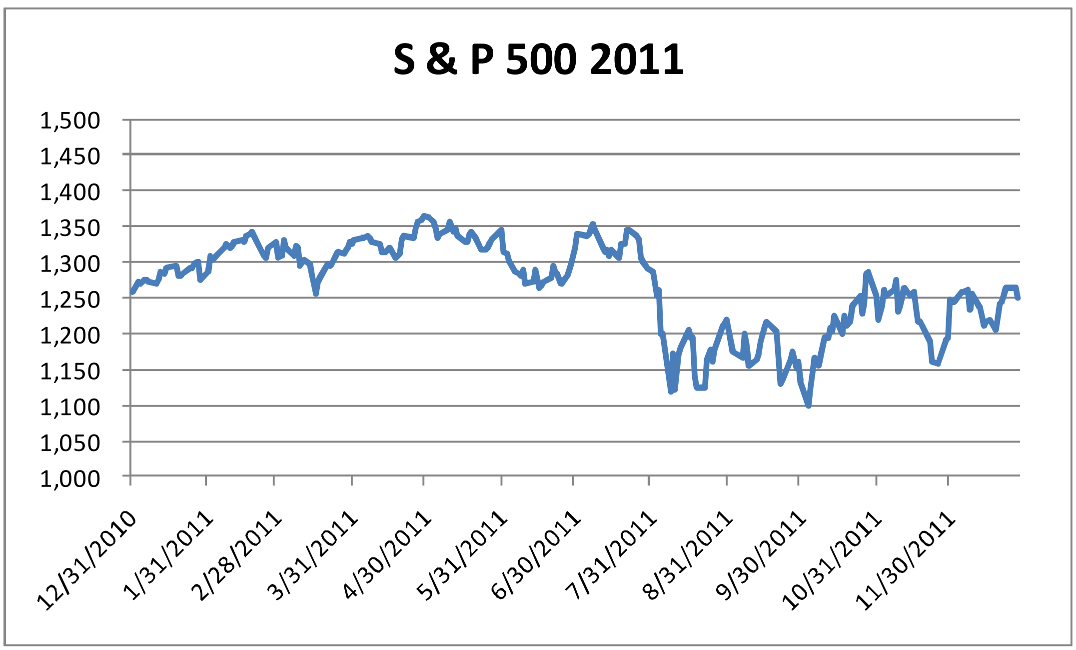
Licensed by the California Department of Corporations as an Investment Advisor

Investment Newsletter – December 2011

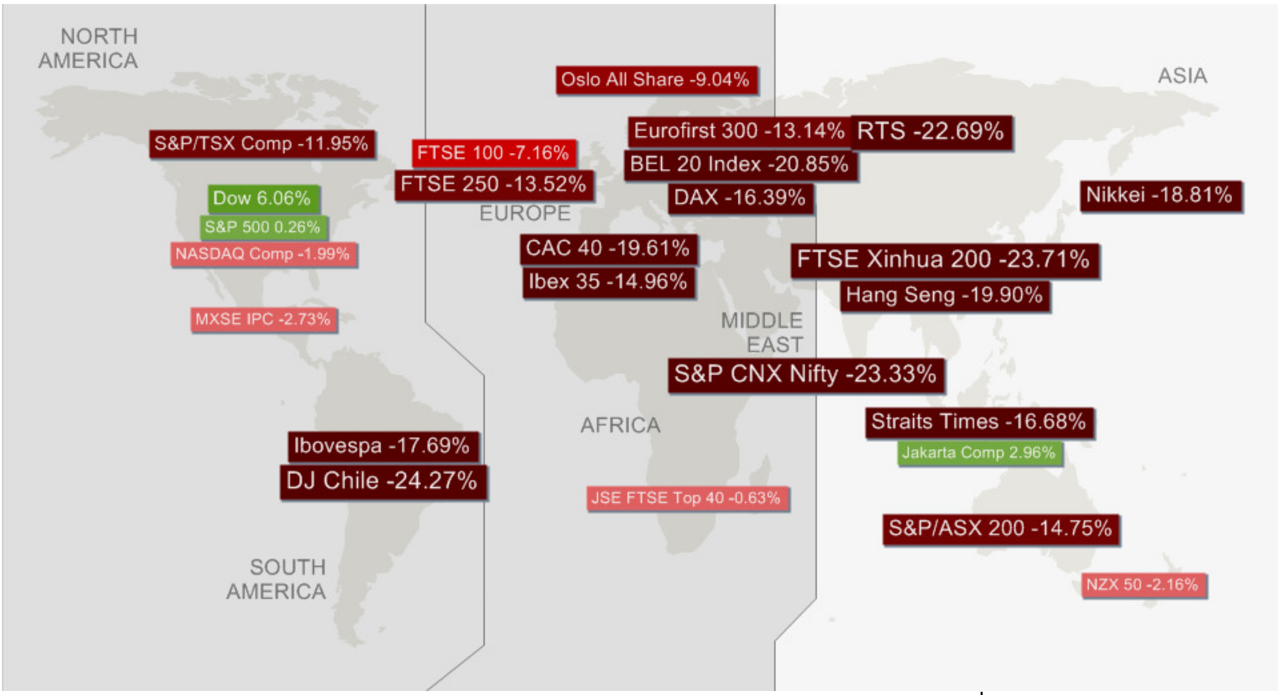
At the end of 2011 we take a look at how the markets performed over the last year, both in the U.S. and abroad. Then we'll compare prospects across various world markets for 2012.

