



January, 2011

2010 Year-End Investment Commentary

Each quarter we share our analysis of investment opportunities and risks including the broader context that informs our views. We have several goals in sharing these views. First and foremost is our desire for you to be informed about what we are doing for you and why. An important secondary goal is to build your confidence in our competence and skill. Our ability to do the best job we can for you is partly dependent on that confidence because it allows us to make long-term investment decisions with the expectation that you will have the patience for those decisions to play out. Your confidence should be based not just on the quality of our ongoing analysis, but equally on the strength and clarity of our entire investment approach, starting with our fundamental beliefs and including our investment process and ability to execute it in managing your portfolio. In the accompanying article (see end of commentary), we talk about how this set of core beliefs governs our decision making and serves as an important source of our confidence in what we do.

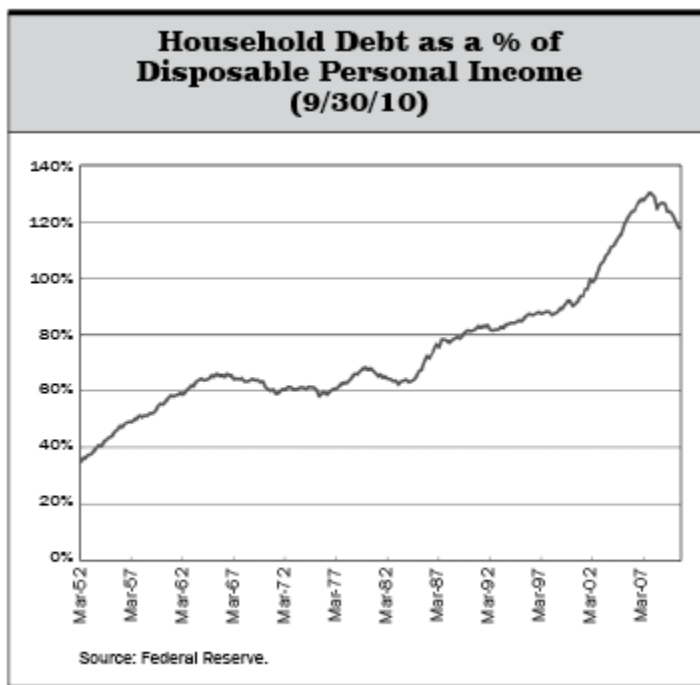
Macro Thoughts

The recent strength in the stock market along with a gradual improvement in the economy should not lull us into a state of complacency. Thought the economy is improving at the margin and could exhibit stronger growth in 2011, structural risks remain. In fact, after re-reading what we wrote a year ago, we could republish most of it with a January 2011 date and it would still reflect our views. The concerns we wrote about back then, and which we have been writing about each quarter over the last few years, remain. Our belief that a subpar recovery is, so far, being proven right. And continued concerns about multiple stress points are still with us.

Last Year's Worries—A Status Report on Where They Stand Today

Household Debt Levels: This is an ongoing major concern. There are three ways to think about household debt levels:

1. **Debt-level trends:** The trend in household debt levels is down and that's good. On an absolute basis and relative to income, household debt has declined at the fastest rate on record. However, much of the decline is due to defaults.
2. **The cost to service debt and other financial obligations:** The financial obligations ratio measures debt service costs relative to income levels and here, the news is good. This ratio has dropped sharply over the past two years as debt has been reduced and because interest rates are very low. The ratio is back down at the level of 10 years ago, when it was historically high, but not in the stratosphere. Longer-term, low



Debt relative to disposable income is improving but still extremely high.

