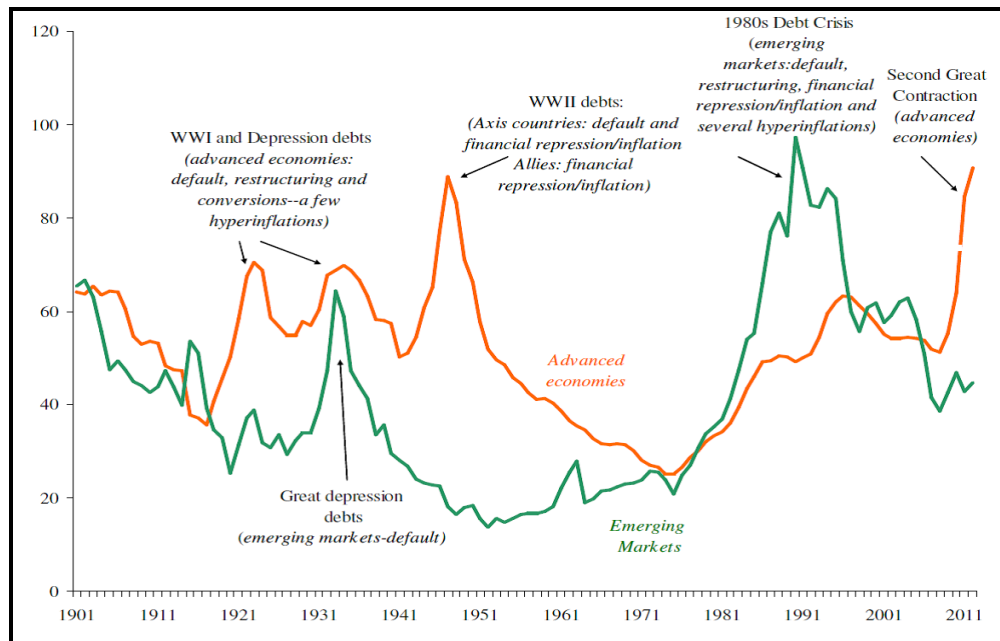


Market Environment – Unanticipated Risks Ahead for Investors

Over the past year, there were several shocks to the economy, including an earthquake and tsunami in Japan, a downgrade to the U.S. credit rating, and numerous debt events in Europe. The effects of these events were felt in the stock market, which declined multiple times- once by as much as 19%¹. The year ended flat for U.S. stocks, while foreign stocks fell by 16.7%. Bonds had a relatively good year, showing a gain of 7.8%².

Throughout the year, the ominous backdrop of mounting government debt continued to worsen. As seen in the chart below, government debt in advanced economies (calculated based on the debt in the U.S., Europe, Japan, and other major economies) now surpasses levels realized after World War II as a percent of Gross Domestic Product. This may be the most significant determinant of economic growth and stock/bond market performance in advanced economies over the coming decade.

**History of Advanced and Emerging Market Country Debts
1900 to Present**



Sources: Reinhart (2010), Reinhart and Rogoff (2009 and 2011), sources cited therein and the authors.

¹ US stock returns based on the S&P 500 index

² Foreign stock returns based on the DJ Global index (ex US) Bond returns based on the Barcap US Agg Bond Index

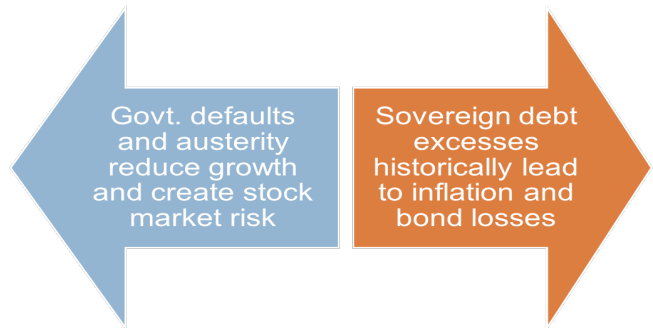
Risks and Opportunities for both Stocks and Bonds

Investors tend to focus on short term outcomes such as the last or next quarter's performance. But the size and direction of our government debt requires zooming out to at least a full market cycle to understand the implications and develop a strategy. The simple answer is that government debt at current levels produces significant risks to both stocks AND bonds. The size of market moves, both higher and lower, are likely to be significant.

Over the past year, EU countries have begun to implement austerity measures to reduce debt. Economics shows that, when governments cut back, economies slow. The inevitable outcome may be stock market losses if companies see revenue declines as economies falter.

