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Patience was rewarded in 2010, as a strong stock market rally in December brought the full year's performance figures up into solid territory for investors. It was a difficult year, but one that revealed a modest recovery is still underway. Analysts expect the pace of recovery to pick up in 2011. Public policy is focused on creating economic expansion in order to pay down budget deficits and help people secure the jobs they need to support their families. Investors share an interest in public policy, although stock market performance is not necessarily limited by the rate of growth in the general economy.

As expected, the mid-term elections resulted in a dramatic power shift within Congress. Republicans gained control of the House, while Democrats retained a narrow lead in the Senate. A divided Congress has historically been good for financial markets, forcing both parties to work together in order to pass any meaningful legislation. Following the election, Congress and the White House agreed upon a compromise tax package that provides a two year extension on favorable tax treatment for dividends and capital gains, as well as a new estate tax program.

Voters expressed their discontent over the sluggish economy and escalating federal budget deficits. People want more jobs and less debt. Investors may also be concerned that a heavy debt burden will weigh down the economy and limit stock market performance in coming years. On that point, there is some good news, and it may be important to distinguish between two separate topics:

1. *Creating jobs and paying down debts* – Accomplishing these objectives is an easier task when the economy is growing. A healthy economy motivates companies to add to payrolls, while expanding the tax base from which the government pays its bills. <u>Public policy focuses on economic growth</u>.

2. *Generating a return for shareholders* – Investors are counting on a company's ability to profitably grow its business, which includes securing labor and financing at favorable terms. <u>Investors focus on earnings and interest rates</u>.

Budget deficits and their impact on economic growth are likely to be an important issue in the coming years, but that does not mean investors will be saddled with substandard performance in their portfolios. Evidence suggests the rate of economic growth has less bearing on stock prices than how well companies navigate the economic environment to generate profits. As an example, the economy was growing fairly well in 2008, with unemployment only around five percent, until the credit crisis interrupted the flow of funds that companies rely on for their business activities. Stock prices collapsed as the prospect for corporate profits suddenly derailed. Conversely, stock prices rose in 2009 and 2010, even though the economy was weak, because corporate profits were recovering. To use a sports analogy, the economic environment is like the weather and field conditions, while the stock market is more about the teams.

The linkage between deficits, interest rates, economic growth and stock market performance was reviewed by Dimensional Fund Advisors (DFA). In a study released by DFA this past October, they arrived at the following conclusions:

1. Large federal deficits do lead to higher long-term interest rates.
2. Large federal deficits do reduce long-run economic growth.
3. However, lower economic growth does not imply lower stock market returns.

The first two conclusions make intuitive sense, but that third one may require some thought. The attached page shows the results of DFA's study, which examined stock market performance of countries around the globe over a 38 year time period. There was virtually no difference between the stock market performance of countries with high economic growth rates and ones with low economic growth rates. Returning to the sports analogy, it was ultimately the teams, not the weather, that generated the results. While this may be surprising, it is actually encouraging news for investors. It means that public policy is only part of the story when it comes to the prospects for their portfolio.

Companies have rebuilt profits largely through cost-cutting efforts, and they are now sitting on a mountain of cash. We expect they will begin to loosen their purse strings in 2011, and that bodes well for capital spending, mergers & acquisitions activity and employment gains. However, spending has to be balanced with revenue gains in order to deliver progress in their bottom line. Too much spending could be disappointing at earnings season.

It is important for our country to get its fiscal house in order. Paying down deficits will support future economic growth, which is the basis of our high standard of living. The outlook for 2011 includes improving economic reports, company revenues and new job creation, while moderating growth rates for corporate profits and some upward pressure on interest rates. We believe these factors will net out positive for investors, particularly if optimism about the recovery motivates people to re-engage funds that are currently sitting on the sidelines.

We send our very best wishes to you and your family in the New Year.

Low GDP Growth Does Not Predict Low Future Returns

A Study by Dimensional Fund Advisors

Each year, divide countries into two groups depending on realized real GDP growth.

Form portfolios of high and low GDP growth countries. This assumes you can forecast GDP growth perfectly.

Returns are not reliably higher for high-growth countries.

Developed Markets (1971-2008)	**Average Annual Return**	**Annual Standard Deviation**	**Average Annual Real GDP Growth**
High-Growth Countries	12.90	23.07	0.92
Low-Growth Countries	13.52	23.04	-4.02
Emerging Markets (2001-2008)			
High-Growth Countries	19.77	31.57	2.52
Low-Growth Countries	24.62	32.55	-4.94

Countries are equal-weighted and returns are in USD, net dividend. Countries are determined as developed or emerging using MSCI definitions. Real GDP data is from the World Bank Development Indicators Database. Return data are from MSCI and exchange rates are from the Federal Reserve Bank of St. Louis.

Source: Dimensional Fund Advisors