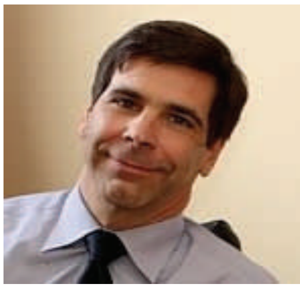
THOMPSON WEALTH MANAGEMENT, LTD.

January 2013



Inside this Issue

The Shore Beyond

"Distant water will not put out a fire close at hand"
(The urgent will easily overshadow the important in the time of crisis)

"We shall nobly save, or meanly lose, the last, best hope on earth." Those dramatic words were penned in 1862 by Abraham Lincoln who, even as the country faced war and the divisive issue of abolition, described a future of unrivaled prosperity and national influence – a future that came true. Lincoln, always a master of the metaphor, likened his political plight to the Great Blondin who crossed Niagara Falls on a tightrope several times, once while carrying his manager on his back. Blondin's secret, Lincoln quipped, was that he never looked down or right or left, but always straight ahead. Even while edging along the proverbial tightrope with the weight of the country on his back, Lincoln kept his eyes on the shore beyond.

That is an instructive message for us as investors today, a time marked by political polarization and economic uncertainty. As we consider the dramatic pace of innovation in the decades after Lincoln's time – Vanderbilt's railroads, Carnegie's steel, Rockefeller's oil, Morgan's finance, Tesla's electricity – we are reminded to avoid too narrow a perspective which can cause investors to fall off of an investment plan. This is one of the hardest challenges for investors amid the deafening blare of news surrounding events that are apt to have only a marginal impact on long term returns. The noise related to short-term economic indicators and sensationalized, transitory events (e.g. "the fiscal cliff") can drown out the factors that truly drive prosperity and equity returns – innovation, population growth and the inexorable forward march of mankind. At the current time, we would add to those factors a gradual upward reverting trend toward historical average ten and twenty-year real rates of return for stocks.

Hopefully Lincoln won't roll over in his grave, but a fitting metaphor for the way many people approach investments came to mind during the fiscal cliff drama as I walked in the woods with my family's beagle. With a sense of smell about 5,000 times more powerful than ours, Bono the beagle runs around the woods with his head down and his snout glued to the ground, running this way and that with every scent. If you've ever seen a beagle, you know what I mean. His powerful instincts can betray him, however. He is so focused on what is right under his nose that if someone was standing 50 paces away with a juicy steak bone in hand he wouldn't know it!

(Continued on page 2)

(Continued from page 1)

Judging from the $600 billion flow of money *out* of equity mutual funds in 2009-2012, *a period when the stock market basically doubled*, many investors were likewise betrayed by their instincts. Last year, investors reacted to slow GDP growth, political divisiveness, uncertainty in Europe, and slowing growth in China by withdrawing about $150 billion from equity funds. Yet the US stock market returned 16% and European stocks returned 18% during 2012.

Anecdotally, while talking with several investors outside of our family of clients, we detect cognitive dissonance -- disconnect between stock market performance and economic indicators. Many people seem genuinely surprised to learn that stocks are in the midst of a bull market while the news headlines trumpet nothing but problems. One explanation, perhaps, is that stock investors are simply ignoring bad news. But another plausible explanation is that investors instinctively tend to rely on news and data that doesn't have dependable predictive quality. Could it be that some investors are focused like my beagle on the obvious while the market, in its collective wisdom, may have already priced in the obvious and may be looking at the shore beyond?

Either way, you shouldn't be surprised about the apparent disconnect between basic economic variables and stock market performance. Economic and stock market performance are rarely synchronized. Plus, it is an irony of the internet age that the more widely available information is, the less likely it is to provide any kind of insight or edge on the market. Just to underscore this last point, I'd like to share this statement from some pretty smart people at MIT Investment Management Company (follow link for full statement):

We view it as very difficult and perhaps impossible for us to generate an edge forecasting macroeconomic events. As a result, we undertake no primary macroeconomic research. Instead, we seek to construct our portfolio with diversification and margin of safety in mind so that our portfolio will be resilient and perform well under a variety of macroeconomic conditions.