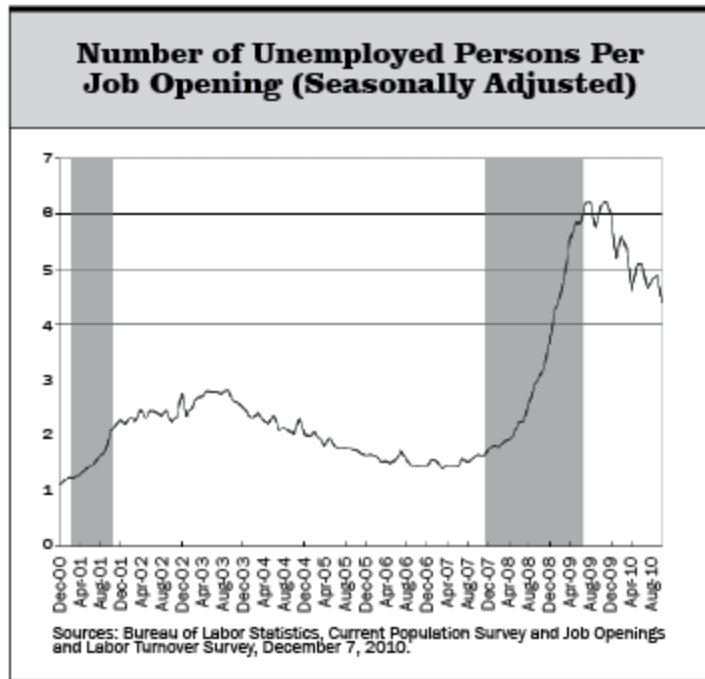


interest rates cannot be assumed so the improvement thus far is not as good as it would be if it was entirely due to debt reduction.

3. **The overall level of debt:** Unfortunately this is the most important measure and despite a meaningful reduction, the overall level of household debt remains excessive relative to disposable income. The income comparison is important because it indicates the long-term ability of households to pay down their liabilities. (Compared to assets, debt levels have improved but still remain very high relative to long-term history. Overall, household wealth is still 17% below its 2007 peak.) Bringing debt back down to manageable levels after decades of debt expansion can't be expected to happen quickly.

The Weak Labor Market:

Jobless claims for unemployment insurance are declining, which strongly suggests that layoffs have peaked. That's good. But job growth is still anemic. Since the job market bottomed last December, about 86,500 jobs have been created on average per month. Over the last three months (through November) the average has been even lower at just over 60,000. This compares to about 100,000 jobs needed per month just to keep pace with growth in the labor force. And remember that 8.4 million jobs were lost in the recession. Other measures of employment are improving but remain horrible. There are 4.2 job seekers per available job opening. This is down from over six, but still an abnormally high level. And of the total unemployed, 42% have been out of work for at least 27 weeks. This measure of the long-term unemployed is slightly off its highs but it remains far higher than at any other time since the start of the data series in the mid-1960s. In short, the labor market is recovering but it's a wimpy recovery compared to past expansions and in light of the number of jobs lost. It will get better. There are multiple indicators that suggest the job market should strengthen. But we have a long way to go to bring employment back up to acceptable levels. It will take years and the improvement will help growth but it is unlikely to be robust enough to support a strong or quick recovery in income, the housing market, or domestic consumption. Note: As this issue was going to press, one labor data source reported stronger than expected preliminary December job figures. While this is encouraging, we need to see a sustained period of significantly better job growth to make a material difference in the unemployment rate.



Material improvement but still bad.

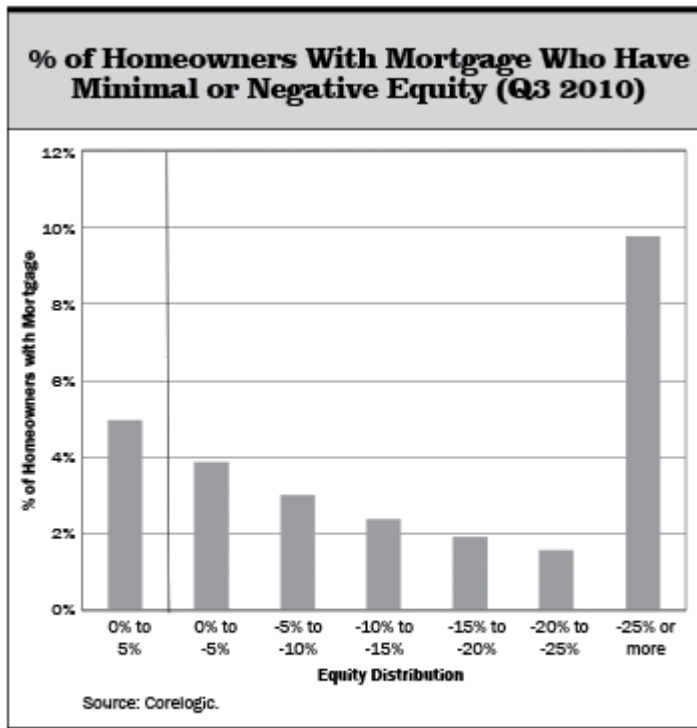
The Housing Market: After showing some strength in late 2009 and early 2010 largely due to the homebuyer tax credit, the market is, as we feared, weakening again. Housing is important because it is a huge household sector asset. A healthy housing market also stimulates other housing-related consumption. If house prices decline too much (analysts say around 10% is a danger point), banks would have to raise additional capital which would negatively impact the availability of credit. In recent months home prices have slid backwards again and the declines are spreading to more markets. Looking ahead, despite hugely improved affordability, there are several reasons to expect some further declines in home prices. (Most estimates we've seen are in the 5%–10% range though it is hard to assess the ability to accurately forecast this.)



