



January 6th, 2012

Enclosed please find a report of your account(s) for the quarter ending December 31st, 2011. Included is our commentary addressing 4th quarter economic and financial market results as well as our current outlook.

COMMENTARY

“The path to overcoming this won’t be without setback, but at the end of this path, Europe will emerge stronger from the crisis than before...” – Angela Merkel

The German Chancellor closed the year with some words of optimism (shown above) on a burgeoning credit crisis overseas. The European Union's (EU) leaders, led by Germany's Angela Merkel and France's Nicolas Sarkozy, have pledged to work together to bring more cohesion to the 17-member bloc. Moreover, EU governments along with the European Central Bank (ECB) are determined to prevent the interest rates of Italy and Spain from rising to levels that forced Greece to ask for a rescue package. The ECB cut interest rates two times in the 4th quarter and has been offering banks unprecedented deals to persuade them to keep lending. The Eurozone crisis, now in its second year, permeated every capital market across the globe. With that as a backdrop, non-US markets were unable to contend with their domestic brethren as investors preferred its relative safety. The year was characterized as one of tremendous volatility, brought on by increasing global and political economic uncertainties, which drove a massive flight-to-safety into higher rated securities. The markets focus, particularly in the 2nd and 3rd quarters, was less on corporate fundamentals and more on political concerns.

The developments last year tested investor discipline as evidenced by the exceptional capital market capitulation. Over the course of the year, the S&P 500 Index moved within a 265 point range, hitting 1,364 on April 29th and dropping to 1,099 on October 3rd. All told, the S&P 500 Price Index finished the year at 1,257.60 after starting the year at 1,257.64, leading to the smallest annual price change since 1947. Fortunately, investors turned their attention from the debt crisis to better-than-estimated US economic data in the 4th quarter and this optimism helped salvage a year where the S&P 500 Index was down nearly 9% after the first three quarters.

In December, the Commerce Department reported that 3rd quarter GDP came in around 1.8%. While the pace of economic activity remains below historical recovery levels, this was a rather strong report given the ongoing calamities facing Europe. Elsewhere, retail sales showed strength during the holiday season and the unemployment rate fell to 8.6%, its lowest level since March 2009.

Despite the fact that equities rallied to end the year, investors remained somewhat cautious. Although European leaders arguably made some headway in containing their debt troubles, investors remained skeptical that the end was in sight. The Euro continued to depreciate against the US dollar in the final quarter of 2011 and US Treasury yields remained near record low levels. The market seems to be pricing in the likelihood of a recession in Europe and investor sentiment remains fragile as the length and depth of the recession depend on future policy decisions.

EQUITIES

The S&P 500 Index surged 11.8% in the 4th quarter and virtually every major global equity index posted solid gains after facing significant declines in the previous quarter. The risk off trade that permeated much of the discussion last quarter was replaced with optimism and risk taking. Talk of a double-dip

recession in the US faded during the final quarter as earnings and economic data pointed toward modest growth rather than contraction. As is typical in a risk on environment, the more cyclical sectors outperformed the defensive sectors. Industrials, Energy, and Materials were the top performing sectors as all three had mid teen to high teen returns. The more defensive Telecom, Healthcare, and Utilities sectors posted high single digit returns, but lagged the overall market index. Despite the outperformance in the 4th quarter, cyclical sectors generally underperformed for the year and Utilities was the top sector in 2011, up 19.9%.

In addition to preferring the more cyclical sectors, investors also favored small and mid cap stocks in relations to large cap stocks. The Russell 2000 Index of small cap stocks increased 16.0% and the Russell Midcap Index improved by 12.3%. Furthermore, value stocks modestly outperformed growth stocks across all market caps in the quarter. However, this quarter's trends were not indicative of the year as large cap stocks were the top performers in 2011 and growth stocks notably outperformed value stocks in the large and small cap categories.

