CAUBLE & HARRE WEALTH MANAGEMENT

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December 14, 2011

Dear:

I wanted to write before the end of the year to briefly comment on a few topics. I will comment on Europe, but limit my thoughts to one paragraph. The US deleveraging process will be discussed, and also an argument for not going to cash when everything is so uncertain.

Europe continues to capture the headlines, and will continue to do so for some time. Again the issue is that there is too much debt. There are only three solutions for too much debt: pay it down by redirecting cash flow from investment or spending to debt reduction, default on the debt and print money to pay off the debt. Some combination of these three choices will be used. The markets and politics will forge an answer. Politics is bad enough in one country and with all the countries in the EU, the process will be noisy and potentially dangerous for the rest of the world. Things will not automatically become a disaster, however, and current stock market prices already reflect a fair amount of pain.

With regard to reducing the amount of debt in this country please refer to the enclosed chart. Again, we had (and still have) too much debt. Some has defaulted. The Federal Reserve has monetized some of the debt, and some has been paid down. The upper left box on the chart shows that Total Domestic Nonfinancial Debt continues to increase, but at a slower than historical rate. This figure is comprised of four sources (the charts on the right hand side): Household Debt (declining for 13 consecutive quarters), Business Debt (Increasing a bit, but at a slow pace), Federal Government Debt (showing strong double digit growth still) and State and Local Government Debt (shrinking). Domestic Financial Debt has been decreasing for11 consecutive quarters. There is more work to be done, but progress has been made domestically without crashing the economy. If we can get this far while maintain positive economic growth, we should be able to achieve our goals without a major recession.

Finally, I wanted to discuss why someone should not give up on stocks, even if the returns are frustrating for some period of time and even if there is a great deal of uncertainty. Consider a portfolio of four stocks: Abbott Labs, Emerson Electric, Microsoft and Proctor & Gamble. To be clear, four stocks do not make a diversified portfolio. These four companies are representative of the bias we have when constructing portfolios (either with individual names or with mutual funds). The intent of this exercise is to show the benefit of investing in growing companies.

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If one had invested $200,000 total, equally divided across the four stocks at the end of 2006, they would have been expecting a dividend income of 4,035.70 at that time. At the end of 2010, this portfolio would have been valued at $210,756 suggesting a return of 1.05% annually. Positive results, but not so great. Consider the dividend cash flow however. At the end of 2010, this investor would be expecting an annual dividend cash flow of $5,941 per year, an increase of 47% over that four year period.

Even though the price of the stocks did not move much during this time period, the underlying revenue and earnings performance of the companies was doing okay. Collectively, these four companies generated $155 billion in revenue during their 2006 fiscal year. This increased 27% to $197 billion during the 2010 fiscal year. Earnings did even better, increasing 54% from fiscal year 2006 to 2010 from $24.8 billion to $38.2 billion.

Companies can increase earnings faster than revenue. Some of a corporation's costs do not increase with increased production. These are called fixed costs. Variable costs would increase with production. If revenues increase, but some portion of the cost structure does not change with this increased level of production, more of the revenue makes it to the bottom line (earnings).

For these four companies, earnings increased about 54% while the stock value increased about 5.4%. The P/E multiple declined over this time period. Price did not move much, but earnings increased materially. While frustrating as an investor, it sets the stage for more constructive returns going forward.

The other major element in the above example is the increased dividend income. In an era where fixed income yields seem to move lower and lower, investing in dividend paying companies (even in volatile economic times) can produce increasing levels of income.

This is likely basic for a lot of you, but I wanted to give you a reminder in the midst of a frustrating year for returns.

Regards,

Peter. B. Harre, CFA

Enc.

