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2011

Fourth Quarter Report

After a volatile year that was marred by the sovereign debt crisis in Europe and political dysfunction, the S&P 500 finished with a return of 2.11% while the broader based Russell 3,000 closed the year with a 1.03% return. Defensive sectors such as utilities and consumer discretionary stocks were the top performers after posting returns of 14.83% and 10.53%. The financials, led by the banks, were the worst performers with double digit losses of -18.41% followed closely by cyclical sectors such as materials with a -11.64% loss.

The MSCI World ex USA Index, the benchmark for developed markets internationally, returned -12.2% while the MSCI Emerging Markets Index returned a -18.4% for the year. The MSCI World ex USA Index was led by the United Kingdom and Australia while the largest losses were sustained by the European countries most affected by the debt crisis. The MSCI Emerging Markets Index was most impacted by the losses in China (-22%), Brazil (-23%), and India (-24%). The Dow Jones – UBS Commodity Index had its first negative year since 2008 with a loss of -13%.

The equity markets started off 2011 with strong first quarter returns driven by an optimistic profit outlook and improving economic fundamentals. Things deteriorated quickly however as the Arab Spring contributed to oil prices spiking over 20%. While the political landscape has changed dramatically throughout North Africa and the Middle East, the biggest fears surrounding key exporters such as Saudi Arabia have pretty much dissipated.

Not long after the Arab Spring kicked into full gear, the tsunami and nuclear disaster in Japan sent shockwaves throughout the financial markets. While fears of an economic collapse in Japan proved to be unwarranted, US companies are still dealing with supply chain issues to this day. Perhaps the biggest impact this event will have is on future energy policy.

The biggest surprise of the year occurred last summer as Congress failed to approve the debt ceiling in a timely manner. The debt ceiling debacle created a panic in the U.S. during a very vulnerable economic time and fanned the flames of the European debt crisis. EU member nations would have had to face these problems eventually but the slowdown that resulted from this action prevented a stronger recovery allowing all nations to face the challenges that surfaced in the European sovereign debt markets almost two years ago.

The European debt crisis was the biggest single factor affecting the equity, bond, currency, and commodity markets in 2011. Italian and Greek governments have collapsed and are currently being led by technocrats while elections in Spain and several other nations have replaced old regimes. After so many unsuccessful attempts at ring fencing the crisis, it appears the European Central Bank under the new leadership of Mario Draghi have at the very least contained the crisis. Instead of stepping up bond purchases – quantitative easing – to levels that would be politically unpalatable to the Germans, the ECB has announced they will lend an unlimited amount to European Banks. This policy serves multiple purposes: 1) it allows the banks to recapitalize themselves over time as they collect a healthy spread by borrowing at less than 1% and using those funds to purchase short term sovereign debt at 3-5%; 2) it creates a new bidder for this debt preventing countries from having to finance their debt at

what would otherwise be much higher rates; 3) alleviates fears of major banks collapsing and the impact it could have on the global financial system.

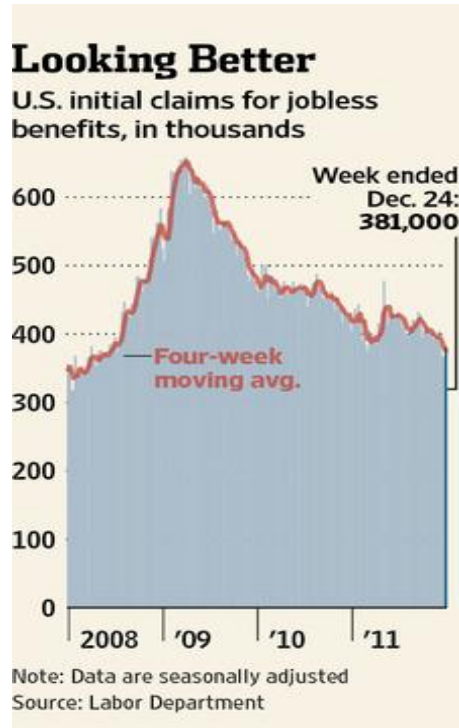
It is almost inevitable there will continue to be headlines out of Europe that will move the market and it would not be surprising to see downgrades in the sovereign debt of the larger EU countries from all the major ratings agencies over the next few quarters. Global markets have largely priced in a recession in Europe however the key will be whether or not they can keep their banking institutions solvent.

The largest threat to continued economic improvement would be an economic depression in the Eurozone; a disorderly default could very easily lead to a collapse in the currency which would have profound implications on the global financial system and markets. Other potential problems for the markets could come from supply disruptions due to a conflict with Iran or the sovereign debt crisis boiling over into other countries such as Japan.

