PVG ASSET MANAGEMENT CORPORATION

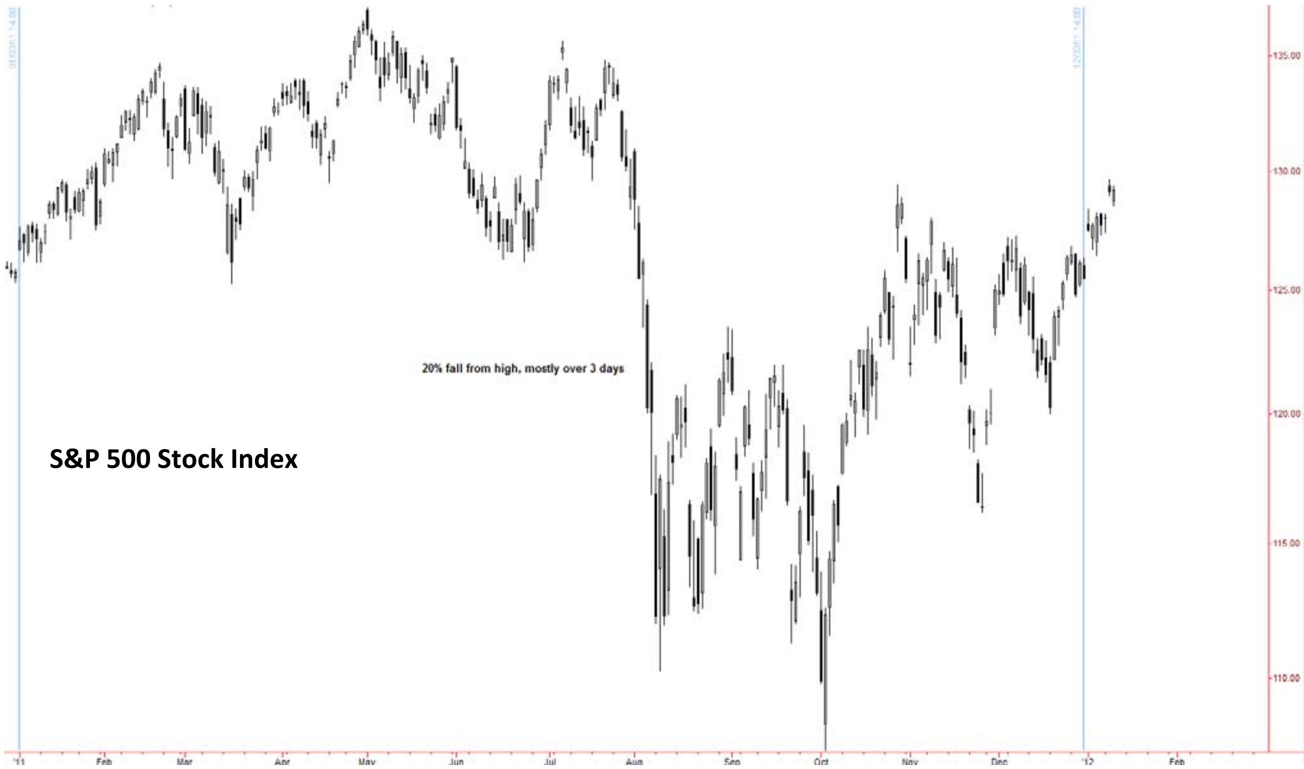
January 2012

2012 LOOKS BETTER FOR U.S STOCKS

We anticipate stronger markets for U.S. stocks and higher yielding corporate equity, bonds and income funds this year. The economy continues its slow expansion. Stock values are attractive, particularly relative to low yields on treasury bonds. And, investor confidence has recently been at extreme low levels, similar to those last seen at the 2008-2009 bottom. Industry consensus appears to expect 10-15% market gains along with continued volatility, from modest earnings growth and valuation expansion. Of course, the consensus is rarely correct since it incorporates past rather than new information that has yet to be anticipated. Forecasts also tend to be conservative after a year like 2011. We think there is a real possibility that the consensus may be too conservative.