On the heels of their worst quarter in 3 years, international equity markets rebounded somewhat as investor angst showed signs of modest improvement. Equities in Europe advanced 5.5% during the quarter, led by a rebound in Ireland, up 22.4%, and stability in the UK, up 9.1%. The magnitude of returns vis-a-vis the US were disappointing as austerity measures in the region imply declining government spending and the likelihood of a regional recession seems high. Both households and businesses remain reluctant to spend given the high level of fiscal and monetary uncertainty.

The euro (€) weakened and declined 3.6% against the dollar (\$) during the quarter and detracted from the region's returns for US investors. Approximately €157 billion (\$203 billion) in debt is scheduled to mature in the first three months of 2012. By the end of that period, leaders have pledged to draft a stricter rulebook for controlling government spending. Assembling the fiscal compact, which anchors debt limits into national constitutions and accelerates sanctions for violators, will entail creating a framework for euro members and other European Union states to draw up rules among themselves. The refusal by the UK to participate in a plan to alter EU treaties could complicate efforts by euro-area governments seeking to use EU institutions to police any new debt scheme.

Emerging market equities, as measured by the MSCI Emerging Markets Index, increased a meager 4.5% in the final quarter. These markets struggled to contend with demand contraction from the waning Eurozone region and continued concerns of economic growth deteriorating. Despite considerable economic and fundamental strength, investors were reluctant to place capital in markets historically known for their heightened volatility and political disruptions. As a result, emerging market equities were unable to hold up to those in the developed world.

FIXED INCOME

Despite a strong rally in the final quarter, the bond market produced the highest returns of any financial assets, beating stocks, commodities and the dollar for the second time in the past decade. Bond outperformance was in direct response to Europe's sovereign-debt crisis as investors fled the equity market in favor of less risky assets. Led by US Treasuries, fixed-income securities worldwide returned 1.1% in the quarter and 7.8% for the year, as measured by the Barclays Aggregate Bond Index.

The corporate credit market experienced heightened levels of volatility throughout the year as investors sought the relative safety of sovereign securities. However, during the final quarter investor angst subsided and credit markets rebounded led by high yield and bank loans. Encouraging economic reports and upbeat earnings data in the US provided ample support for investors to wade back into the market following an abysmal 3rd quarter.

The benchmark 10-year note yield closed at 1.88%, its lowest at year-end since 1963. It tumbled 142 basis points, or 1.42%, from December 31st, 2010, in the biggest annual decrease since the 181 basis-point drop in 2008. Treasuries were supported by the Federal Reserve, which pledged to hold its benchmark interest rate near zero until mid-2013. Not surprisingly, the Treasury Department took advantage of the low rate environment and attracted \$3 for each dollar \$1 of the \$2.1 trillion in notes and bonds sold this year. It was the most since the government began releasing the data in 1992.

Elsewhere, the municipal bond market had a tremendous year as some analysts negative outlook failed to come to fruition. Municipalities across the continent recognized the danger associated with over-extending their balance sheets with excessive leverage and quickly worked towards solutions to balance their budgets. Investors rewarded the alleviation of these concerns and pushed the group 1.9% higher during the final quarter and 8.6% for the year. Defaults by municipalities nationally reached \$2.1 billion in 2011, down from \$2.8 billion in 2010. The year also saw a 10-year low in new issuance, with only \$295 billion of tax-exempt bond issuance nationally. The reduced supply provided an even stronger fundamental footing for the asset class throughout the year.

MARKET OUTLOOK

As we move into the New Year, the risks in Europe remain front and center. Against the drumbeat of negative headlines coming out of Europe, it has been easy to overlook significant changes that have taken place over the last 12+ months. Substantial resources have been committed to aid troubled sovereigns via the European Financial Stability Facility (EFSF) and the European Central Bank's Securities Market Program. The crisis has ushered in new governments in Ireland, Portugal, Spain, Italy and Greece. Recently, German and French leaders have sponsored a plan to install new guidelines by March. A crisis that began in Greece more than two years ago has moved to the euro area's core. Leaders are struggling to persuade investors they can contain the risk and assure the euro's survival. Leadership will be critical and heavily scrutinized as presidential elections in the US, France and Russia portend possible changes as well.

We continue to work diligently to help you achieve your investment goals. Please call us if you have any questions.

Very truly yours,

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