Sound Investments Inc.

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Fourth Quarter 2012

DJIA 13104 S&P 500 1426 NASDAQ 3110

Year End Commentary 2012

Stocks shrugged off numerous worries, from the election to the fiscal cliff, to log a good year in 2012. When the final bell rang, the Dow Jones was up over 15%. Europe gained 20% and emerging markets or less developed countries were up 19%.

On the bond side, high yield bonds were up10% while investment grade bonds returned 4%. Again, foreign bonds did the best returning 15%.

Below we look at the big picture, outlining of what could go right and tie it back to our portfolio positioning.

Outlook for the U.S.

In the United States we are still recovering from the great recession and having got through the cliff, we are now facing spending cuts to entitlement and health programs. Make no mistake, things have improved significantly from 2009. On the back of this page, a job growth chart tells a less than stellar performance but an improvement nevertheless. We continue to hear about the new normal economy with growth rates of less than 2%, facing high debt levels and an aging population. This is all true but there are a lot positive things going on. Corporate balance sheets are in phenomenal condition with cash at an all time high. Stock prices have risen in the past 4 years. Stocks are near previous records, but valuations are lower because earnings have risen. Home and auto sales are rising. The foreseeable holdback is the high level of public debt. If Washington can come close to solving this problem, or at least show a change in direction, stocks can go higher. Earnings are expected to grow about 5% this year. There is positive news on shale oil and lower gasoline prices. The only sector that isn't growing is the government sector which is a good thing!

The World View

Our June client letter related that from 2003 to 2007, we had significant holding in international funds and after selling most of them off in late 2007, we started adding them again this past summer. United States represents approximately 22% of all equities in the world, so the balance, or 78% of all equities, are international.

In order to best understand the recession in Europe, you have to look at the creation of the Euro in 1999. This allowed weaker countries in Southern Europe (i.e. Greece, Spain, and Italy) to borrow money at the same rate as

One of Our Investment Approaches to the Market

We upgraded based upon the observation, that few, if any money managers consistently excel. Instead, we observed a wide range of performance returns, with only a small percentage of professional money managers investing in the right sectors of the equity markets at any given time.

This is because each money manager has a particular style that works well in some, but not in all market environments. Market leadership rotates between large-caps and small-caps, growth and value styles, and international and domestic areas. Leadership changes because economic conditions change. However, most fund managers do not change their particular styles when the market leadership changes.

Since market leadership is forever changing, we move incrementally towards the top ranked funds by progressively selling the lower ranked funds and investing in the new leaders. **This continuous process provides an effective way to invest in a broad range of investment opportunities as they develop.**

We use no load funds, exchange traded funds and some stocks as they provide access to the talents and research of the country's leading money managers, while they are at the top of their game.

This is a momentum strategy and have used it successfully for over 10 years.

The Investment Letter is mailed quarterly to our clients and friends. The

Germany and rates dropped drastically. This set off a borrowing binge that fuelled consumption and a housing bubble. Because these countries were not competitive with Germany and the northern European countries they ran large trade and current account deficits to finance this spending. This greatly benefited Germany's export market. Lenders were lax in their underwriting and ultimately, banks were saddled with bad loans, leading to a severe banking crisis and the need for bank bailouts—this part of the story is still unfolding. You have to put this situation in context --- It is only the Spain and Greece that are in real trouble --- Germany and the core European countries are slowing down and will survive. Some smaller countries may leave the European Union. The European Banks are currently being refinanced, like their American counterparts three years ago. Stocks are down over 20%, compared to American valuations and offer a good risk reward. (see back of this page for a Morningstar report on Oakmark International)

A brighter spot is the less developed counties. (i.e. Latin America, China, Korea, etc.) These countries are generally less indebted and are growing faster. Some examples show this transformation. For much of its history, Latin America has had a few rich people, lots of poor people and not many in the middle. But that's changing. From 1990 to 2010, the number of middle income households increased from 56 million to over 135 million. In a relative short period, Chinese consumers have become the number one buyers of luxury goods, ahead of Japan and America. In 2010, emerging markets accounted for 12 trillion in spending. By 2025, emerging markets are expected to account for 30 trillion in spending or nearly 1/2 of globally spending. Five or ten years from now, these countries will continue to develop and this should be reflected in their stock markets.

Other Concerns

1. Interest rates: There is growing consensus that rates will rise later this year. The 10 ten year bond is currently trading at 1.6% and it could easily go to 3% and rates would still be low. A 1% increase will reduce the value of a 10 year bond by 9% of the principal. In accounts holding bonds, we have been reducing the term of these holdings and investing in high paying dividend stocks as an alternative. **Foreign government bonds yielding 5 to 6% are also attractive.**
2. Presidential Election Cycle: The chart on the back of page one, shows gains and losses in the different years of the election cycle. Generally, in the first year, results are weaker.
3. Stock Market Corrections**:** One of the things that was different in 2012 was the fact that we never saw a strong correction. The S&P 500 Index only managed a brief 9.9% pullback from Apr 2nd to June 9th. This was much different from 2010 and 2011, when health restorations corrections paved the way for additional up side progress. Foreign markets did have these corrections and this is one of the reasons they are more attractive.
4. Inflation: We are looking at inflation of 2% this year. At some point the economic student in me, thinks whenever you print the amount of money we have printed for the past 5 years inflationary pressures will arise. It hasn't happen yet though.

Conclusion

We are allocating more funds to internationals and emerging markets. We also like government bonds issued by foreign governments that have low debts and are yielding 5 to 6%. In our last letter, we ended with the quote, "The world usually ends up better than the pessimistic think. We wouldn't have gotten this far if the pessimists had always been right." We continue to remain hopeful on equities with a favorable outcome from Washington and reasonable earning results will be the deciding factors – in how well the market will do in the early 2013.

Postscript: I have helped several clients on financial problems such as taxes, purchasing rental properties or refinancing their mortgage at favorable rates over the past year. I have a number of good contacts and would be happy to help out.

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