ANCHOR BAY CAPITAL, INC.

INVESTMENT MANAGEMENT & WEALTH ADVISORS

Financial security anchored by old-fashioned values.

LETTER FROM THE FOUNDER AND CHIEF PORTFOLIO MANAGER

Scott Spiering
Founder & CEO

Investors were taken on another roller coaster ride in 2010. After a robust beginning, U.S. stocks took a mid-summer swoon on fears of a double-dip recession in the United States and a debt crisis in Europe. Since then, the S&P 500 has bounced back more than 20% from its July lows and is up over 12% for 2010. But the real star performers in 2010 were precious metals.

But what's ahead for 2011? "I think 2011 will feel better than 2010."

I'm upbeat on the U.S. economy and U.S. equities, but wary about bonds, particularly Treasuries.

Usually when you exit a recession, you have pent up demand for consumer durables—like cars and washing machines—and housing. This is typically one of the first big drivers of a recovery. Not this time. Housing and autos are both well below their 2007 levels. But I believe there may be a silver lining in this slow recovery: consumer demand, rather than coming back with a bang, may have a longer fuse. So, I think 2011 will feel better than 2010—and certainly better than 2009. Because incomes drive spending, I believe improvements in the labor market are still critical for the economy. Despite a worse-than-expected December unemployment number, we are getting lots of signs of a continued recovery in the job market. Private sector jobs are growing at a rate not seen since 2007.

Finally, one of the biggest drags on the labor market, construction and manufacturing, may finally be stabilizing. Over the past three years, the U.S. economy lost more than 7 million jobs. More than half of those jobs were in construction and manufacturing. Over the past year, the job losses in these sectors have slowed or even stopped. Going forward, the recent rise in pending home sales and the continued strength of manufacturing surveys indicate that jobs losses in the worst hit sectors of the economy may be behind us, and we may even see gains in 2011. As these key sectors normalize, I believe we'll continue to turn the jobs and income picture around.

A higher stock market?

I think that profit growth is going to track gross domestic product (GDP) growth, which is nothing to write home about. But corporate profits are already extremely high; both U.S. total profits and S&P earnings are at or above their 2007 levels. I believe this implies that the market should be trading higher than it is. Another reason I am bullish for 2011 is that investors might start to think about exiting bond funds. From October 2007 to October 2009 bond funds attracted $650 billion, which is a staggering amount. At the same time, $265 billion has been redeemed from stock funds since the October 2007 high, according to the Investment Company Institute.

With interest rates low, the bond market isn't providing much in terms of returns. If $200 billion to $300 billion leaves the bond market and goes running after stocks, it could send interest rates higher and push up stocks. I don't know if that will happen, but we should not underestimate the impact if it does. With interest rates artificially low, I think stocks are priced to give a better return potential than bonds. In fact, I'm not sure that bonds are priced to give any kind of material return at all. I worry that most categories of fixed income could produce capital losses over the next couple of years. While I think stock returns may not be too exciting in absolute terms, I expect they may look very attractive when compared with those of bonds. It's been a challenging time for stock pickers of late, because almost everything has gone up together. However, looking ahead, I don't think the market will continue to exhibit such high correlations. Once you have more dispersion in returns—when investors start to make the distinction between good companies and bad ones—I believe the market will favor stock pickers again.

Letter from the founder and chief portfolio manager

I'm looking for companies that can outgrow their markets and be more profitable than average. So I believe that while consumer spending probably will continue to be somewhat sluggish, some companies appear poised to deliver more profitability than others. I look for companies with strong brands and that exhibit uniqueness against their competitors.

Investment and economic review

Jonathan L Chatfield, CFA
Portfolio Manager

Quarter In Review

The fourth quarter was a breakout quarter for the stock market. The S&P 500 posted a solid +10.76% return for the quarter representing more than 2/3 of its gains for the year. The Barclays U.S. Aggregate Bond Index declined -1.29% as investors pulled money out in anticipation of a potential end to the Fed's low interest rate policy, but it still managed to post a respectable 6.5% return for the year. For the year, the broad market (Russell 3000) was up 16.9% reflecting the outstanding performance of the mid- and small cap sectors which were up over 26% for the year. The best performing sector was REITs, with that index posting a 28% gain. Commodities and foreign stocks were the laggards, with the GSCI posting a 9% gain and the MSCI EAFE up 7.75%.Overall it was a great year for stocks, and bonds held up as well.

Portfolio Strategy

In our last update we noted our concern over a possible correction in stock prices and defensive steps we had taken to add some downside protection to the portfolio.