Securities Investing in 2011

In 2011 the U.S. stock market, as measured by the S&P 500 index, returned 0%- breaking even almost exactly for the year. As the graphic shows,



the flat finish was achieved with a LOT of volatility over the year. Our clients' returns are in positive territory (just barely) - but with less volatility than the index. The lack of losses by the S&P 500 is an amazing result considering the combination of relatively high stock valuations and weak economic fundamentals. Europe is already in recession, China is facing a big drop in growth, and leading economic indicators show that the U.S. is also entering a recession in the near term. As the map from the Financial Times on the next page shows, the U.S. market performance is an anomaly in the context of world markets.



The table below gives details by country as of December 23rd.

Country	Index	2011 USD Return		Country	Index	2011 USD Return
North America				**Australia/Oceania**		
USA	S&P 500	0.6%		Australia	S&P/ASX200	-12.4%
Canada	TSX Composite	-13.4%		New Zealand	NZX 50	-3.4%
Mexico	IPC	-14.3%		Malaysia	FTSE Bursa KLCI	-3.8%
BRICs				Indonesia	Jakarta Composite	2.0%
India	BSE Sensex	-35.0%		Singapore	FTSE Straits Times Index	-16.8%
China	Shanghai Composite	-18.3%		**Eurozone**		
Russia	RTS	-22.9%		Germany	Dax	-17.0%
Brazil	Bovespa	-25.7%		France	CAC 40	-20.5%
Continental Asia				Italy	FTSE MIB	-27.1%
Hong Kong	Hang Seng	-19.2%		Spain	IBEX 35	-15.5%
Taiwan	Weighted Pr	-23.6%		**Europe ex-Euro**		
Japan	Nikkei 225	-14.6%		UK	FTSE 100	-6.5%
Korea	Kospi	-10.1%		Sweden	OMX Stockholm 30	-17.1%
Thailand	Bangkok SET	-3.5%		Switzerland	SMI Index	-8.7%
Vietnam	VNI	-31.8%		**South America**		
Africa				Chile	IGPA Gen	-21.1%
South Africa	FTSE/JSE 40	-18.8%		Peru	Lima General	-13.4%

Looking at this, we should consider ourselves lucky to break even for the year.

Because both consumer and government debt are so high, government policy will seek to lessen the burdens by depreciating the dollar and consumer spending will slow. As a result, I expect international markets, particularly Asia and Brazil to significantly outperform the U.S. over the next few years. As the

Lipper Indices:	
Equity Fund Indexes	**YTD return**
Large-Cap Growth	-3.55
Large-Cap Core	-0.68
Large-Cap Value	-2.9
Multi-Cap Growth	-4.72
Multi-Cap Core	-3.57
Multi-Cap Value	-4.86
Mid-Cap Growth	-5.93
Mid-Cap Core	-6.48
Mid-Cap Value	-5.37
Small-Cap Growth	-4.04
Small-Cap Core	-4.61
Small-Cap Value	-5.47
Equity Income Fd	1.89
Science and Tech Fd	-6.43
International Fund	-15.73
Balanced Fund	0.13

table on the prior page shows, this expectation did not play out in 2011; our foreign positions were a drag on performance.

The table at left shows 2011 returns for various mutual fund indices. It was a tough year for active managers; only equity income funds and balanced funds are positive for the year. The trend towards higher correlation among stocks continued. This is being driven by the index investing of exchange traded funds. This type of trading tends to increase the "noise to signal" ratio in the markets which makes it more difficult to earn consistent returns from good analysis and good stock picking. It's like playing bridge (or any other game of strategy and skill) with really bad players – the illogical moves of the know-nothings negates standard strategy and introduces more randomness to results. A good player should still win, but will experience inconsistency and frustration along the way.

