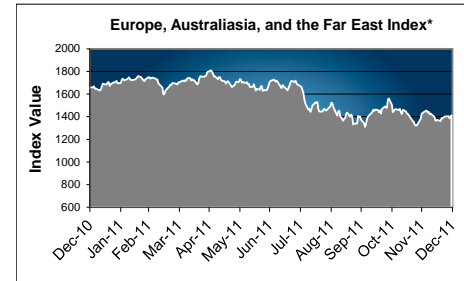
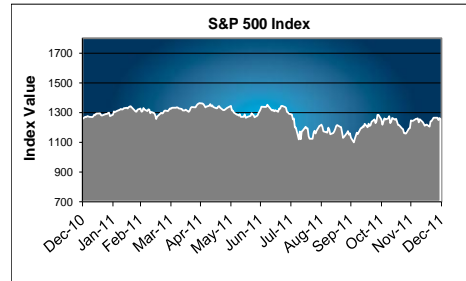


Stock Market Analysis



Confidence Void

It is not surprising to hear the growing skepticism of market participants when many of the basic rules of investing no longer work. The first lesson of investing is that investors should be rewarded for taking greater risk and stocks should out-perform bonds over time. A whole new generation of investors now questions the validity of this assumption after shares have produced negative returns for more than a decade and bonds have sustained a thirty year bull market. The second rule of investing is that the expected return should be related to the risk free rate which historically is measured by the yield of the domestic government bond. The market volatility surged after the ultimate safe haven, the U.S. Treasury lost its AAA rating. At the same time the price to insure German, Chinese, Japanese and even U.S. government debt has risen above some corporate debt issuers, while Spanish and Italian sovereign debt trades like junk bonds. This raises the question, what is risk free?

As a result of the market uncertainty, investors are once again more concerned about return of capital and not return on capital, resulting in another cycle of risk aversion. The MSCI World Index sank 17 percent in the third quarter, its worst performance since the 2008 financial crisis. Fears of a global economic downturn caused the iShares MSCI Emerging Markets Fund (EEM) to slump 26.3 percent, the worst quarterly performance since it was created almost a decade ago.

Most economists are coming to the realization that it will take time to deflate the leverage bubble in which infected both financial and government balance sheets over the past two decades. It remains our opinion that developed economies will continue to sputter along with below optimal growth while the deleveraging process continues. It does not help investor sentiment to have lawmakers bickering over proposed solutions as the major focus of the financial media. The extraordinary attention on government and central bank policies around the world has confused investment professionals who fear lawmakers' and central bankers' growing grip on the free market mechanism. The slow motion collapse of the Greek debt market is a clear example where policymakers have prolonged and increased the pain to investors rather than simply recognizing that the Greeks have defaulted. They need to simply allow the risk takers in the market who were rash enough to bet on a successful Greek outcome to take their losses. Every day that the default is delayed increases the ultimate debt restructuring expense.

The greatest market uncertainty relates to another potential meltdown of the financial sector due to the European financial crisis and a potential global economic downturn. Ironically most banks in North America and Europe now have record capital ratios despite stock prices that imply the contrary. Clearly there is investment risk if central bankers and policy makers do not work together to reduce government deficits over the next decade but investors must separate the media politics from the progress being made away from the cameras. In the U.S. most elected officials recognize the importance of reducing the budget deficit but must pander to their party line with a presidential election on the horizon. Following the election, we assume that a rational coalition will gain the fortitude to reduce defense spending, realign entitlement models and raise some taxes. Anchor's economic models show that this effort, combined with reasonable economic growth will slowly reduce the U.S. deficit over the next decade. We are also becoming less concerned about the housing cycle and the impact on Bank's balance sheets. The U.S. housing downturn is in its fifth year and builders are completing about 600,000 units per year, approximately half the estimate of household formation. Simply put they are building about half of what is needed which should eventually assist the U.S. banks' foreclosure inventory. While we do not expect a robust recovery, price stabilization has occurred in most markets over the past six months and housing affordability is near a record high due to record low borrowing costs.

In Europe, a successful restructuring of Greek debt should allow for more investor clarity. Over the longer term, country politics needs to be removed from Eurozone monetary policies. It is important to create a European Central Bank with a single coordinated agenda and the introduction of a Eurozone government bond. A coordinated effort to reduce government debt is also important to protect the value of the euro. In the short term, combining the euro-area "TARP-like" rescue fund (EFSF) with the European Central Bank's sovereign debt stabilization program is only a temporary remedy. The good news is that the Europeans already have a proven bank bailout model that was used during the 2008 financial crisis. An interesting side-note is how the media focuses on problems in Greece while ignoring the significant progress in Ireland where the yield on 10-year Irish debt fell more than four percent during the quarter.

The macro events have over-shadowed attractive stock fundamentals and valuations. After under-performing most asset classes over the past decade, shares are trading at the low-end of their historical range based on their price/earnings ratios and other metrics. Investors now receive a higher dividend on many of their common shares than long-term government bond yields. We believe that stocks already discount an economic downturn. While growth will likely remain weak in developed markets, this is not slowing the global urbanization trend. More than half the world's population now lives in cities due to the prosperity of the growing middle class in emerging markets. This silent wave of successful urban dwellers is buying Microsoft Xboxes, Pepsi sodas and Gillette Razors at record volumes. We expect this momentum to sustain reasonable global economic growth during the deleveraging process in developed markets.