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- First, according to industry data provider CoreLogic, as of the end of September, 23% of all homes with mortgages had negative equity—in other words they owed more than the house was worth. This amounts to 10.8 million homes. Of these, more than 40% (over four million) had negative equity of at least 25%. Another 2.4 million homeowners had equity of 5% or less (meaning a 5% price drop would put them in a negative equity position). Negative equity correlates strongly with defaults and foreclosures so this data suggests that foreclosures will remain high for some time.



In total, over 20% of homeowners with mortgages have negative equity and almost half of those have negative equity of at least 25%.

- Second, prices are driven by supply and demand. On the supply side the number of homes for sale compared to average monthly sales has spiked up again and is near peak levels. The actual number varies depending on the data source at between 12 and 13 months. That is about twice the normal level. Unfortunately the story is actually much worse than that because of the millions of houses that are either in foreclosure or likely to be foreclosed. Based on CoreLogic's numbers the total inventory-to-sales measures, including "shadow" inventory, is at an alarming 23 months. These numbers suggest that house prices have further to fall.
- Finally, the job market is a key driver of housing demand, and this is obviously another problem.

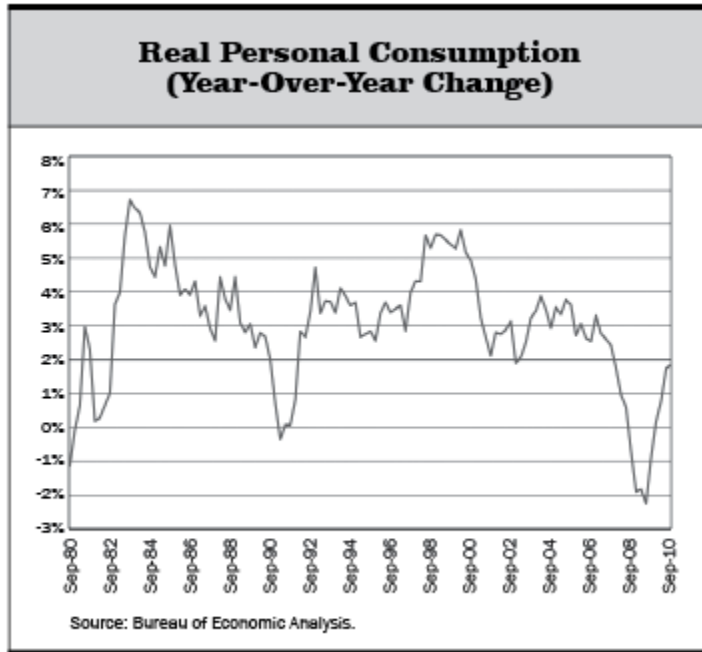


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Consumer Spending Headwinds: Each of the above factors is a problem for consumer spending.

Generally, we've made the case that consumption, which remains at around 70% of the economy, is likely to grow at a subpar level given the need to reduce debt. In the past, debt growth fueled spending but now deleveraging is a headwind. Moreover, there is an adverse feedback loop as weak spending is a drag on the overall economy, which impacts the labor market, which is a driver of income growth, which in turn is a key driver of consumption growth, completing the loop. Over the last year (through 9/30) consumer spending has rebounded and is up 2%. However, this is not an exciting level of growth, and in total, quarterly spending has barely regained the level of three years ago. We continue to believe spending growth over the next few years is likely to be below average, consistent with a subpar recovery.



The U.S. Government Debt Explosion:

Improving but still not consistent with a normal recovery.