Vanguard recently studied stock returns going back to 1926, looking specifically at the predictive ability of popular indicators. (See TWM Blog -- Vanguard: What Signals Matter). Those include growth in GDP and corporate profits, consensus forecasts for GDP and earnings growth, price earnings ratios, past returns, interest rates and government debt as a % of GDP. Their conclusion was that none of these factors -- *which investors often cite when explaining their moves* – come remotely close to forecasting how stocks will perform in the coming year. The study states, "One-year forecasts of the market are practically meaningless."

The reality is that near term returns in the stock market are a lot more random than people want to think. That uncertainty – added risk – is what provides a premium return over time. The best way to profit is to do what the fewest people are capable of or have the courage to do -- and that is to invest for the long run, while always maintaining an asset allocation that investors can live with in bad and good times.

That doesn't mean we ignore macroeconomic factors as they play a key role in determining investment outcomes and affect planning assumptions. In particular we focus on long-term relationships between stock prices, earnings and inflation, which the Vanguard study singles out as the only indicator with predictive quality over a ten-year time horizon. In addition, we stress test your portfolio on a periodic basis to estimate the impact of extreme events in the context of your financial ability to incur the risk.

So why did the US stock market return 16% while European stocks returned 18% in 2012? After returns of just 2% in 2011, *low expectations* created conditions where the market could do well even with all the uncertainty. Analysts point to low inflation, continued Fed stimulus, low interest rates, election year dynamics, earnings didn't slow as much as feared, Europe didn't blow up, and inflation lessened in China leading to hope for possible stimulus and renewed growth. Others point to a rebound in the housing sector, good news for banking and consumer confidence.

The increase in corporate dividends is another factor. In 2012 the companies in the S&P 500 Index raised dividends by 13% on average, which is a great bump in income for investors. Over long periods of time there is a direct correlation between rising dividends and market returns -- reinvested dividends account for nearly half of equity returns since 1926. Again,

(Continued on page 3)

that is something easy to miss when we focus on shorter term issues.

Another factor may be simply that the market is continuing to revert back toward its long-term average returns after a below average decade. We see this as a prominent general trend overlaying continued volatility around post crisis debt reduction issues (European crisis, fiscal cliff, debt ceiling, etc.).

The stock market's trading range since 2008 has been defined by a floor of loose monetary policy, low inflation, and a return to record levels of corporate profits. However, the need to get spending and deficits back in line with reality, at the national, state, local and household levels, has created fiscal headwinds. Obviously these issues get ugly as people fight over how to divide a smaller economic pie.

We don't dismiss these potential pitfalls along the path to recovery. Near-term risks must be respected when planning for liquidity and cash flow needs, and when devising an appropriate portfolio asset allocation based on individual risk tolerance. We are always interested in hearing from you if your financial needs or risk tolerance change.

But at the same time, it is critical to do what Lincoln did – keep an eye on the shore beyond. "Distant water will not put out a fire close at hand," goes the Chinese proverb - a reminder that the urgent will easily overshadow the important in the time of crisis. It could be that stocks are rising because, while investors are preoccupied with urgent news headlines, the market in its collective wisdom is beginning to anticipate the next wave of technological innovation.

To help with perspective on this, we've provided the table **Waves of Technological Innovation**, which lists the major periods of technological innovation through history. These periods have corresponded with great economic growth and prosperity (though never without conflict or uncertainty). When the last wave of innovation hit in the early 1980's, very few people realized it until the market had already advanced significantly.

The Shore Beyond:
Waves of technological innovation

	Technological Revolution	Period	Length of wave (years)	Years between waves	Leading Sectors
1	Financial-agricultural	(1560-1740)	180	40	finance, agriculture, trade
2	Industrial	(1780-1840)	60	40	textile, iron, coal, rails, channels
3	Technical	1880-1920	40	20	chemistry, electro-technical, machinery
4	Scientific-technical	1940-1970	30	15	air-industry, nuclear, astronautics, synthetic materials, oil industry cybernetics
5	Information & telecomm	1985-2000	15	15	telecomm, cybernetics, informatics, internet
6	?	(2015 -?)	?	?	?