*All stock index returns are adjusted for 30 percent foreign withholding tax. *MSCIEAFE Index*

Fixed Income Analysis



Merrill Lynch Fixed Income Indices				Modified Duration	Macaulay Duration	Maturity WAL	Period Total Return*			
Name	Code	Yield to Worst	Yield to Maturity	To Worst	(Years)	(Years)	Quarter	1 Year	3 Years	5 Years
Global Bond	GBMI	2.3%	2.3%	5.7	5.8	7.5	0.3%	6.0%	6.2%	6.5%
Non-US Bond	GBXD	2.4%	2.4%	6.3	6.4	8.2	-0.3%	4.6%	5.7%	6.5%
US Corporate/Govt	B0A0	2.1%	2.1%	5.8	5.9	8.1	1.2%	8.6%	6.7%	6.5%
US Government	G0A0	1.1%	1.1%	5.5	5.6	7.1	0.9%	9.2%	4.0%	6.6%
US Corporate	C0A0	3.9%	3.9%	6.4	6.6	10.1	1.8%	7.5%	12.1%	6.6%
US High Yield	H0A0	8.1%	8.5%	4.0	4.9	6.8	6.2%	4.4%	23.7%	7.3%
US Hybrid Preferred	P0H0	6.7%	7.4%	6.5	9.8	N.A.	1.1%	1.9%	9.8%	1.0%

*3 and 5 year returns are compounded annualized returns

Asia and Europe in the Spotlight

2011 proved to be another eventful year. From a capital market perspective, the earthquake/tsunami in Japan, the political and social crisis in the Middle East and the sovereign debt problems in the Eurozone were big drivers of the volatility in financial securities. Investor uncertainty and heightened volatility of asset prices helped government bonds to outperform riskier fixed income instruments and the stock market. Despite Standard & Poor's downgrade of the U.S. government's obligations, the Merrill Lynch U.S. Treasury Agency Master Index returned 8.7 percent in 2011. This performance was closely matched by high-grade corporate bonds, while high-yield bonds and preferred securities underperformed, but still posted positive returns. On the currency front, the Japanese yen hit a post-World War II high versus the U.S. dollar despite two publicized interventions in this currency pair over the course of the year. The yen nevertheless proved to be the best G10 currency in 2011, outperforming the greenback by about 4 percent. The U.S. dollar staged a big comeback in the second half of the year, once the euro came under pressure due to the debt crisis in the Eurozone.

To offset some of the negative growth effects of fiscal austerity and continued deleveraging, monetary policy became more accommodative in 2011. Benchmark interest rates are expected to drop even further in 2012. The Federal Reserve announced a measure called "Operation Twist" where it sells short-dated bonds for longer-dated Treasury securities. The impact will probably be minimal but could flatten the yield curve and anchor long-dated bond yields at a low level. The U.S. economy has slowly recovered, although leading indicators are just hovering around the boom/bust line. The U.S. central bank sees moderate growth ahead but economic problems in the Eurozone pose downside risks to the global economy. The U.S. unemployment rate is still elevated but recent data points have shown some encouraging signs with the leading initial jobless claims index hitting a three and half year low – signaling continued healing in the US job market. We are encouraged to observe that the Fed has been supportive for the financial markets and will continue to provide liquidity to the financial system in case economic downside scenarios play out. The Anchor managers expect preferred securities, investment-grade and high-yield bonds to outperform government bonds in 2012. Tier 1 securities and high-yield bonds are pricing a recession in the U.S. and a rapid increase in the default rate. While we agree that there are considerable downside risks, a negative outcome has already been discounted in many bond prices and the odds for a positive versus a negative surprise are higher in our opinion.

Globally, 2012 will be a challenging year. From an economic point of view, Asia and Europe will likely remain in the spotlight. Europe is an important export market for several Asian countries and European banks are also big lenders to the Asian region. A contraction in Europe and bank defaults would have significant ramifications for Asia. The Chinese Purchasing Manager Index (PMI) has fallen below the expansion/contraction line of 50 and the year-over-year change in Indian industrial production contracted almost as severely as it did during the Great Recession period of 2009. The Chinese authorities have started a monetary easing cycle but much more needs to be done. The Bloomberg consensus outlook calls for a weak recession in the Eurozone in 2012. This forecast is driven by continued deleveraging, austerity programs and higher bank capital requirements (which can lead to reduced lending). Although the European Central Bank is providing liquidity to the banking sector, in our opinion it is not doing enough to counter the contractionary impact from fiscal austerity. Lack of consensus between European policy makers and the European Central Bank, whose monetary policy is not as accommodative as in the U.S. or in the U.K., actually increases the risk that the forecast for a mild recession might turn to a more severe outcome. The Anchor managers end the year with a 30% overweight in the U.S. and no allocation to the euro and Japanese yen. We continue to see value in the British pound, Swedish krona, Norwegian krone and the Canadian dollar. Our exposure to Asia is through the Singapore and New Zealand dollars.