Government debt levels remain very high. Gross federal debt is pushing 100% of GDP and state and local debt is another 20% (some research suggests that GDP growth rates drop meaningfully when gross government debt exceeds 90% of GDP). Many developed countries face similar problems. And the absolute level of debt is only part of the problem. The impact of aging baby boomers will exacerbate the problem as Social Security trust fund expenditures increase along with increasing demands on Medicare and Medicaid. We're all aware of these problems and the economic risks that accompany them. In our opinion, higher taxes and significant changes in spending will be needed. We believe we need a clear long-term plan that we and the markets believe has a strong likelihood of being implemented. The bipartisan deficit panel offered a good start to the dialogue. But how it plays out in a political environment that seems primarily concerned with making the opposition look bad rather than reaching the best decisions for our country is hard to know. This is likely to be a very important issue during our five-year decision horizon that could have a material impact on the economy and financial markets.

State and Municipal Governments: This sector of the economy continues to be highly stressed. State tax collections have risen but remain 7% below 2008 levels according to the Nelson A. Rockefeller Institute of Government. At a local level, property tax collections are dropping and there is more to come as housing values have not been fully reflected in property tax assessments. Overall, state and local governments are not expected to contribute to any improvement in the labor markets in 2011 and will continue to face long-term structural problems from past spending decisions including underfunded pensions and post-retirement obligations. It seems probable that we will see an increase in local government debt defaults though it does not appear likely that these will be widespread. They will generate headlines though, and that may trigger temporary sell-offs in the municipal bond market.

European Sovereign Debt Crisis: The weakness in Europe's periphery continues to create enormous uncertainty. Most of the southern European economies are uncompetitive and either have too much debt, high deficits, or both, amounting to a longer-term solvency issue for some (Greece and Portugal). Ireland also has a solvency issue resulting from its ill-advised decision to guarantee Irish bank debt. Short of exiting the euro zone (a possibility), these countries don't have the option to devalue their currencies to increase their global competitiveness. Because of high debt levels they have had to accept fiscal austerity to reduce deficit growth. That will be a drag on economic growth and if the drag is large enough it could actually undermine efforts to reduce deficits.



Of great importance, the European banking sector remains stressed with lots of short-term debt that must be rolled over, fewer lending sources, rising rates, and more loan losses to come. At present, they don't have enough capital to handle a sovereign default but that could change within a few years. Fortunately a default in the near term seems unlikely given European and IMF efforts, though eventually defaults by Greece, Portugal, and Ireland would not be at all shocking. Spain is particularly important in assessing the risks to Europe, given the size of its economy. A key concern is whether Europe will have to bail out the Spanish banking sector. The Bank Credit Analyst believes that won't happen because bank losses are unlikely to exceed levels that Spain's government can handle. In dealing with the crisis Europe must balance domestic political interests and philosophical biases against practical solutions. It won't be easy.

While it's possible Europe will muddle through, it is the region that seems most at risk for falling back into recession. And although the risk of a destabilizing breakup of the euro is now on the radar, it remains unlikely in the foreseeable future because the benefit of any breakup relative to the costs is questionable. The negative scenarios for Europe would impact the global economy and are therefore a key risk factor.

Emerging Markets: A new worry is the economic strength in many emerging markets. The problem is not that the economies are strong, but rather that in a number of cases, policies to prevent their currencies from appreciating (and hurting their export competitiveness) necessitate low interest rates that can ignite inflation and asset bubbles. Inflation in China is the most visible problem and it is already driving a tightening of monetary policy and fears that this will cause growth to slow too much.

Should We Cheer Up?

We continue to believe that the balance of the macro evidence skews to the negative. However, despite all the negativity you've just been bombarded with, there are positives. The overall global economy did generate a reasonably healthy level of growth in 2010—with most coming in the developing world. Things are slowly getting better on many fronts.

The macro positives start with emerging markets which, as already mentioned, are growing nicely thanks to strong exports and improving domestic consumption. They are flush with foreign currency reserves and lack the debt problems almost all the developed world faces. In the United States, the corporate sector has record cash levels (though debt levels are also high) so it is in a good position to hire and invest more when confidence improves. Capital investment is already beginning to strengthen. Profits have been better than expected as companies have aggressively cut costs and benefited from lower interest rates and low wage growth. Trade flows have been strong and the United States has benefited via improved exports. The recent tax bill will offset the scheduled decline in government stimulus, providing more support with extended unemployment insurance and reduced payroll taxes. Though it adds to deficit concerns, this will buy more time for the economy to gain momentum and will probably result in a healthier level of growth in 2011. We've seen estimates of a GDP growth boost of as much as 1%, which would be material. Finally, we continue to believe that inflation is unlikely to spike dangerously higher in the near term in the developed world given excess labor and manufacturing capacity and anemic demand. As the economy strengthens, inflation risk will increase but we don't believe a quick spike to harmful inflation levels is likely. This suggests that interest rates will stay in a relatively low range for a while (rates have spiked higher lately but in a longer-term context remain extremely low) though that range could top out above current levels.