Many well known investment managers had a difficult 2011 – especially those using gold to profit from the consequences of the credit bubble of the last decade. Gold was up 9.6% in 2011 but many investors invest in gold miners rather than the metal itself. The reason for this is that gold mining stocks generally go up 1.5 – 2.5 times the rise in the gold price; if you like gold you should love the miners. Unfortunately this trade did not work in 2011. The chart to the left shows the divergence of mining stocks from the price of their product. At Berkeley Investment Advisors, our gold mining stocks declined roughly 7% on average despite the increasing value of gold reserves. At the end of 2011, the value of gold mining stocks relative to gold is very low compared to historical levels. We can expect such stocks to enjoy good returns in 2012 even if gold prices don't change.

Given that two of our major asset allocations, foreign stocks and gold, underperformed, we had to do very well elsewhere to make up the shortfall. Our biggest successes in 2011 were high dividend stocks and a well timed purchase of Brigham Exploration - which was bought out less than 5 months later at a 35% gain. Our clients also benefited from allocations to the Long Term Income portfolio which returned 13.5% in 2011.

World Stock Market Valuations

While short term stock markets are un-predictable, we can get a sense of long term returns from relative valuations. The table below shows how each country's main stock index price-to-earnings ratio has changed through time. (The 2011 returns are as of December 23rd).

Financial Times Data	Index	2011 USD Return	Country Price to Earnings Ratio				
			12/31/2007	12/31/2008	12/31/2009	12/31/2010	12/23/2011
North America							
USA	S&P 500	0.6%	16.1	10.5	22.0	17.2	13.9
Canada	TSX Composite	-13.4%	17.7	9.3	22.1	19.6	13.4
Mexico	IPC	-14.3%	13.5	11.6	20.8	16.3	14.1
BRICs							
India	BSE Sensex	-35.0%	27.2	12.9	22.7	23.7	15.2
China	Shanghai Composite	-18.3%	25.0	9.7	18.0	13.1	7.8
Russia	RTS	-22.9%	23.1	4.2	12.9	9.7	5.9
Brazil	Bovespa	-25.7%	17.3	8.9	13.5	14.4	10.8
Continental Asia							
Hong Kong	Hang Seng	-19.2%	24.1	9.8	18.1	14.5	9.1
Taiwan	Weighted Pr	-23.6%	14.1	7.9	29.7	15.5	12.9
Japan	Nikkei 225	-14.6%	17.5	11.6	34.2	15.2	13.7
Korea	Kospi	-10.1%	13.4	7.6	19.3	16.0	11.7
Thailand	Bangkok SET	-3.5%	14.5	6.5	18.4	14.9	12.3
Vietnam	VNI	-31.8%					
Australia/Oceania							
Australia	S&P/ASX200	-12.4%	15.1	10.7	17.3	15.1	12.4
New Zealand	NZX 50	-3.4%	14.1	12.9	19.3	24.9	14.9
Malaysia	FTSE Bursa KLCI	-3.8%	15.3	15.3	20.3	15.8	15.3
Indonesia	Jakarta Composite	2.0%	21.2	21.2	18.3	20.2	15.8
Singapore	FTSE Straits Times Index	-16.8%	12.4	5.2	19.7	14.3	7.4
Eurozone							
Germany	Dax	-17.0%	13.6	11.2	26.8	15.1	9.3
France	CAC 40	-20.5%	14.0	7.9	21.0	15.6	9.7
Italy	FTSE MIB	-27.1%	11.7	6.1	18.8	13.2	10.9
Spain	IBEX 35	-15.5%	12.7	7.8	12.2	9.4	8.5
Europe ex-Euro							
UK	FTSE 100	-6.5%	11.8	8.4	12.4	15.5	10.4
Sweden	OMX Stockholm 30	-17.1%	11.2	7.5	11.8	15.3	11.3
Switzerland	SMI Index	-8.7%	13.9	12.8	17.7	12.8	14.1
South America							
Chile	IGPA Gen	-21.1%	18.2	12.3	18.0	22.7	15.9
Peru	Lima General	-13.4%	26.9	24.2	38.0	57.6	34.0
Africa							
South Africa	FTSE/JSE 40	-18.8%	14.7	9.9	14.8	18.8	14.8

Looking at the U.S. numbers, we see that most of the returns volatility in the last few years was driven by changes in how the market values the earnings of companies. In the Eurozone countries, we see that the market now requires higher returns to compensate for the risks of the credit crisis going on there. When P/E ratios get too high for the risks in an economy, the potential losses from realization of those risks becomes relatively large compared to the returns to be had if all goes well. On the other hand, when the market is pessimistic, P/E ratios are low. In this case, as long as things don't get even worse, returns are likely to be sufficient for the risks taken.