We also anticipate less attractive prospects for US Treasuries and gold into which "panicking" investors' poured money last year, starting in August when the market fell 11% during three days. We don't expect a renewal of the strong bull market in commodities as longer-term supply and demand is moving into balance. European, Asian, and Latin American markets appear less expensive than those in the U.S., but they face continuing and more immediate economic problems while the U.S. is expanding. Our caveats are macro in nature as they were last year. These include the possibility of greater than expected financial disorder in Europe, a more severe economic slowdown in China as they seek to moderate growth, Iranian issues, and of course, American political dysfunction. The optimistic view with regard to these macro-issues is there is little that has not already been anticipated by the markets, as we discuss below.

2011: PVG Equity Income portfolios performed well during 2011. Our Loss Averse Growth stock approach came up short with a loss for the year. Short term volatility was the problem. The markets gyrated frequently and significantly as events like the US and European debt crises generated headlines, and investor uncertainty and panic causing them to pile in and out of the markets. The first seven months saw the S&P 500 Index swing quickly up and down three times by about 8%. It then collapsed 11% during just three days of August. From the May top to the October bottom, the market fell 21% as seen on the chart below. Daily volatility or price movement exploded during August and through the fourth quarter, denying us an opportunity to apply multiple month hedges as we were able to successfully do during 2008 and 2010.

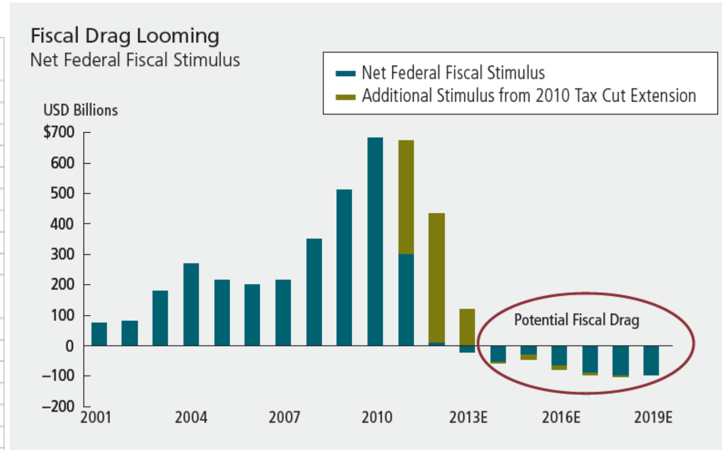


PVG is an active growth manager seeking absolute returns rather than just allowing portfolios to rise and fall with the market. Last year stops and other risk management tools dictated selling into swift market declines. Volatility kept our protective cash positions relatively high. While the S&P climbed close to break-even by year end as conservative groups like utilities rose, the securities of many growth companies that we favor remained lower. Other growth funds experienced a similar problem, even those that hedge risk. According to performance measuring service HFRX, funds that employ hedging lost a whopping -19.6% on average during 2011, a number greater than during the 2008-2009 decline.

Fortunately we were able to do much better and think the macro political/economic issues that led to this environment are now largely baked into the market. We anticipate a more stable 2012. This should allow our active approach and particularly the use of growth stocks to generate more favorable returns going forward, as we discuss below.

A Surprising Standout Economic Performer – the United States: World economic news has been dominated by sovereign debt issues in the US and Europe, sharply slowing Chinese growth, Japanese disasters, along with other negative domestic and global issues. Concerns have recently shifted to the impact of fiscal austerity in the US and Europe, and the impact of this austerity on China. In the US, it seems likely that last year's budget "deal" guarantees at least some "fiscal drag" as tax cuts expire and automatic budget cuts are enacted over the course of 2012 and 2013. The full impact of this drag amounts to 2.4% of Gross National Product during 2012 and another 2.6% during 2013, as shown on the chart below. The second chart shows the drag continuing through 2019, assuming Congress and the President do nothing. We think that is unlikely given politics, particularly once this year's election is over.