A possibility we can't ignore is that low interest rates and marginal economic improvement will continue to lure investors back into a risk-taking mode and that this will result in bubble valuations again and set markets up for another (later) period of painful adjustment. A likely candidate for a run up in this scenario would be emerging markets (both equities and debt) given their strong fundamentals and growing acceptance among investors. We're not there yet though—emerging equity markets are not cheap but we also don't believe they are overvalued and there is plenty of room for them to run if bullish forces prevail.



Portfolio Positioning

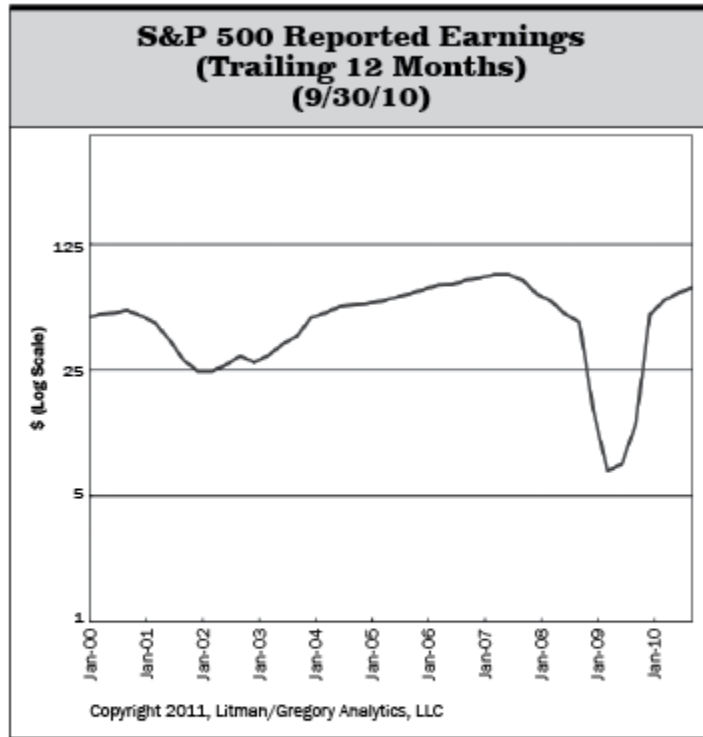
Our positioning has not changed in recent months. **Equities:** Earnings have recovered at a faster rate from last year's trough than we expected. We never place a lot of weight on shorter-term earnings paths or projections. Our goal always is to assess likely earnings levels and valuation multiples five years out, and we complement this analysis with other valuation metrics and analyses to assess attractiveness of equities. Still, it is important we understand why earnings have recovered faster than we expected as it may influence our longer-term earnings projections.

Much of the rebound over the past year or so has been due to cost cutting, interest-rate reductions, and government stimulus—factors which can't be sustained. Most of the rest is emerging-markets driven and we believe this will continue to be a positive factor for many U.S. companies who are gaining an increasing share of their profits from sales to emerging markets. In fact, based on intensive research we recently completed, we believe the emerging-markets benefit will be greater than we previously assumed and we have increased our U.S. earnings estimates by varying amounts in our scenarios as a result. Similar potential for an emerging-markets-driven benefit applies to stocks in other developed

markets. Given the strong profit rebound, we also revisited our assumption that earnings will remain roughly around their long-term trend line at the end of our optimistic five-year scenario. Within the context of our deleveraging thesis we still believe this is reasonable as the most optimistic of the formal scenarios we consider when making portfolio-level decisions. However, we are aware that there are even more positive outcomes possible, and that our optimistic scenario is quite conservative relative to a post-1980s normal recovery. We know that the Fed is trying to engineer a strong recovery, and they may succeed in the short term, but we give it very low odds of success longer term.