(obviously, the years given are for guidance purposes only) *Source: Journal of Economics, Vol.2(4), Apr 2010

As Warren Buffett has said, "mankind moves forward in great leaps and bounds, not in a straight line." The periods between waves, such as *1970 to 1985* and *2000 to present*, are characterized by economic stagnation. During these interim periods it is more profitable for businesses to fully adopt and exploit innovations from the prior period. This continues until the one-time innovation becomes a fact of life (e.g. the Internet). Eventually, general economic stagnation provides the impetus for new innovations (the recession-trigger effect). The table illustrates that the time between waves has been diminishing, probably due to globalization and advances in transportation and communication. The last wave of

(Continued on page 4)

innovation ended in 2000 with the tech and internet stock implosion. However, a decade of stagnation has triggered dramatic new innovation in nanotechnology, hydrogen-energy, robotics, bioinformatics and energy production.

Now innovations in energy production, for example, are beginning to have a huge impact on the economy. The US is projected to reach energy independence within the next several years, and this has already led to cheap natural gas prices. Aided by the inevitability of rising wages in China, this is causing manufacturing to move back to the US.

In May of 2012 the Government Accountability Office (GAO) reported to Congress that the newly discovered Green River Shale Formation in Colorado, Wyoming and Utah contains about triple the oil reserves of Saudi Arabia and about ¾ of it is located under federally owned lands. It is estimated that the federal non-tax royalties alone would be enough to pay off the entire US debt twice. That is probably an overestimate because oil prices would drop significantly, and there are critical environmental and geopolitical issues for debate. But this illustrates the kind of promise the future holds, which many investors may even recognize amid myopic focus on short-term factors.

So we will continue to do what Lincoln did -- keep our eyes on the shore beyond. But we will always do so with realism, pragmatism and with a balanced appreciation of short-term risks and long-term opportunities. That's the mindset we will maintain as we help you plan. Honest Abe.

Highlights – American Taxpayer Relief Act of 2012

- **Estate tax** exemption of $5 million for individuals and $10 million for couples is made permanent. The exemption will be indexed for inflation. The estate tax rate for amounts above the exemption rises from 35% to 40%. The permanency of the law is a huge positive as it will enable more certainty in planning.
- The top **individual tax rate** rises to 39.6% from 35% for singles with income above $400,000 and families above $450,000.
- **Tax on Capital Gains and Dividends** will remain at 15% for income under $400,000/$450,000. Tax will rise to 20% for those with higher income. This deal is a big victory for investors because it was anticipated that dividend tax rates would rise to the highest ordinary income rates (35%/39.6%).
- **The Obamacare tax** of 3.8% will apply to dividends and capital gains for those with incomes over $200,000/$250,000.
- The employee portion of **social security withholding** tax goes back to 6.2% from 4.2%.
- **The Alternative Minimum Tax** is adjusted permanently retroactive to 2012 and indexed to inflation, good news for middle income taxpayers. If you've been paying AMT over the last several years, that probably won't change.
- **Federal Unemployment Insurance** will be extended for another year.
- There are new **limits on deductions and the personal exemption** for individuals with incomes above $250,000 and families above $300,000.
- Employees can **convert existing 401k plans to Roth 401k plans** (if their employer offers Roth accounts without hold restrictions and tax penalties). Amounts being converted will still be taxed so, in general, this may make sense for individuals who expect their income to rise over time.

Andy will be sending more detailed information in the near future and, of course, we will be looking at how the tax changes will affect each client individually.

