Q4 NEWSLETTER

PILOT
WEALTH MANAGEMENT

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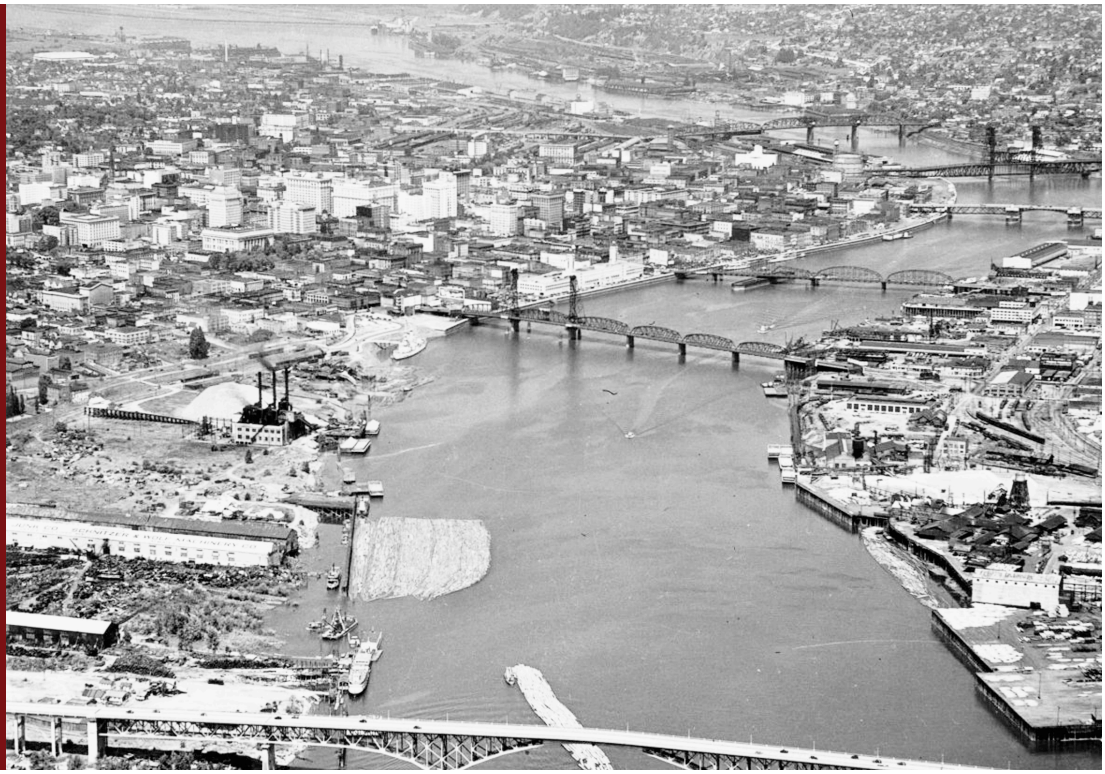

Aerial view of the Willamette River looking north, circa 1935. Photo courtesy of the City of Portland Archives.

Insert Sensational Headline Here

Otherwise known as the 4th Quarter Commentary

In early December we discussed all the doom and gloom on the horizon. According to the latest news headlines, there are not many reasons to be optimistic about our future. Some of them have read:
"Stocks Fall as Europe's Debt Crisis Flares Up"
"Stocks Recoil after Federal Reserve Inaction"
"US May Fall Back into Recession"

Economists have the near impossible job of aggregating an overabundance of data regarding our economy: the political environment, interest rates, global policy, trade, money supply, consumer spending, weather, tax structure and fiscal stimulus. It is important to note that very few people (if any) have been able to correctly forecast economic growth with any regularity. Furthermore, as evidenced in the recent revision of existing home sales data, we cannot without discernment trust the numbers. How all of this relates to individual investment decisions is beyond us. We view these odds as unappealing and therefore have no interest in wasting our time analyzing whether a recession is coming, who will be the next president, or how we balance the budget (don't get us wrong, we have plenty of opinions, but they are futile in helping us make better investment decisions). Likewise, we have no special insight into where the market as a whole will be at the end of next year (do the analysts ever forecast the market to drop?). We are however; extremely confident the economy (and housing) will improve and grow over the next five years (albeit at a less vigorous rate than the recent past), in spite of all the hurdles we face. As a country, we have dealt with revolutions, civil turmoil, class warfare, world wars, social upheaval, virulent inflation, asset bubbles and an uncertain political environment. Through all of this,