So far that protection has not been needed, but we are keeping the strategy in place for now because we feel the market has gotten ahead of itself and may correct this quarter. We would be likely to remove the hedge when we do get the correction we expect, particularly if the economic indicators continue to improve

We continue to look for opportunities and as a result of ongoing research we believe the addition of selected additional asset classes enhances the core portfolio's diversification benefits (lower risk per unit of return) we are able to offer. We have decided to add small positions in international and emerging markets fixed income securities that will boost the portfolio yield and offer low correlation with U.S. stocks and bonds, which helps to smooth out the ride, cushioning the portfolio when domestic assets are down. These assets are expected to provide comparable returns to U.S. fixed income securities, while also offering a hedge against a possible decline in the dollar. In addition we have added a small position in high yield corporate bonds in our Hybrid Income portfolio for those clients who need to maximize income. The spread between investment grade and high yield corporate bonds has narrowed as the economic outlook has improved, and high yield bonds appear fairly valued. The ETF we are using yields over 8% in dividends. We also continue to favor short term individual bonds in anticipation of a rise in interest rates. A significant backup in rates would be the catalyst for us to move to longer term individual bonds. Steps like these are a part of our ongoing, evolving strategy that is designed to produce risk adjusted returns while emphasizing downside protection.

Economic Update

Gross domestic product rose at a 2.6% annual rate in the third quarter, seen as an ongoing threat to recovery in the labor market. Economists see a 3.5% or better GDP growth rate as more likely to spur hiring and begin to lower the unemployment rate, currently stuck at 9.8%. As we look ahead into 2011 we expect to see modest GDP growth in the 2.5% - 3.5% range which poses a continued challenge to the unemployment level. Some economists believe sustained GDP growth of 5% is needed to lower unemployment in a meaningful way. Economists surveyed by CNN Money.com expect unemployment to remain elevated, falling slightly to just below 9% by the end of 2011 and to 8.2% by the end of 2012.

Investment and Economic Review

Recent economic indicators point to an upswing in economic activity, auguring a modest economic recovery in the months ahead. The ISM manufacturing index climbed to 57 in December from 56.6 in November, the largest rate of increase in 7 months. Readings above 50 indicate expansion in the sector, which makes up about 11% of the U.S. economy. The report sparked a rally on January 3 and followed the December increase in economists' 4th quarter GDP growth forecasts, following passage of the 2-year Bush-era tax cut extension and expanded unemployment benefits. Finally, November auto sales were encouraging as well, rising to a 12.26 million unit annual sales pace, the highest since the cash-for-clunkers program in August 2009.

Federal Reserve To Keep Rates Low

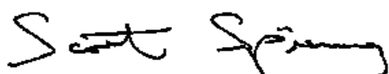
In its December meeting the Federal Reserve affirmed it will proceed with "QE2", the $600 billion Treasury bond buying program that was established earlier in the year. Fed action and the Republican takeover of the House and Senate in November, and the subsequent extension of the Bush-era tax cuts combined to send stocks rocketing higher in December. According to the minutes, business and consumer spending had improved leading up to December, and economic recovery would gain momentum following an expected enactment of an extension to the Bush-era tax cuts. Risks to the economy remained, however, in the form of the ongoing housing crisis, spending cuts, and persistent high levels of unemployment.

Outlook

Looking ahead, further market gains will depend on GDP growth and a reduction in unemployment. We believe a meaningful decline in the unemployment rate below 8% could spur a strong rally in stocks, which may be range-bound in the absence of an improvement. The bond market is under pressure at this point as concern over potential inflation, and a suspicion that a period of rising rates is right around the corner.

Because of the employment situation, and in the absence of any inflationary trend, the Fed will keep rates near zero for the next year. The policy should continue to spur modest economic growth. We may finally be entering into a "Goldilocks" economy, neither too hot nor too cold, but generating enough GDP growth to slowly return the employment rate to a more acceptable level.

Sincerely,



Scott Spiering
Chief Portfolio Manager

Sincerely,

Jonathan L. Chatfield, CFA
Portfolio Manager

Final thoughts

April Reed
Client Services

As we reflect on 2010 and continue to navigate the always uncertain economic environment, we want to take a moment to thank you for the trust and confidence you have placed in us. We wish you financial success in the year ahead. We pledge to work in your best interest, seeking investments trading at decent valuations, generating sizeable levels of income, and to construct your portfolio to provide superior risk-adjusted returns.

Contact Anchor Bay regarding any change in your financial condition.

A critical part of the effective management of your assets is ongoing communication with Anchor Bay about your financial condition. Please keep us informed of any changes in your financial goals, concerns, or time horizon so that we may incorporate them into your financial plan and make the appropriate adjustments to your investment portfolio. Such changes might include the purchase or sale of a house, any large expenditure you may be planning for which we need to provide liquidity, or any change in your tolerance for risk which may require adjustment to a more conservative portfolio.

Sincerely,

April Reed

Client Services Manager

5780 FLEET STREET, SUITE 308, CARLSBAD CA 92008 ~ PHONE 760-602-3470 ~ FAX 760-602-7811
WWW.ANCHORBAYCAPITAL.COM ~ EMAIL: INFO@ANCHORBAYCAPITAL.COM