Investment Comments and Highlights

Index and Benchmark Returns
31-Dec-12

Indexes	Q4	2012	3 YR	5 YR	10 YR
Morningstar Short Term Bond	0.36	3.66	3.21	3.31	3.21
Total Bond Market Index	0.22	4.22	6.19	5.95	5.18
Total US Stock Market Index	0.19	16.39	11.31	2.29	7.93
Total International Stock Index	6.69	18.21	3.9	-3.03	9.41

Risk Category		Q4	2012	3 YR	5 YR	10 YR
1.0	Conservative Benchmark	0.35	3.48	3.96	4.17	3.89
2.0	Income + COLA Benchmark	0.64	7.40	6.12	3.83	5.47
3.0	Balanced Income Benchmark	0.77	9.33	7.04	3.46	6.15
4.0	Balanced Benchmark	1.08	10.68	7.44	3.05	6.66
5.0	Balanced Growth Benchmark	1.22	12.00	8.00	2.73	7.11
6.0	Growth Benchmark	1.53	14.33	8.66	2.41	7.66
7.0	Aggressive Benchmark	2.12	16.37	8.85	0.58	8.33

Index and mutual fund performance tables are attached to provide additional insight on portfolio performance of a general nature.

In 2012 the benchmark return for the most Conservative clients was 3.48% and for the most Aggressive clients was 16.37%. The middle of the road Balanced Benchmark returned 10.68%. Individual portfolio returns will reflect the specific positioning of the portfolio.

Portfolio performance in 2012 was affected by a "risk on" attitude (i.e. investors are confident and willing to take more risk), which was a big change from 2011's "risk off" environment. Evidence of this can be found by comparing the difference in returns between low and higher risk bond and equity funds in the attached tables. Looking at the Core Bond Funds table, for instance, the performance of the Vanguard Total Bond Index Fund was 4.15% while the Vanguard GNMA Fund returned 2.45% and the Vanguard Intermediate Term Investment Grade Bond Fund returned 9.24%. This paints a helpful picture of the diverging returns in the bond market sectors last year. The Total Bond Index owns a cross section of bond sectors, including corporate bonds, and represents the middle of the road. The GNMA fund owns strictly government and agency guaranteed bonds and reflects low credit risk (default risk). The Investment Grade Bond Fund owns strictly corporate bonds, which entail more credit risk. Given this, it is clear that investors favored *riskier* (relatively speaking) bond sectors in 2012. This is really evident when you look at the returns last year for high yield corporate (~15%) and emerging markets bonds (~20%)!

Remember, the returns on those higher risk bond sectors are highly correlated to stock market returns and, as a result, have and should have relatively modest portfolio weightings. What goes up can come down. Investors are flocking to these bond sectors in the current low yield environment and the Fed's bond buying programs are providing the cash to do it. But money could, at some point, reverse out of these sectors very quickly.

In 2012 tax exempt bonds outperformed the Total Bond Index by 2 to 3 percentage points. This is partly because municipal bonds still offer relatively high yields, and because the value of tax exempt income increases with rising taxes. For example, the Fidelity Mass Muni Income Fund has a 12-mo yield of 3.31% compared with 2.65% for the Total Bond Index. But the tax equivalent yield for an investor in the new 43.4% tax bracket (includes Obamacare tax) in the tax exempt bond fund is 5.85% -- nearly double the after tax yield of the bond index.

Similar "risk on" patterns can be seen in the Core Equity Funds as well. In general, dividend paying stocks underperformed the market last year. Note, for example, that the Dow Jones Industrial Average (which represents the performance of 30 companies that gen-

(Continued on page 6)

(Continued from page 5)
erally possess wide economic moats) returned 10.05% last year while the S&P 500 Index returned 16%. This was a reversal from 2011 when the Dow returned 8% and the S&P only 2%. Conservative dividend paying sectors Utility stocks and Energy stocks returned only 1.15% and 3.37% respectively. So this was a comparative negative for income oriented retirement portfolios in 2012.

On the positive side, large cap growth stocks (dominated by technology and health care) returned a few percentage points better than the market (see QQQ +18%), and small cap stocks in general came on strong in the last quarter to post ~18% returns for the year. The best performing sector was financials (see XLF +28.42%) and this helped to offset lackluster returns in energy and utilities.

We note that International Equities returned 18.21% last year, and a big chunk of this return came in Q4 when international returned 6.69% compared to -.39% for the S&P 500 Index. The MSCI Small Cap Index Fund returned 21.28% last year.