> The real standard of living for Americans improved nearly seven-fold during the 1900s…Compare the record of this period with the dozens of centuries during which humans secured only tiny gains, if any, in how they lived. Though the path has not been smooth, our economic system has worked extraordinarily well over time. It

In This Issue:

has unleashed human potential as no other system has, and it will continue to do so.[1]

If we don't spend our time trying to guess where the economy is going, what do we spend our time doing? We view the most important question to be: What return can I reasonably expect to receive from an asset class or individual security? Of course we have to make a few important assumptions in order to answer this question. 1) How much am I paying for it? 2) What does it produce in terms of earnings, dividends or interest? 3) Do I understand it? and 4) How likely is it that this will continue into the long-term? Most people forget that the first of these questions can trump all the rest.

1. Buffett, Warren. Berkshire Hathaway 2008 Annual Letter to Shareholders.

Deconstruction of the old Portland wharfs while crews drive pilings for the soon-to-be-built seawall on the west side of the Willamette, 1928. Looking north with the Burnside Bridge in the background. Courtesy of the City of Portland Archives.

2012 Outlook

We believe the present volatility will continue in an on-again, off-again manner into the near future. We are in an environment where a feedback loop is easily perpetuated through "news," represented by opinion, speculation, and entertainment. Indeed, through much of December, Analysts have decreased their expectations for future earnings in both the U.S. and Europe and most investors have yet to realize this. As we have discussed in previous quarters, there are plenty of reasons to be skeptical of present stock market valuations. There were opportunities, for a very limited time, that were intriguing. In fact we were able to take advantage of a few of these during the 3rd and 4th quarters. Unfortunately, the lightning like October rally quickly pushed valuations to levels that were not nearly as attractive…so we wait. Patience is a virtue.

In the long-term, some of the most reliable corporations in the U.S. are selling at reasonable valuations, especially those doing business in the emerging markets, where a growing middle-class has created enormous growth opportunities. Companies with world renowned brand names are competing for nearly 2 billion new consumers who currently spend $7 Trillion and are projected to spend $20 Trillion in the next 10-15 years.[1] This will not happen overnight, it is an opportunity that will take a decade or more to play out.

In spite of the aforementioned, we are currently underweight emerging market stocks, as they are selling for record premiums compared to Large U.S. stocks. As with any growth story that is priced to perfection, any short-term "news" to the contrary will create volatility. Indeed the financial pressures from Europe will surely impact demand for emerging market goods and even more importantly their nearly insatiable need for capital. We are actively looking for opportunity to add emerging market exposure, but not without an adequate margin of safety.

Similarly, small company stocks in the U.S. are selling at more than a 30% premium over large companies. This has occurred only twice in the last 32 years (1983 & 2007) and in both instances small companies vastly underperformed.[2] In the 24 years of exceptional prosperity, small company stocks certainly outperformed large stocks. But, as we look forward, investors may be disappointed with the reward and risk inherent with their text book "optimal asset allocation."

On a side note, throughout history, investors have tended to create simplified investment themes, and push associated asset values to unsustainable levels. When unlimited virtue is involved, even seemingly favorable developments can lead to disappointment, and disillusionment.[3] "Optimal asset allocation" and its inevitable exposure to the frothiest of assets may be one such theme.