Expiring/taking effect end of 2011/start of 2012	Annual value $bn
99 week unemployment insurance benefit	50
2% employee payroll tax cut	110
Alternative Minimum Tax "patch", other tax provisions	22
Override of Medicare fee cut	12
Discretionary spending cuts from August debt deal	40
Other expiring Recovery Act stimulus	125
Total	359
% of GDP	2.4%
Expiring/taking effect end of 2012/start of 2013	
Bush tax cuts for high earners	50
All other Bush tax cuts	205
3.8% Medicare tax on investment income	21
$1.2 trillion 10-year sequester	109
Total	385
% of GDP	2.6%
Sources: J.P. Morgan, ISI Group, Congressional Budget Office	



Source of chart data: Strategas Research Partners, 11/30/11.

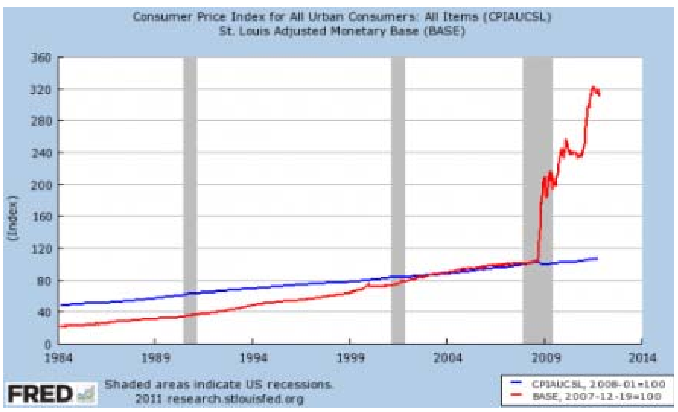
Regardless, the American economy has continued expanding, albeit slowly compared with past recessions. Gross Domestic Product continues to expand. Manufacturing output is growing briskly; to some extent as higher costs in China, and disruptive earthquakes and floods in Japan and Thailand, are prompting some companies to move plants back home. Despite government obstacles, the US is importing less energy than it has in years as domestic production of oil and gas surges. Furthermore, while consumers are generally reducing credit card debt, the consumer driven housing industry seems to have ceased being a drag on the economy. Recent leading economic indicators, inventories, exports, employment, industrial production, railcar loadings, factory output, automobile sales, personal income, retail sales, ISM manufacturing and non-manufacturing data all reflect economic expansion. Even the dollar has gained up to 8% against many currencies.

Despite our government debt problems, the U.S. economy is in relatively better or at least predictable shape than Europe and many other countries, including China. Europe seems destined for recession this year as their austerity measures bite. This will negatively affect China, their largest trading partner. Slower or slowing Chinese growth will affect dependent countries like So. Korea, Malaysia, Argentina and Brazil, and other natural resource dependent countries might suffer as commodity demand slows and prices stagnate or fall.

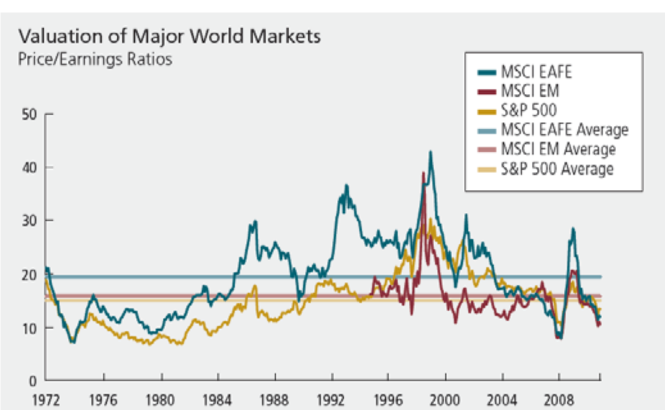
The world's debt problems are not going away tomorrow. Dealing with this debt will likely cause relatively slow growth around the world and subject all economies to potential shocks for some time to come. However, debt problems have been recognized and efforts are being made to correct the problems, something that is likely to cause the issue to be less of an unknown than was true last year. Surprisingly, the U.S. might be in the lead for the moment.