Based on the P/E ratios for 2011 in the table on the prior page, Hong Kong and Singapore stand out as relatively good value among those markets with sound legal systems for investors. Brazil also promises attractive returns given its strong economic fundamentals. All three of these economies will be negatively affected if the Chinese economy continues to weaken, but longer run, they should perform well. Russian and China are very cheap - these markets must offer much higher returns to compensate for legal, political, and accounting fraud risks. Peru stands out as vastly over-valued given the political and legal risks layered on top of world-wide economic risks.

Investing in 2012 – risks and returns

The probability of a new recession is rather high going into 2012. From our perspective this is not a big deal in itself since we're really only talking about economic growth going from +2% to -1%. In the overall picture this will not have a big impact on most companies' cash flows.

The bigger risk here is the impact on current market perceptions of growth, and thus the likelihood of lower price-to-earnings ratios. Expectations run in cycles from overly optimistic to overly pessimistic. Currently expectations are leaning towards the optimistic view. Current market prices seem to assume virtually no chance of a recession and that Europe will suddenly figure out how to reduce government debt without paying it off or anyone taking a loss. When news arrives that doesn't meet those expectations investors may decide that valuations (and thus future returns) are out of alignment with risks. In that case we could see price to earnings ratios for the S&P come down to levels consistent with negative growth.

Another possibility is that the relatively high P/E ratios in the stock market are driven by the fact that we are now in a low return environment. The 10 year U.S. Treasury bond now has a yield of just 1.87% - that is below the current rate of inflation. With long term government bonds paying less than the inflation rate, investors are willing to take low returns for high risks so as to preserve the purchasing power of their capital. This may persist for quite a long while but eventually interest rates will move up.

Our strategy is to own stocks whose earnings and dividends provide adequate returns right now - even with slightly negative growth. Real Estate Investment Trusts (REITs) are where we see the safest returns in this environment. In addition, the Federal Reserve's promise of keeping rates low for an extended period to subsidize banks and drive up inflation is greatly benefiting non-bank financial companies that do not have the risks that the banks have. Mortgage REITs, in particular, are benefiting - so much so that we are earning dividend yields of 17 - 20% on these positions.

The credit crisis in Europe and China's insistence on lending us trillions of dollars to buy their products has kept the dollar relatively strong. Our government's actions, however, are squarely aimed at weakening the dollar's buying power. All investors should dedicate some portion of their portfolio to protecting against this risk so as to generate compensating returns when the goal of a cheaper dollar is realized. For us this means a significant allocation to gold mining stocks and energy exploration and production companies. The value of these commodities is tied to real economic outputs and thus they constitute a safer store of value than any government IOU. As governments try to get out of their obligations by default or inflation, the companies producing these commodities will provide good returns to investors.

Berkeley Investment Advisors Long Term Value Portfolio

The economic and market views described have led us to focus on stocks with lower P/E ratios and higher dividends so as to ride out this uncertain period while generating dividends in excess of the returns available on government bonds. The table at left shows how our portfolio compares to the S&P 500 stocks. These numbers are from Folio Institutional (which uses different earnings numbers than those in the table taken from the Financial Times).

Statistic	Longterm Value	S&P 500
Price/Earnings	7.49	12.36
Dividend Yield	4.37	2.24
Price/Book	1.04	1.8

Fixed Income Investing

The principal risks for bond investments are interest rate changes. The primary drivers of changes in bond interest rates are inflation, real returns on investment in the economy, and pricing of credit risk. Both inflation and real returns are now very low relative to historical norms. These factors are likely to drive up interest rates in the longer term; it may be a few years before this happens. Thanks to the European debt crisis credit risk is well compensated at the end of 2011. The current yield on our Short Term Income portfolio is 6.26%. This portfolio has no long term rate risk. Our Long Term Income portfolio also has relatively short average maturity as protection against rising inflation. Its current yield is 7.51%. I consider these yields very good opportunities in the current low rate environment; these portfolios are likely to outperform the major equity indices over the next year.

Summary and Conclusions

The past year saw major declines in markets throughout the world except the U.S. where the stock market broke even despite the volatility. We enter 2012 with much uncertainty. In this environment investors should be prudent, not greedy. Patience will be required to avoid mistakes and await opportunities for better risk compensation. As always we appreciate the opportunity to work with you and we look forward to your comments and questions about this newsletter, 2011 results, or our strategies going forward.

Contact Information: RayMeadows@BerkeleyInvestment.com 510-367-3280