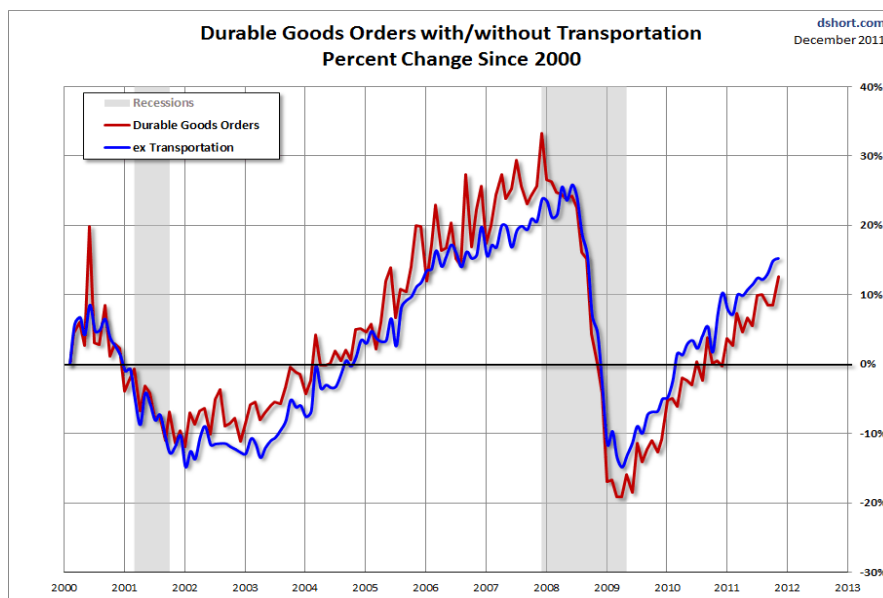
While an economic contraction in the EU – the world's second largest economy – would have a significant impact on the global economy, it is important to note that only 10% of the S&P 500 sales are derived in Europe. Looking beyond that statistic, most of those sales are comprised of non-cyclical items such as pharmaceuticals that tend to be more consistent regardless of economic conditions. Exports currently represent 14% of US GDP and only ¼ of those exports are to EU member nations. Even though the US economy can withstand a moderate to mild European recession, all developed economies are dependent upon emerging markets for growth. European banks account for an estimated 3 of the 5 trillion in emerging market loans and are a key provider of the credit necessary for emerging markets to continue growing.

As bad as the economy may have felt last year, S&P 500 earnings will come in near \$98 or 11.71% higher than the previous record of \$87.72 in 2006. This is an impressive figure considering GDP growth was a disappointing 2%, unemployment was near 9% throughout most of the year, continued declines in residential housing, and incomes were relatively flat. Even though GDP growth was a modest 2%, real GDP was a record high \$13.3 trillion. Perhaps the most impressive takeaway is that earnings were able to eclipse the prior record with the financial sector contributing a significantly lower percentage, a healthy development in our opinion.

The economic data continues to improve with several leading indicators such as average weekly hours, jobless claims, building permits, and durable goods orders gaining momentum. Several coincident indicators such as non-farm payroll employment and manufacturing are starting to move in the right direction. Contrary to popular belief, manufacturing is on the rebound and we are continuing to see positive trends in everything from the auto to petrochemical industries. The charts below illustrate the decline in jobless claims and increase in durable goods orders.



