

Market Commentary—1st Quarter 2012

The new year started with a bang, as most equity indices gained over 10% in the first quarter. The adage “the market climbs a wall of worry” has been in force, reflected by the nearly 30% return of the S&P 500 Index since the 2011 intra-day bottom on October 3rd. Small- and mid-capitalization shares have done even better. Not only have recent returns been strong, but three-year equity returns are exceptional as the impact of the 2008 meltdown fades further into the distance. Three-year large-cap equity index returns are tracking a 20%-25% annualized pace, and most “down-cap” indices, such as the Russell 2000 and Russell Midcap, have gained in the vicinity of 30% during the same period. While the definition of a “bull market” is difficult to pinpoint, those who were well positioned in equities over the past three years enjoyed “bull market” returns.

For most investors, it has not felt like a bull market despite phenomenal returns over the past three years and in the first quarter of 2012. The “flash crash” of 2010 in which some blue chip shares momentarily fell to pennies, revealed the vulnerability of electronic exchanges and the degrading effect of high frequency traders while undermining investor confidence in the

integrity of the equity trading infrastructure. Persistent fears about the possibility of a recurring credit contagion—notably in Europe—and concerns about economic deceleration in Asia added to investor skittishness, leading to periodic rapid market selloffs and intermittent high volatility in both 2010 and 2011. This, together with prevailing low interest rates, drove pundits to emphasize mega-cap and high-dividend-yield shares as 2011 came to a close. Yet those shares have been laggards this year, as the “risk on” trade has brought greater rewards to other areas of the market. The utility sector, which offers the highest dividend yield but lowest growth of all the sectors, led the market in 2011 but had the weakest returns in the first quarter of this year. Our fourth quarter comment in which we stated that “this could be another year of elevated volatility” has so far proven wrong, as the market has demonstrated only modest volatility so far over the course of its upward trajectory.

There are indeed reasons for worry in the current global geopolitical and economic environment. There always are, to some degree. We anticipate modest economic growth of about 2%-3% in the United States, slightly negative growth in most of Europe and continued strong (though possibly somewhat

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-muted) 4%-7% growth in emerging markets. European economic authorities have injected nearly one trillion dollars of three-year credit liquidity into the banking system, reducing (or at least postponing) concerns about credit contagion on the continent. Sabre-rattling in the Middle East heightens the possibility of an attack on Iranian nuclear facilities. Such an event could result in far-reaching conflict in the region. It would not, however, likely impede overall global Gross Domestic Product growth, nor affect the credit markets. Nor would it likely result in a sustained elevated price of oil, as Saudi Arabia would increase oil production to make up most or all of the difference of any lost production.

The strongest returns year-to-date have been concentrated in consumer discretionary and technology shares, many of which are traded on the NASDAQ. Of significance, the financial sector has come to life, sparked in part by encouraging results from government stress tests, indicating a strong recovery in the economic health of the financial system, notably banks. Healthy returns in the financial sector are especially encouraging, given the world lives on credit – a lesson learned in 2008. Industrial

cyclical, energy and utility shares have lagged, precipitated by weakness in coal and natural gas prices and associated industries.

Over the course of the quarter, we made modest reductions in energy and industrial equity exposure, while building positions in consumer discretionary shares, notably ones with visible high growth prospects and a domestic market focus.

In the midst of what has been a great market environment, new investment vehicles have proliferated as investment managers have sought new ways to attract investor assets. Incremental focus on alternative investments and a multitude of exchange traded funds (ETFs) have come to market, including triple-leveraged funds for investors who really want to “roll the dice.” The Chicago Board of Exchange recently introduced a VIX of VIX Index, translatable as the volatility of the volatility index, noting that traders will have the ability to formulate new strategies based on the Index. In the midst of such new equity exotica, traditional “long only” indices have quietly reflected exceptional equity returns over the past three years – results which we believe many alternative investments will be hard-pressed to match.

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We remain committed to a conservative growth strategy, a position we have maintained since the 1980s. While we would not be surprised to see profit-taking or the summer doldrums cut into some of the market gains enjoyed in recent months, the general environment for equities remains constructive—very low interest rates, below average price-to-earnings ratios, economic growth and the absence of investor euphoria.

Quote of the Quarter:

“Our main business is not to see what lies dimly at a distance, but to do what lies clearly at hand.”

--Thomas Carlyle

Price-to-Earnings is a valuation ratio of a company's current share price compared to its per-share earnings. The S&P 500 Index is an index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The Russell 2000 Index is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index. The Russell Midcap Index measures the performance of the 800 smallest companies in the Russell 1000 Index, which represent approximately 25% of the total market capitalization of the Russell 1000 Index. The VIX Index shows the market's expectation of 30-day volatility.

Mutual fund investing involves risk; principal loss is possible. Small- and medium-cap companies tend to have limited liquidity and greater price volatility than large-cap companies. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer term debt securities. Investments in Asset Backed and Mortgage Backed Securities include additional risks that investors should be aware of such as credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. Investments in foreign securities involve greater volatility and political, economic and currency risks and differences in accounting methods.

The Funds investment objectives, risks, charges and expenses must be considered carefully before investing. The summary and statutory prospectuses contain this and other important information about the investment company, and may be obtained by calling 800.536.4640 or by visiting www.rainierfunds.com. Read carefully before investing.

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