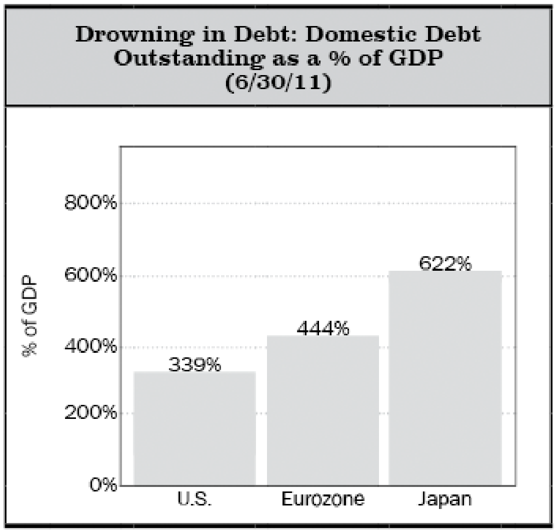
Pacific Crest Financial Advisors, LLC

Dear Clients and Friends,

Looking back at 2011 we saw a lot of volatility in the markets with numerous large single day swings. However, if we simply look at the starting point and finishing point of the S&P 500 through 2011 we start and finish the year at the same point of 1,257. The return on the S&P 500 index was all from the dividends being a 2.1% total return for 2011. Small and mid-cap stocks closed the year down 4.2% and 1.7% respectively. The turmoil in Europe dragged foreign stocks down 11.8% as seen by the MSCI World ex USA Index. Emerging markets equities dropped even further and ended 2011 down 18.8%. High quality bonds both domestic and foreign, produced positive mid-single digit returns for the year. Thus we have another year of the positive bond returns leading the return in our client portfolios.

We continue to believe Europe is far from solving its financial problems. We expect a higher level of short-term volatility from historical averages. We still have years of deleveraging in the developed world economies ahead of us.

Almost the entire developed world is struggling to dig out from under a mountain of debt. The problem is that there is no easy or quick solution to doing so. All options involve economic pain that is compounded by political uncertainty. The spotlight is on Europe, but the U.S. and Japan also face debt-related challenges. The following table quantifies all debt, public and private, in the majority of the developed world.



Sources: U.S. Federal Reserve, Bank of Japan, and Eurostat.

Having hit debt levels that are unsustainable, deleveraging (debt reduction relative to GDP) is necessary. Ideally this comes from economic growth—increasing the denominator in the debt/GDP ratio. But when debt is so high, it becomes a headwind to growth—as households spend less because they are already committed to high levels of debt service, are out of work, and/or need to rebuild their savings due to the negative wealth effect from the plunge in housing prices and financial assets. Governments try to use fiscal stimulus to counterbalance the private sector's retrenchment, but this can only continue for so long, as the increased government spending/stimulus adds to the growing burden of public debt. Eventually, growth in government spending must contract, adding to the headwind. So, growth as a near-term option for deleveraging is not realistic. That leaves spending reductions and tax increases as solutions at the government level (austerity), or some degree of debt default. Default can happen in two ways: (1) not repaying debt (e.g., Greece and probably at least some other European governments will default on a portion of their debt, and many households are defaulting on their mortgages and credit card debts), or (2) creating inflation by "printing" money so that money is devalued. Both of these options create other problems.

Most of the developed world will be forced to spend less and pay higher taxes in coming years. Some governments will default. Others will attempt to create inflation to reduce the debt burden. Governments can also attempt to force what is referred to as "financial repression," where they use all possible tools to keep interest rates low. This serves several purposes including keeping their borrowing rates low so that the debt-service burden does not explode to impossible levels. For investors, this means low returns from fixed-income investments.

The analysis outlining these challenges is not controversial. The lesson from economic history is that, without exception, a debt-induced financial and banking crisis results in a lengthy period of subpar economic growth. This is what has been happening throughout the developed world economies since the 2008 financial crisis.