There is another way we could get a more optimistic scenario that is also more sustained. It is possible that the low interest rates many emerging-market nations are importing by managing their currencies could result in continued asset appreciation, and even asset bubbles, that lead to a positive "wealth effect" in emerging markets. This wealth effect could prop up emerging-market consumption and global growth for an extended period, and S&P 500 earnings, owing to their increasing exposure to emerging markets, might do quite well despite subpar U.S. economic growth. This seems a more believable outcome now than a year ago given the rapid rate that companies have oriented their businesses to emerging markets. At this time, this is not a scenario we are factoring into our portfolio decisions, but it is a question we will be evaluating more deeply in the coming months.

Overall, we remain underweighted to equities because even with a greater earnings boost from emerging markets, stocks are selling above our fair-value range, resulting in five-year return expectations under most scenarios that are too low to justify a normal equity weighting given the elevated risks we see (we



The earnings decline from peak in reported terms exceeded the declines seen during the Great Depression. We think some of the earnings decline in the current cycle was overstated due to accounting issues. Adjusting for accounting issues, we believe earnings will likely be below the long-term trend at the end of our five-year decision horizon.



expect low-single-digit returns in our base-case scenario, lower in other scenarios, and 11% in our most bullish scenario). However, given somewhat higher odds on a bullish scenario, we have slightly increased the level at which we would implement another round of equity underweighting. In most of our balanced portfolios the equity underweight is almost 20% (though in terms of “net risk exposure” that takes into account where the assets have been redirected, the effective underweight is around low-double-digit percentage points). However, the possibility of a normal recovery (and lack of compelling competing investments) keeps us from being even more underweighted, as does our belief that over the long run our active equity managers will deliver higher returns than the overall market. Within our equity allocation we continue to maintain our underweighting to small-cap stocks because our valuation work tells us that they appear clearly overvalued relative to larger companies, and because we believe that in the event of a market downturn, small caps will perform worse than larger-cap stocks, as has been the case historically.

Outside the United States we continue to view developed-market equities as offering low expected returns roughly in line with U.S. equities. Despite the problems Europe faces and continued economic challenges in Japan, valuations and earnings expectations (which also include increasing exports to the emerging world) are within a fair-value range relative to the United States. Moreover, a crisis usually creates opportunity. Despite the uncertainty about how Europe will play out, many of our foreign equity fund managers have been making portfolio shifts to focus on companies that they believe have been excessively punished in some of the stressed peripheral countries.

Emerging-markets equities are likely to deliver higher returns over five years than developed-market equities, based on our models. This could be helped along by infrastructure-related spending, an increasing wealth effect from rising asset prices, and growing domestic consumption. Moreover, there is potential for very large returns if a speculative bubble develops, which is more than a remote possibility. However, given the global macro risks, we are concerned about higher volatility in emerging markets. So, other than in our Equity model, we currently don’t have a dedicated emerging-markets equity position. However, we do have significant emerging-markets equity exposure via our core international funds and we also have exposure to emerging markets via developed-market companies that increasingly sell into those markets. Between these two factors we estimate that between 15% and 20% of our equity allocation in our portfolios is capturing exposure to emerging markets. On top of that we have sizable emerging-markets bond allocations (discussed next).

Emerging-Markets Local-Currency Bonds: Some of the capital that is freed up by our equity underweight is allocated to emerging-markets bonds denominated in local currencies. In 2010, the fund we use, PIMCO Emerging Local Bond (PELBX), delivered a very strong 15.5% return and made a nice contribution to our performance. We believe there is more upside over five years. Moreover, we believe there is less downside risk than we are likely to face from equities. Looking ahead, our analysis suggests returns consisting of interest income and modest currency appreciation against the U.S. dollar over the next few years will amount to a high-single-digit return in our most likely scenario. In most of our scenarios, emerging-markets local-currency bonds still offer the highest potential returns of any asset class. But we don’t expect a steady ride. Because they are an emerging-market investment, we view these bonds as potentially much more volatile than traditional bonds, but less volatile than equities. Specifically, we think of them as having about half as much risk as equities in a severe stress scenario (however, their relative performance versus stocks in a down equity market would depend on a variety of factors).