# Credit Comment

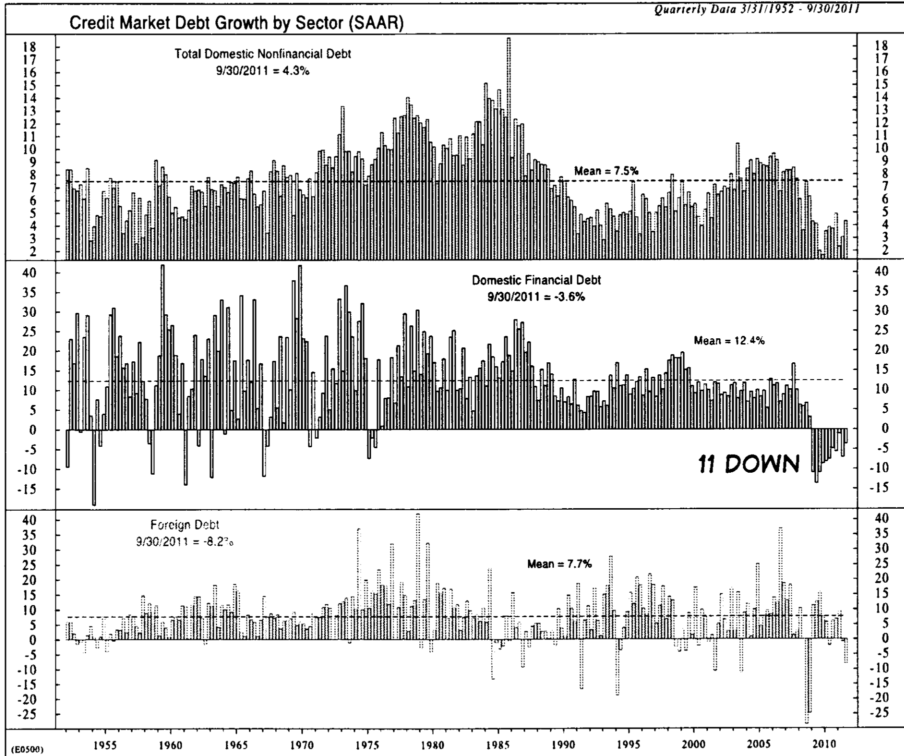
December 8, 2011

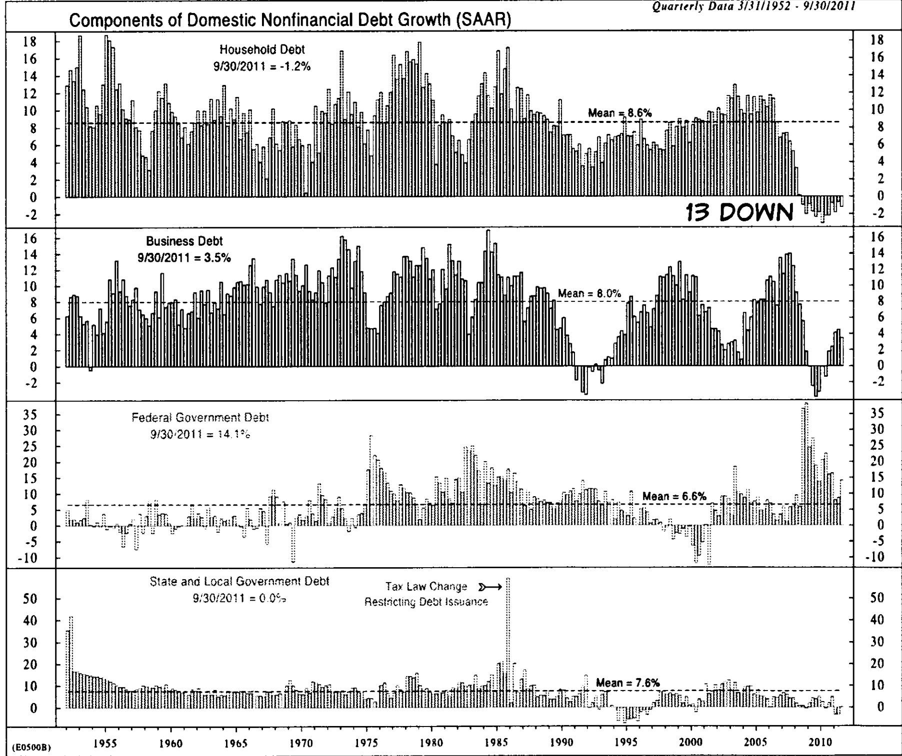
## THE DELEVERAGING STORY CONTINUES

Joseph F. Kalish, Senior Macro Strategist

- **Domestic nonfinancial debt grew at a 4.3% annual rate in Q3, led by a 14.1% surge in federal debt.**
- Household debt contracted for the 13th consecutive quarter, declining at a 1.2% annual rate. Once again, mortgage debt led the way, falling at a 1.8% rate.
- Business sector debt rose at a slightly slower 3.5% annual rate. Corporate debt expanded for the seventh straight quarter.
- The financial sector continued to delever, contracting for the 11th consecutive time.
- The foreign sector also shrank at the fastest pace since 2008.
- **The deleveraging of mortgage and financial debt is alive and well and still has several quarters to go.**

Prepared Exclusively for Peter Harre

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Issue #CC201112081
*(EGN754)*