The Best Investment Opportunities always occur during a Crisis: Or as one market strategist commented “you can’t have good news and cheap stocks at the same time”. We have not changed our long term view of a volatile and range bound market – not yet anyway. The S&P 500 and the Nasdaq market indices remain far below their 2000 and 2007 highs. The excess enthusiasm of the 1982-2000 bull market continues to be reversed, perhaps speeded along by baby boomers shifting money to low yielding investments perceived to be safe as they approach retirement. Economic problems are continuing.

However, this view does not preclude immediate investment opportunities. The 1966-1982 and 1929-1947 long volatile, sideways markets presented many. This similar secular bear market has and will also continue to provide opportunities. We think opportunities are most predictable after a crisis, an investor panic, like we think saw during 2003, 2009, 2010, and again last year. They are because economic conditions and corporate profits vary but markets rise and fall primarily on monetary conditions, valuations, and psychology. All three conditions are related and look attractive to us going into 2012.



Money is what allows markets to rise, whether housing, commodities, or stocks. Right now, U.S. monetary conditions are extremely loose, as you might expect given that the Federal Reserve Bank has been buying debt from banks and near banks, driving the 10 year Treasury yield to under 2%. The expansion or perhaps it should be said explosion of money can be seen by the red line on the chart to the left. Yet inflation remains tame as the blue line illustrates. At this point the Fed is promising to keep short term interest rates at low levels to help borrowers restructure, but at the same time punishing to savers. Eventually money chases the highest returns once panics subside. High yielding bonds, bond like investments, and stocks appear positively in the way of this liquidity.



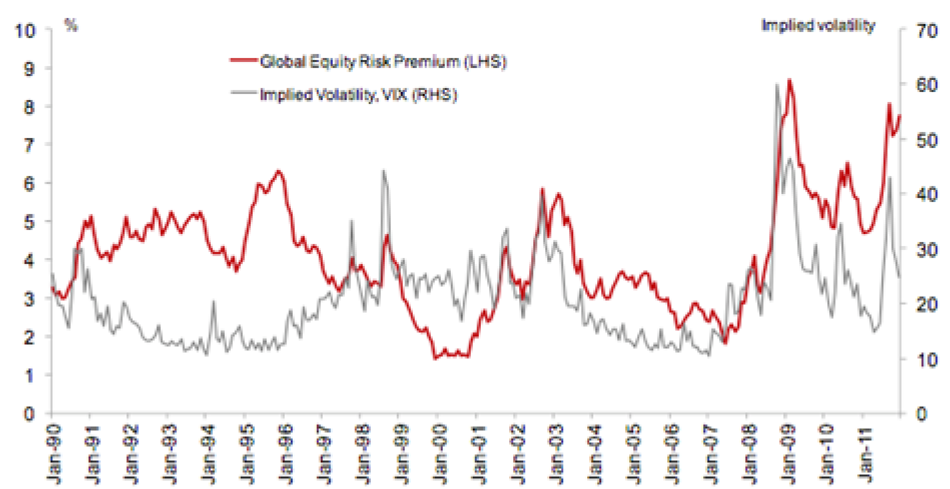
Source of chart data: Factset and Ned Davis Research as of 11/30/11. Price/Earnings Ratio (last 12 months) is a valuation ratio of a company’s current share price compared to its actual per-share earnings over the last 12 months. **Past performance does not guarantee future results.**

Stock valuations are down and may shrink further over future years, but they don’t seem particularly excessive at this point in time. In fact, relative to bonds, stocks look downright cheap.