The shaded columns mark recessions -



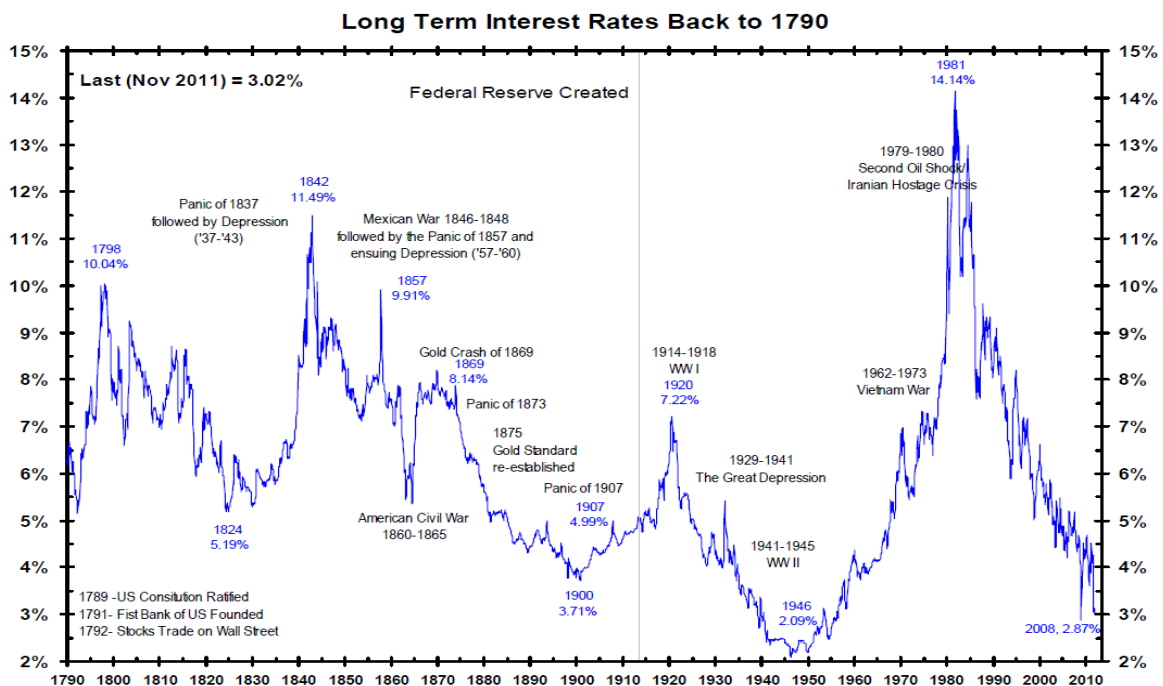
To put the figures above into perspective, the S&P 500 earned \$51.68 per share when the S&P 500 closed at 1,469.25 in 1999. Earnings are currently 89% higher even though the market is 14% below 1999 levels. It goes without saying that valuations were extended during the end of the dot-com era but it is worth noting that earnings have almost doubled over the past decade during what has been a frustrating period for most market participants. According to Bloomberg, the S&P 500 trades for 13.6 times forward earnings, down from 15.2% a year ago and 19% less than the average level since 1960.

According to Bespoke Investment Group, U.S. stocks are trading at their cheapest levels in decades when evaluated on price-to-earnings, price-to-book, and ratios such as dividend yield. The S&P started 2012 with a trailing P/E of 13, the lowest since 1990 and well below the 80 year average of 15. The current price-to-book ratio of 2.05 is well below the average of 2.43 since the late 1970s.

Even though market-cap weighted indices like the S&P 500 and price weighted indices like the Dow Jones Industrial Average have been flat over the past decade, equities as a whole have performed much better. For example, had you purchased an equal amount or 0.2% of all 500 stocks in the S&P 500 index you would have returned over 61%. Even more impressive, the small cap Russell 2000 index has returned 82% over the past decade while the Russell Midcap achieved returns in excess of 104%. It was the large mega-cap companies that underperformed. Whether you use any of the major equal weight large cap indices or any of the mid and small cap indices stocks were the second best performing asset class behind gold over the past decade.

Despite the evidence above, stocks remain the most under owned and underappreciated asset class based on fund flows, allocation by both retail and institutional investors, and sentiment polls. When we look at the world of asset classes, we think equities are attractive compared to fixed income, commodities, currencies, real estate, and precious metals.

Perhaps the most challenging asset class right now is fixed income. Treasuries no longer offer a yield in excess of inflation and are guaranteed to lose in real terms barring a deflationary event. As of today, we are avoiding treasuries and agencies, remain neutral on high yield, and are finding better value in the investment grade corporate and municipal bond space. We are keeping durations low in anticipation of higher interest rates in the years to come. The chart below shows short term interest rates going back to 1831.



We expect volatility to remain high as we move into what will be one of the most contentious elections in decades. It is worth noting that markets tend to outperform during years when an incumbent president is seeking re-election. In addition to the politically driven news cycle, market participants must confront a new form of financial journalism that has emerged in the past few years. Profiting from market declines has gone from a cottage industry in prior decades to a booming business in recent years. It is important to recognize that almost all of these people are either trying to sell a book, achieve a radical political agenda, or most likely stand to profit by positioning their clients in investments that benefit from chaos in the financial markets.

All of the negativity in the news cycle is creating incredible opportunities. As Jim Grant recently quipped, “You can either have cheap stocks or you can have good news, but you can’t have both.” Our portfolios are currently positioned for moderate economic growth and we will continue making adjustments as we navigate through the ever changing investment landscape.