As economies decline, government revenue that could be used to reduce debt declines too. If debt continues to increase, it ultimately may reach the point where governments are unable to repay, creating a strong incentive for them to print money and create inflation. High inflation, in turn, creates risks for bonds, CDs, and other fixed income assets.

During the past three instances of hyper-inflation in the US, bonds have lost 28.3%³ in inflation adjusted dollars on average.



Finally, if governments are forced to print money to effectively reduce their debt, this can and has in some instances created enormous stock market rallies as inflation pushes up company prices, revenue, and profits. Each of the past 2 inflation episodes in the US created stock market rallies approximating 200%⁴. To summarize, historical data point to two outcomes, and one conclusion:

- 1. Both Stocks and bonds face significant risks. Our data points to losses of up to 50% in equities and inflation adjusted losses of up to 40% for fixed income.**
- 2. On the other side of declines, or if we see inflation move higher, stocks may see massive rallies of up to 200%.**
- 3. This is overtly not a market to buy and hold a portfolio and necessitates a strategy to attempt to enter and exit markets.**

The Toews System and Current Volatility

Over the past year, markets have moved higher and lower on multiple occasions, generating exits and re-entries into stock and bond markets. Also, the amount that the market moved each day (one day volatility), on average, was higher than it has been historically. One day volatility has a direct impact on

³ Source: Global Financial Data. Based on inflation adjusted returns of the Dow Jones Bond Total Return Index

⁴ Source: Global Financial Data. Based on the S&P 500 index.



our system's primary vulnerability. When we exit, if market moves are significant before we re-enter, the Toews system can underperform or experience losses.

Question: What is the historical outcome for the markets when one day volatility increases as it has over the past year?

Answer: High one day volatility has been a predictor of significant market trends, an environment that our system favors.

Since 1928, when the Dow Jones Industrial Average moved by an average of less than .5% per day over the prior month, the index was 13.5% higher or lower one year later. As one day volatility moved higher, the amount of the evolving trends increased too. When the Dow moved by over 2.5% per day over the past month, it ended 40% higher or lower one year later⁵.

Average daily % change (past month)	Average Index Gain or Loss 1 Year Later
0-.49%	13.5%
.5-.99%	15.0%
1.0-1.49%	21.0%
1.5-1.99%	27.8%
2-2.5%	31%
Greater than 2.5%	40%

Over the past quarter, markets have moved by an average ranging from 1.5% to 2.5% each day. That data predicts a move of roughly 30% one year from now. Considering the global debt backdrop, that could be even higher.

We refer to this as a best/worst type of market for our system. As one day volatility increases, the system becomes more vulnerable to under performance. Typically, these trendless periods last for 12 months before a significant trend evolves. **However, the outcome from that same volatility tends to produce big market moves.** If the market moves significantly higher, we are in a position to potentially capture those gains. If the market makes a big move lower, we attempt to remain in money markets to avoid losses, and we aim to capture big gains during the market rebound (as we did during 2008/2009). Further, the size of the trends may dwarf any under performance or losses that occur during whipsaw markets.

Despite all of the headlines and volatility, our management team **prefers** the current environment to lackluster markets that rarely produce significant market moves. The key for investors is to avoid exiting the system before big trends play out (cautionary data point: peak redemptions from our system occurred in late 2007/early 2008).

Conclusion

The path to navigate these markets is straightforward but requires constant execution: 1) Stay committed to equity markets, the best performing asset class that helps protect investors against inflation; and 2) hedge your equity portfolios against losses. Both are pillars on which the Toews system is built.

⁵ Source: Global Financial Data. Data based on the Dow Jones Industrial Average – 10/28 to present



Disclosure

Prior performance is no guarantee of future results. There can be no assurance, and individuals should not assume, that future performance of any of the portfolios referenced will be comparable to past performance.

There can be no assurance that Toews will achieve its performance objectives.

This document refers to the performance of the majority of Toews portfolios to illustrate the effect of Toews' management on US and intl. stocks and high yield bonds. Performance of individual accounts varied based on the client's investment risk profile and their specific investment funds. For your individual account performance, please refer to the enclosed quarterly statement or the quarterly statement recently sent to you. In addition, not all model portfolios were referenced in this letter. It is not, nor is it intended to be, a comprehensive accounting of Toews asset management. There are other portfolios that Toews manages that performed differently than what is referenced in this letter.