Burton Malkiel is well regarded financial economist, most famous for his classic book *A Random Walk Down Wall Street* and a leading proponent of the “efficient market hypothesis” which basically said we money managers don’t add any value over index funds – that we cannot predict. So it is really surprising when he now says that some markets are "**evidently inefficient**". He recently commented that bonds don't look particularly attractive because if an investor buys a 10-year U.S. Treasury bond and holds it to maturity, he will make exactly 2%, the current yield to maturity. Even if the inflation rate is only 2%, the informal target of the Federal Reserve, investors will have earned a zero rate of return after inflation. With a higher inflation rate, U.S. Treasuries will be a sure loser. Other high-quality U.S. bonds will fare little better in his opinion. "When I look at the relative yield of equities (many stocks yield over 4% while the average S&P 500 yield is over 2%) versus the 10-year bond – it's at historically wide levels," he explains. "Cash balances on balance sheets remain considerable. And America's has improved its corporate structure. I think all that is very impressive," (for stocks) he implies.

The equity "risk premium", or the gap between stock earnings yields and 10 year sovereign bonds, is another way of considering valuations. This risk premium is show below by the red line. Note that it has only been higher at the 2009 market bottom, and the highs of 1995, 2003, and 2009 all identified major market bottoms. We think the current high is also predicting higher stock prices.

Fig. 1: Global equity risk premium* and implied volatility



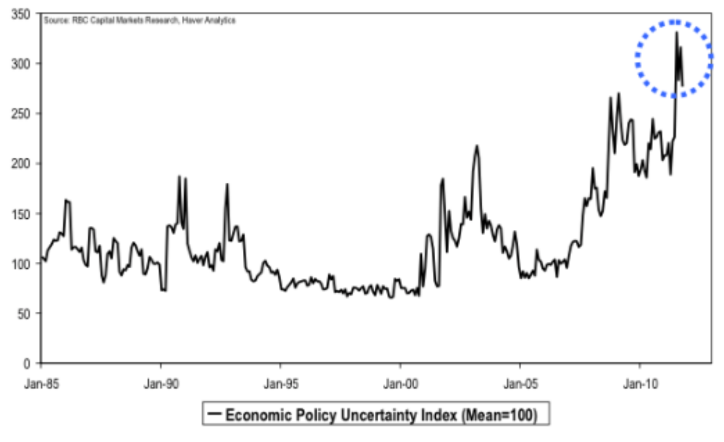
*Calculated by taking the normalised earnings yield less the (equity) weighted global sovereign real yield (nominal 10-year yield less contemporaneous headline inflation). Source: CBOE, MSCI, Nomura Strategy research

Image: Nomura

Investor psychology also supports higher stock prices in our opinion. The repeated market declines of 2000-2003, 2007-2009, 2010, and 2011 together with price volatility and negative global economic events have led to unprecedented selling of stocks by scared investors. Their shift into treasuries and other investments perceived to be "safe" looks like a crisis or a panic to us. Estimates are that over $130 billion came out of equity mutual funds just during 2011, mostly during and after August.

Another positive is the negativity of investment advisors. A recent *Investment News* survey indicates that only 44% of respondents (investment advisors) are planning on increasing their clients' allocation to stocks in 2012. Consider that at the end of 2010 when the market was near its most recent high, 63% of advisors said they would increase exposure to stocks.

Still another contrarian indicator is the index of economic policy uncertainty shown below. It was created by Professors Bloom (Stanford) and Davis (Univ. of Chicago that we think shows a high degree of negativity and coincides with market bottoms. It recently rolled over from a very high level, suggesting a more positive future. The indicator consists of: (i) the frequency of references to economic uncertainty and policy in Google; (ii) the number of Federal tax code provisions set to expire in future years; and (iii) the extent of disagreement among economic forecasters over future Federal government purchases and CPI inflation.