At this time we are not particularly attracted to precious metals, despite the fact that they are shiny and pretty to look at, we think large, multi-national U.S. stocks are an equally appealing long-term inflation hedge and sell for a more reasonable valuation. Contrary to popular belief, the U.S. dollar remains the only readily available, international safe haven. The argument, that compared to 1980, on an inflation adjusted basis, Gold should be at $2000+ per ounce is ridiculous. That is like saying, on an inflation adjusted basis, compared to 1999 valuations, Microsoft Corp. should be worth $100 per share…of which we would love, but unfortunately is poor logic. Animal spirits do tend to be irrational and nonsensical.

As for bonds, we see long-term treasury bonds as rather speculative, given a paltry yield and significant potential volatility from interest rate fluctuations. Bonds with short-term maturities are much less susceptible to interest rates. Likewise, corporate bond prices tend to move much less with interest rates (more so with credit spreads) and many of the largest corporations have a healthy amount of liquidity, so we continue to be overweight cash, short-term treasuries and intermediate-term corporate bonds, and we wait patiently.

Despite the doom, gloom and the "news" of the increasing probability of a recession on the horizon, we do see better days ahead. For the discriminating investor, plenty of opportunity surely looms right around the corner.

1. Court, David and Narasimhan, Laxman. "Capturing the World's Emerging Middle Class" McKinsey Quarterly, 7/22/10.
2. Cheng, Jonathon. "Are Small Caps too Pricey." Wall Street Journal. 4/11/2011.
3. Marks, Howard. "What's Behind the Downturn?" Oaktree Capital Management Memo from the Chairman.

Performance Results

While certainly not sexy, our results were quite good on a risk adjusted basis. Compared to the seesaw of the stock market averages, our clients' results were satisfactory. Results fell short on an absolute basis however, as we underweighted interest rate sensitive bonds. Just when we thought interest rates could go no lower…they did. The day of reckoning will come for intermediate and long-term bonds. It will be very difficult to earn interesting returns on fixed income assets until interest rates return to more sustainable levels. In the meantime, we will settle for a paltry return on our allocation to safe haven assets.

	Q4	Q3	Since Inception
Pilot Wealth Composite	2.29%	-2.41%	0.65%
S&P 500	11.82%	-13.86%	-1.88%
Merrill Lynch Bond Index	1.06%	3.90%	8.49%
Russell 2000 Small Cap	15.47%	-21.86%	-6.02%

Data as of 12/31/11. Performance calculated quarterly.
Composite inception 2/3/2011.

Disclosures:

They are necessary and sometimes long-winded, but ours are pretty straight-forward. Composite return represents all assets custodied at Charles Schwab Institutional under our discretion, excluding accounts designated for cash management. Performance data is time-weighted and net of fees. Individual returns will vary based on risk tolerance, timing of investment and other factors. Returns include both fixed income and equity investments. S&P index data, Merrill Lynch Bond index data, and Russell 2000 Small Cap data includes gross dividends. Investors cannot own an index, a hypothetical portfolio without fees or expenses. Data is provided for purposes of comparison only and may not be the most relevant benchmarks. Data is believed to be accurate but is not audited or guaranteed. Past performance is no guarantee of future results.

Young Entrepreneurs Business Week Happy Hour Friendraiser: 2/2/12

Don't miss this opportunity to learn how you can help build the next generation of business leaders.

Join us Thursday, February 2nd from 4:30 - 6pm for appetizers and drinks and learn more about this amazing initiative.

Contact Jason Lesh (503-260-0108 or jason@pilotwm.com) or register online at www.yebw.org

2011 YEBW students, staff and volunteers.

About YEBW

If businesses are to remain competitive, it is crucial that our future workforce have an understanding and appreciation of the real world challenges and uncertainty facing the business community.

Founded by Nick Fisher (Portfolio Manager, Pilot Wealth Management) and his wife Maurissa, Young Entrepreneurs Business Week (YEBW) is rooted in the principles of providing, "Real World Experience, Life Changing Results." YEBW teaches real world business skills in a fun, challenging and interactive environment, with the goal of developing the next generation of business owners, entrepreneurs, CEO's, and community leaders. YEBW shows students at a younger age that there is a business side to every occupation.