The debt load of the developed economies versus the emerging economies that have little debt and a low level of pension and health care commitments cast a positive light on a deliberate investment allocation towards the emerging growth economies. The emerging economies provide investments that have a low correlation to our developed market which are in tighter and tighter correlation between all the developed market equity markets with each passing year. With the strong decline in emerging market equity markets in 2011 (down 18.8%) and also seeking broader diversification, we will be establishing a deliberate allocation into the emerging market economies which would be a small deliberate apportionment from your international allocation.

We feel the strongest drive in the market is the deleveraging of developed economies that could take quite a period. Our domestic stocks do look cheap compared to interest rates as measured by the inverse of the price/earnings ratio compared against the yield on Treasury bonds. Another favorable equity outlook is that negative outlooks are well understood and so they are already reflected in equity stock prices. Our domestic economy is slowly improving but most economists do not expect this to accelerate.

Social Security

We continue to hear the comment that Social Security is going bankrupt. It is not. Even in the event that the program's entire surplus runs out in 2036 as projected with no changes, payroll checks would continue to cover most of it. Payroll taxes at current levels would cover 77% of the promised future benefits including inflation adjustments. The bottom line is social security is not going to disappear. Our best guess is that the retirement age might be pushed out further for the younger generation. We are seeing this pattern of later retirement with many new clients whose first question is - can I retire at age 67 or do I need to work to age 70. Five and ten years ago that opening question was can I retire at age 62 or do I need to work to age 65.

Personal Information

Phishing activity continues but is more focused and personalized. The crooks are gathering more and more personalized data that makes their emails appear legitimate. Between June 2010 and June 2011, according to a report by the network company Cisco, money that spearphishers (personalized email scammers) squeezed out of victims quadrupled from $50 million to $200 million. During the same period, money made from traditional spam dropped from $1 billion to $500 million.

Scammers realize that these days you're likely to ignore a "Dear Friend" request asking for your bank account number. But when the same request comes in an email purportedly from your bank — and addresses you by name — the odds greatly increase that you'll give the sender the hoped-for response. If you ever get an email asking for any personal or account information, do not respond to the email. You can call the organization's service agents using an independently verified phone number to check if the information request is truly from them.

IRA's and Lawsuits

One other question raised that may be of interest is does an IRA account provide asset protection in case of bankruptcy or personal injury lawsuits? In Washington State directly owned IRAs provide asset protection up to a $1 million dollars (index by inflation). This protection does not apply to inherited IRAs unless the beneficiary is a surviving spouse.

New Office Location in Seattle

We have moved our office in Seattle three blocks east of our old location. The new Seattle office will be located in the Two Union Square building on the 4200 floor. In the new location we will have access to administration support when needed. The new address is as follows:

601 Union Street, Suite 4200
Two Union Square
Seattle, WA 98101

Our phone number will stay the same as before and we will still validate parking for client parking in the buildings garage for scheduled appointments.

Tax Documents

For those of you that had sales of investments in 2011 (in a taxable account) we have enclosed a Realized Gains and Losses report. Please be sure to keep this report to aid in the completion of your 2011 income taxes as it details not only the sale date and proceeds but also the original purchase date and cost basis (items not reported by Schwab).

Personal Updates

We both had a wonderful Christmas involving the excitement of our young daughters anticipating Christmas morning. Alec was even more thankful after having had a colon cancer scare after his first colonoscopy this fall that required surgery in early December to remove a tumor. The post-surgery pathology report on the removed tumor and 8 inches of colon showed no spreading cancer. Alec spent much of Christmas holiday recovering from surgery and hugging his children a little harder and longer. Darron and Jenny (his wife) spent the holidays surrounded with lots of extended family. The Kuehn daughters spent the holidays playing with adoring grandparents that came from near and far.

As always, we greatly appreciate those of you who have been sharing our name and the work we do. Most importantly we treasure your trust.

Sincerely,

Alec

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Managing Director

Darron

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