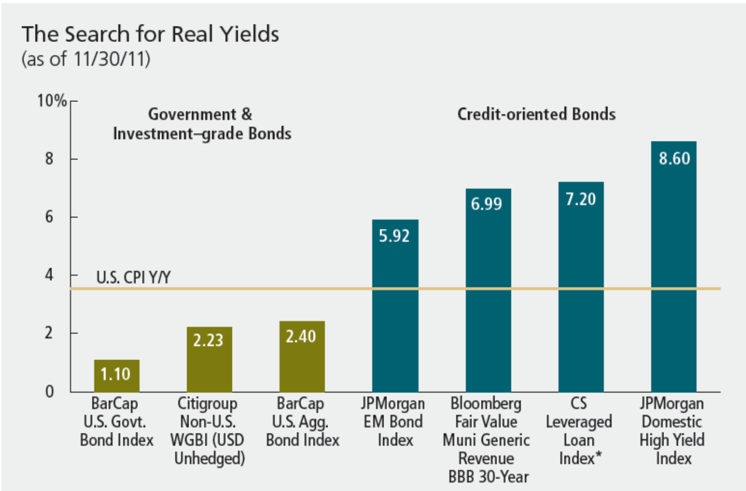


Again, we are not roaring long-term market bulls. However, history has proven time and time again that combination of bearish investors, loose monetary conditions, and lower valuations, are positive for the markets.

Attractive Investments Include Stocks and Higher Yielding Corporate Credit: Stocks are obviously appealing to us. As of Dec. 9, the consensus of analysts' forecasts for S&P 500 calendar-year earnings growth was 15.0% for 2011 and 10.1% for 2012, according to Thomson Reuters. Factor in some valuation expansion along with dividends and it is easy to get to the high 15% end of consensus projected market returns this year, and perhaps higher.

Although PVG is a growth manager, there is a reason to favor growth over other stock types, as we do in portfolios. Investors have most recently focused on negative economic events and safety, without concern about which companies have the best future prospects. Companies growing faster than average or the overall economy offer the advantage of both higher earnings growth, and the potential of expanding valuations. Furthermore, growth stocks were harder hit last year and remain more depressed than those perceived to be safer. If company and stock identification, as opposed to indiscriminate selling, makes a comeback, we think growth stocks should prosper.

If U.S. stocks rise, all stocks are likely to rise as markets are highly correlated. However, we are less positive on Europe, emerging markets, and even China, along with commodity oriented companies. While all depressed in price along the overall markets, commodity prices are coming off highs inflated as liquidity flowed toward these investments, perhaps based on Chinese demand. Now China's economy has slowed and may experience further slowing as European growth lags U.S. growth. Commodity prices also face the impact of rising supply as higher prices have encouraged investment in these economic sectors. The impact of these events on the developing world makes U.S. stocks relatively attractive in our opinion.



After the pain of last year and the last 11 years investors' have understandably been searching for safety and yield. This is partly why U.S. Treasury yields are so low. However, we think credit oriented bonds may offer much potential at greatly reduced risk, as suggested by the chart to the left.

These credit sensitive investments include high yielding bonds, pipelines, mortgage investment trusts, real estate investment trusts, senior secured loan lenders, which have current yields are in the 8% to 10% range. Municipal bonds can also be included in this group. Although they have recently had a substantial price move, they continue to yield the equivalent or more than U.S. Treasury bonds even though credit risk of the majority of states and localities has improved over the last year. PVG's Equity Income and Balanced portfolios all have invested in attractive combinations of these securities.

Higher yielding common stocks, the primary investment of our Equity Income Portfolios, should also be seen attractive for the similar reasons. We would much rather own a quality company with a stock yield of 4% or more than a Treasury bond with a 2% yield that is certain to lose value when artificially low interest rates eventually rise. Of course all higher yield securities have the same drawback as stocks; they tend to be volatile. But values are compelling.

PVG, while positive about the immediate future, recognizes that the world economies remain fragile and that unexpected shocks could quickly change the outlook. We continue to think changing stock and bond allocations as events unfold, along with tactical hedging of market risk with inverse ETFs will remain important parts of any investment strategy. As we have all learned over the last eleven years, the consequences of losses are more important to investors than maximizing returns. Reducing portfolio volatility and protecting against the risks of meltdown seem the prudent approach.

Regards,

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