Pilot Wealth Management has partnered with YEBW to help provide high school students with progressive and immersive programs in the key areas of entrepreneurship, business fundamentals, financial investments, career readiness and leadership development. Our economic development depends on a strong pipeline of future CEO's, entrepreneurs, civic leaders, and employees. In order to support the filling of this pipeline, our fundamental goal is to provide the YEBW experience to as many high school students as possible.

YEBW runs July 15-22nd at Oregon State University.

On Market Timing and Whiskey

Perspective is of absolute importance when investing. Just as there are different ways to look at Whiskey, there are different perspectives on market timing. Sometimes our human bias clouds our view of a subject. Of late, many academics and "research studies" have murdered the idea of market timing. The following extols the virtues and pit falls, we hope it is obvious where we stand.

JJ Abodeely of advisorpersepctives.com rewrote the "Whiskey Speech" regarding "market timing."

My friends, I had not intended to discuss this controversial subject at this particular time. However, I want you to know that I do not shun controversy. On the contrary, I will take a stand on any issue at any time, regardless of how fraught with controversy it might be. You have asked me how I feel about market timing. All right, here is how I feel about market timing: If when you say market timing you mean the loser's game, the fool's errand, the speculator's effort that separates savers from their capital, turns investors into gamblers, lines the greedy pockets of brokers, strategists, and newsletter writers, challenges the irrefutable logic of efficient markets, yea, literally plunders the wealth from widows and retirees; if you mean the evil action that disrupts the well counseled man and woman from the pinnacle of appropriate strategic asset allocation, balanced objectives, long-term orientation into the bottomless pit of fear, and greed, and meaningless noise, high expenses, and tax inefficiency, and short-termism, then certainly I am against it.

But, if when you say market timing, you mean assessing fundamental value compared to price, favoring undervalued assets while avoiding overvalued ones, always demanding a margin of safety and being in cash when none exists; if you mean being opportunistic and forward looking, buying low and selling high; if you mean the activity which saves investors from catastrophic and permanent losses of capital, achieving positive absolute returns, the endeavor that avoids following the herd up the mountain of excess and over the cliff of despair, favoring instead consistent compounding of modest returns, and the ability to sleep well at night; if you mean that undertaking which has provided capital as the gasoline for the engines of economic growth and prosperity, protected purchasing power and met future liabilities, funded robust retirements, sustainable wealth transfer, and philanthropic endowments, then certainly I am for it.

This is my stand. I will not retreat from it. I will not compromise.

- JJ Abodeely, 2011

Judge Noah Sweat, Jr's famous Whiskey Speech:

My friends, I had not intended to discuss this controversial subject at this particular time. However, I want you to know that I do not shun controversy. On the contrary, I will take a stand on any issue at any time, regardless of how fraught with controversy it might be. You have asked me how I feel about whiskey. All right, here is how I feel about whiskey: If when you say whiskey you mean the devil's brew, the poison scourge, the bloody monster, that defiles innocence, dethrones reason, destroys the home, creates misery and poverty, yea, literally takes the bread from the mouths of little children; if you mean the evil drink that topples the Christian man and woman from the pinnacle of righteous, gracious living into the bottomless pit of degradation, and despair, and shame and helplessness, and hopelessness, then certainly I am against it.

But, if when you say whiskey you mean the oil of conversation, the philosophic wine, the ale that is consumed when good fellows get together, that puts a song in their hearts and laughter on their lips, and the warm glow of contentment in their eyes; if you mean Christmas cheer; if you mean the stimulating drink that puts the spring in the old gentleman's step on a frosty, crispy morning; if you mean the drink which enables a man to magnify his joy, and his happiness, and to forget, if only for a little while, life's great tragedies, and heartaches, and sorrows; if you mean that drink, the sale of which pours into our treasuries untold millions of dollars, which are used to provide tender care for our little crippled children, our blind, our deaf, our dumb, our pitiful aged and infirm; to build highways and hospitals and schools, then certainly I am for it.

This is my stand. I will not retreat from it. I will not compromise.

-Noah S. "Soggy" Sweat, Jr., 1952

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