tax Relief Act provides for "portability" between spouses of the estate tax applicable exclusion amount. Portability allows a surviving spouse to elect to take advantage of the unused portion of the deceased spouse's estate tax applicable exclusion amount. The executor may elect to allow the surviving spouse to use the decedent's unused exclusion amount by filing a timely Form 706, including extensions. A timely filed Form 706 is required even if the decedent's estate is not otherwise required to file an estate tax return. The surviving spouse can claim the deceased spouse's unused exemption in addition to the surviving spouse's $5,120,000 applicable exclusion. Currently, this portability feature of the applicable exclusion amount is scheduled to expire December 31, 2012. The new law does not allow a surviving spouse to use the unused generation skipping transfer tax exemption of a predeceased spouse.

Jeanne FitzGerald s the Tax Manager at Woodstock Services Company. You may contact her at jfitzgerald@woodstockservices.com.