Bonds: There is growing debate about whether bonds are a bubble. We don’t view them as a bubble from the standpoint of having the downside risk that equity asset classes do when they are in bubble territory. Moreover, it is too simplistic to generalize about the bond market. Despite the recent back-up in rates, we don’t view most of the investment-grade sector, especially governments, as offering attractive long-term returns from current levels. However, some sectors of the bond market still offer reasonable value—the potential to earn mid- to upper-single-digit returns. And over time we believe most of the flexible funds we own are capable of adding more value and return opportunistically, as some bond sectors sell off. Given macro uncertainty we are comfortable holding assets we think offer a high



probability of allowing us to stay ahead of inflation. Some of these are clearly a lower-risk parking place for our portfolios as we wait for higher return opportunities to appear—and we are certain they will.

As a result, we remain overweight to bonds across our balanced portfolios (excluding our emerging-markets local-currency bonds position). As has been the case for quite a while, our positioning does not emphasize traditional investment-grade bond funds. Generally, the funds we own are much more flexible in their willingness to invest globally, across bond sectors, and to adjust their maturities. The result is that we are significantly underweight to traditional investment-grade bonds (as we have been for a while) with an emphasis on (generally) shorter maturities (FPA, Osterweis, and PIMCO Unconstrained), some non-dollar exposure (through Loomis Sayles Bond and to a lesser extent PIMCO), and more corporate credit exposure through all the funds except FPA. Osterweis Strategic Income and Loomis also make high-yield bond investments. Overall, this has paid off in a big way over the past couple of years. Nevertheless, we do want some traditional investment-grade exposure as a hedge against recession risk. Generally our funds have been strong performers relative to the investment-grade index and all but PIMCO Total Return out-returned the benchmark in the recent bond market sell-off. In fact, Osterweis and FPA held their value after taking income into account during this period. (Note that we have been researching leveraged loans and recently published research on this asset class. The asset class largely consists of floating rate loans so risk from rising interest rates is minimized. We are considering possible investment in a leveraged loan fund.)

Tax-Exempt Bonds: We continue to hold tax-exempt bonds in taxable accounts, though we don't allocate all fixed income in these accounts to muni bonds and currently we have a significant weighting in some of the flexible/unconstrained bond funds mentioned above. Muni bonds have been in the headlines perhaps more than any other investment category. With stretched state and local budgets there is growing fear that defaults could become a major problem for the tax-exempt market. A confluence of other factors recently contributed to a more than 5% decline in the prices of muni bonds since mid-October. For all of 2010 this asset class lagged taxable bonds, delivering barely positive performance. Part of this was due to a general rise in intermediate and long-term interest rates across all investment-grade bond markets. But muni yields rose more (and prices dropped more) due to credit fears, rising new issue supply, and also because of two technical factors. One was the tax bill, which kept tax rates from rising for another two years (making tax-exempt interest less attractive than it would have been). The second factor was the ending of the Build America Bond (BAB) program. This program allowed some tax-exempt borrowers to benefit from a federal interest-rate subsidy so they could issue taxable bonds. This issuance effectively replaced a portion of the supply of new tax-exempt bond issues, which positively impacted the supply/demand dynamics in the tax-exempt market boosting bond prices. The end of this program at year end will impact the supply of tax-exempt bonds—particularly long-term bonds (most BABs had 15-year maturities or longer).

Currently, tax-exempt yields are very attractive relative to equivalent quality taxable investment-grade bonds. Unless we see a material increase in defaults in the tax-exempt bond universe, investors in well-managed tax-exempt bond funds should do quite well over time. Though we believe defaults are likely to be much more common than in past cycles, we don't expect them to be so widespread that well-managed muni bond funds will be hit with meaningful performance impact from defaults. There are many solid revenue bonds to build a portfolio around as well as general obligation bonds where debt servicing is mandated to have a high priority call on the borrowing entities' revenues. Moreover, in many cases debt servicing is not onerous. The state of California is a good example. Debt servicing is only about 6% of the budget and the state is required to service its debt ahead of any other claims on its budget except for education. So, we believe long-term investors will do fine with tax-exempt bonds relative to comparable taxable alternatives. However, given the sorry condition of many state and local budgets we expect temporary headline risk to remain and volatility to be higher than in past cycles as the absolute number of defaults increases. This is a growing concern and we are considering the shorter- to intermediate-term risk to the muni market even though we believe the funds we like will not experience a material level of credit problems.