Among alternative assets, the Vanguard Real Estate (REIT) Index rose 17.67% in 2012. The SPDR Gold Shares (GLD) returned 6.6% and the PIMCO Commodity Index ended the year with a 5.31% gain. Commodity prices were buffeted by slowing growth in China.

Selected Bond Fund Returns 12/31/2012
Ranked by Category/Risk

Ticker	Name	Category	3 Mo	12 MO	3 YR	5 YR	10 YR	Standard Dev 3 YR	Expense Ratio
WUSMX	Wells Fargo Advantage Ult S/T Mun In Adm	Ultrashort Bond	0.1	0.81				0.39	0.6
ESADX	Wells Fargo Advantage Adj Rate Govt Adm	Ultrashort Bond	0.01	1.95				0.55	0.6
VMLUX	Vanguard Ltd-Term Tx-Ex Adm	Muni Short	0.01	1.85	2.56	3.26	2.97	1.31	0.12
FSTFX	Fidelity Short-Intermediate Muni Income	Muni Short	0.17	2.24	2.86	3.54	3.09	1.44	0.48
VFSUX	Vanguard Short-Term Investment-Grade Adm	Short	0.57	4.63	3.98	4.12	4.04	1.55	0.11
FFRHX	Fidelity Floating Rate High Income	Short-bank loan	1.1	6.8	5.41	4.74	4.79	3.82	0.71
FBIDX	Spartan U.S. Bond Index Investor	Intermediate-Term Bond	0.04	4.06	6	5.64	4.94	2.48	0.22
VBTSX	Vanguard Total Bond Market Index Signal	Intermediate-Term Bond	0.13	4.15	6.11	5.91		2.54	0.1
VFIJX	Vanguard GNMA Adm	Intermediate Government	-0.36	2.45	5.75	5.99	5.16	1.97	0.11
VFIDX	Vanguard Interm-Term Investment-Grde Adm	Intermediate-Term Corp	0.92	9.24	9.14	7.56	6.18	3.68	0.1
FDMMX	Fidelity Massachusetts Municipal Income	Muni Massachusetts	0.82	7.17	6.58	5.64	4.96	3.96	0.46
VMATX	Vanguard MA Tax-Exempt Inv	Muni Massachusetts	0.4	6.46	5.94	5.42	4.72	4.04	0.17
VAIPX	Vanguard Inflation-Protected Secs Adm	Inflation-Protected Bond	0.62	6.9	8.79	6.79		4.41	0.11
LSBDX	Loomis Sayles Bond Instl	Multisector Bond	3.06	15.13	10.71	7.79	10.18	7.06	0.63
VWEAX	Vanguard High-Yield Corporate Adm	High Yield Bond	3.07	14.47	11.37	8.68	8.21	6.39	0.13
SPHIX	Fidelity High Income	High Yield Bond	2.61	14.87	10.55	9.32	9.84	7.6	0.76
FNMIX	Fidelity New Markets Income	Emerging Markets Bond	3.87	20	12.85	11.18	12.64	6.8	0.87