Arbitrage Strategies: We continue to hold two arbitrage-oriented funds. As we've discussed in the past these are relatively low risk, moderate-return strategies that are not highly correlated with stocks and bonds. We expect mid- to high-single-digit returns from these funds over a period of years. Not exciting, but given relatively low risk this is an acceptable place to wait around for better return opportunities in other asset classes.

Missing Out?

So far our macro concerns over the last two-plus years are roughly playing out. However, stock returns have been stronger than we thought was likely. Our ongoing expression of concern may lead our readers to feel we are too cautious and perhaps not capturing the returns we should. As it turns out, despite being underweighted to stocks we have done quite well over the past two years as our tactical moves into asset classes such as high-yield and emerging-markets local-currency bonds, our use of flexible fixed-income funds, and the performance of our active managers have, collectively, added significant value. Over this period each of our active model portfolios has handily beaten their benchmarks and we've done so with less risk.

Details:

- Our portfolios delivered huge outperformance in 2009 across the board.
- This year our portfolios have delivered clear but more modest outperformance also across the board.
- Overall, the outperformance versus benchmarks over two years has ranged from 12% to 14% depending on the portfolio (this is a cumulative number).
- We have done well in up and down months on a cumulative basis (data through 11/30/10). In up months we matched or slightly beat the benchmark on average, depending on the portfolio. During down months our cumulative outperformance was sizable, ranging from six to nine percentage points. We're particularly happy with this pattern of performance.

Overall, we're pleased with the past two years' performance, especially coming off of a terrible 2008. Longer term we've outperformed benchmarks from 1.6 to 2 percentage points annually since instituting our neutral weightings and fat-pitch approach 12 years ago, and from 1.5 to 1.9 percentage points since we began publishing our models in December 1989.

As we look ahead to next year, we continue to believe the range of possible outcomes is wide. Europe could muddle through, China could manage its inflation problem, the U.S. economy could accelerate while inflation stays low, and the Fed could stay accommodative. With close to \$3 trillion in money market funds earning close to nothing, investors may take on more risk and drive stocks higher around the world. So 2011 could be a good year. On the other hand, weak economic recoveries and a dangerous debt overhang could mean that 2011 could be a tough year and vulnerable to shocks.

We are not confident that we can precisely predict what next year will bring, but our investment approach does not require us to have an answer for the next year. As always we fall back on our scenario analysis to understand the possible range of outcomes over longer periods (which can be assessed more reliably) so we can gauge risk and reward. Our analysis covers time frames that are likely to reward us for getting the fundamentals mostly right; understanding that our clients have investment needs that last far beyond one year. With that guidance we remain cautious as we do not view equities, broadly speaking, as offering potential returns commensurate with the risks as we assess them. As we said last year, if risk-taking takes hold for a while, our balanced portfolios could well underperform. However, we continue to be confident in our positioning over our multiyear time frame, and ready to take advantage of tactical opportunities to add to our risk exposures should fear reassert itself in the markets.



Market Recap

A strong fourth quarter rally, punctuated by a December sprint, turned an okay year for stocks into a very good one. The large-cap Vanguard 500 Index gained nearly 11% for the quarter, and ended 2010 up 15%. The small-cap iShares Russell 2000 and iShares Russell Midcap both returned in the mid teens in the fourth quarter, and gained 25% and 27% for the year, respectively. Looking abroad, the story was similarly positive for emerging markets, with the Vanguard Emerging Stock Index climbing 7.5% in the quarter and 19% for the year. Developed-market foreign stocks also had a good year, but returns for the benchmark Vanguard Total International Stock Index were restrained by concerns over Greece's fiscal problems earlier in the year and Ireland's later in the year, which drove the euro (and therefore returns to U.S. investors) lower. The Vanguard Total International Stock Index nevertheless gained a healthy 7% in the fourth quarter and 11% for the year.

Turning to fixed income, the Vanguard Total Bond Market Index Fund, a proxy for high-quality intermediate-term bonds, saw most of its 1.4% fourth-quarter loss come in December. Still, its strong performance earlier in the year left it with a full-year gain of just over 6%. Foreign bonds also struggled through the fourth quarter, with the Citigroup World Government Bond Index falling 1.8% and the emerging-markets JPMorgan GBI-EM Global Diversified Index down 0.4%. Each index was in the black for the year, with emerging market debt returning a notable 16%.