TWM CORE STOCK FUNDS		12/31/2012							
Ranked by Category/Risk									
Ticker	Name	Category	3 Mo	12 Mo	3 YR	5 YR	10 YR	Standard Dev 3 YR	Expense Ratio
IDU	iShares Dow Jones US Utilities	Dividend Income	-0.88	1.15	9.45	0.72	9.58	9.51	0.47
DVY	iShares Dow Jones Select Dividend Index	Dividend Income	2.17	10.48	14.17	2.37		11.61	0.4
SDY	SPDR S&P Dividend	Dividend Income	3.47	11.61	12.48	5.82		12.47	0.35
FUSEX	Fidelity Spartan 500 Index Inv	Large Blend	-0.39	15.93	10.79	1.61	7.03	15.3	0.1
VTSSX	Vanguard Total Stock Mkt Idx Signal	Large Blend	0.19	16.39	11.31	2.29		15.99	0.06
VTV	Vanguard Value ETF	Large Value	2.95	15.19	10.98	1.22		15.03	0.1
VUG	Vanguard Growth ETF	Large Growth	1.26	17.02	12.74	4.13		16.49	0.1
QQQ	PowerShares QQQ	Large Growth	-1.59	18.11	14.74	6.69	10.84	17.88	0.2
POAGX	PRIMECAP Odyssey Aggressive Growth	Mid-Cap Growth	-0.26	21.22	13.62	7.61		19.31	0.69
VO	Vanguard Mid-Cap ETF	Mid-Cap Blend	4.99	16.22	13.51	3.94		17.71	0.1
DON	WisdomTree MidCap Dividend	Mid-Cap Value	4.8	14.4	14.45	6.3		15	0.38
FSEVX	Fidelity Spartan Extnd Mkt Idx Advtg	Mid-Cap Blend	2.82	18.05	13.46	4.22		19.02	0.07
FLPSX	Fidelity Low-Priced Stock	Mid-Cap Blend	3.21	18.5	12.65	4.88	11.17	16.26	0.88
VB	Vanguard Small Cap ETF	Small Blend	5.42	18.29	14.85	6.05		20.06	0.16
VBR	Vanguard Small Cap Value ETF	Small Value	6.18	18.98	13.6	5.74		19.34	0.21
DES	WisdomTree SmallCap Dividend	Small Value	4.77	18.31	14.84	6.18		16.84	0.38
VTSGX	Vanguard Total Intl Stock Index Signal	Foreign Large Blend	6.69	18.21				20.15	0.18
FSIIX	Fidelity Spartan International Index Inv	Foreign Large Blend	7.55	18.69	3.94	-3.31	8.33	19.98	0.2
FDIVX	Fidelity Diversified International	Foreign Large Blend	5.05	19.41	4.13	-4	8.75	19.66	0.9
FSGDX	Fidelity Spartan Glb ex US Idx Advtg	Foreign Large Blend	6.8	17.69					0.18
IDV	iShares Dow Jones Intl Select Div Idx	Foreign Large Value	6.62	19.44	7.79	-0.68		20.62	0.5
SCZ	iShares MSCI EAFE Small Cap Index	Foreign Small/Mid Blend	8.64	21.28	8.4	-1.03		20	0.4
VWO	Vanguard MSCI Emerging Markets ETF	Diversified Emerging Mkts	9.02	19.2	5.71	-0.16		22.26	0.2
FPEMX	Fidelity Spartan EMkts Idx Inv	Diversified Emerging Mkts	6.65	17.2					0.31
DEM	WisdomTree Emerging Markets Equity Inc	Diversified Emerging Mkts	7.27	15.56	9.36	6.46		19.46	0.63
VGRSX	Vanguard REIT Index Signal	Real Estate	2.49	17.67	17.98	6.07		18.28	0.1
GRI	Cohen & Steers Global Realty Majors ETF	Global Real Estate	8.7	29.55	14.41			18.66	0.55
FRXIX	Fidelity Spartan Real Estate Idx Inv	Real Estate	2.21	16.77					0.24
PCRIX	PIMCO Commodity Real Ret Strat Instl	Commodities Broad Basket	-5.78	5.31	6.51	-0.85	7.67	19.13	0.74
GLD	SPDR Gold Shares	Commodities Precious Metals	-5.19	6.6	14.99	13.97		18.37	0.4
IAU	iShares Gold Trust	Commodities Precious Metals	-5.18	6.89	15.15	14.07		19.29	0.25
VDE	Vanguard Energy ETF	Equity Energy	-0.78	3.37	9.6	-0.2		23.13	0.14
XLF	Financial Select Sector SPDR	Financial	8.17	28.42	7	-7.97	-0.78	20.86	0.18
MERFX	Merger	Market Neutral	1.34	3.61	2.89	2.93	4.26	2.78	1.37
HSGFX	Hussman Strategic Growth	Long/Short Equity	-0.35	-12.62	-5.05	-4.01	1.69	7.82	1.07

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