STRATEGIC BALANCE, LLC

February 7, 2012

	Strategic Balance Partners, LP	S&P 500
January	**-1.8%**	**4.5%**
Year to Date	**-1.8%**	**4.5%**
Since Inception	**50.4%**	**57.2%**

The information provided is historic and should not be taken as any indication of future performance. SBPLP returns are unaudited for this year and net of 1% management fee and 10% incentive allocation. Actual returns may differ due to differences in contribution date, fee structure and new issue eligibility. All returns are time weighted with dividends reinvested. S&P 500 returns are provided strictly for informational purposes to reflect general equity market performance. Fund Inception 8/1/03.

Dear Investor:

We spent last month marveling at the dramatic and sudden reduction in risk premiums across multiple asset classes. According to Bespoke Investor Group, non-dividend-paying stocks in the S&P500 are up 8.3 percent on the year, while dividend payers are down 1.3 percent. Our portfolio is overweight high quality stocks that pay attractive dividends (which served us well last year). These stocks still look quite cheap relative to the market, but they certainly sat out January.

The sustainability of the 'risk' rally remains suspect as it was not accompanied by any sort of normal volume. Just to put some numbers on it, according to Bloomberg data, January 2012 average daily volume on the NYSE was down 26% from January 2011 and down an incredible 59% from January 2008. The four week moving average of volume has now fallen to levels not seen since 1999.

We usually suffer when a market is generally overvalued and also experiences a big rally, and last month was no exception. In adherence to our disciplines, we moved past 'well hedged' and into 'net short' on a beta-adjusted basis. We are compelled to remain in a risk-averse mode as we believe that the risk of major negative surprises across the globe is high.

As of last week, the Shiller P/E resides over 22 (the average is about 16), so we would characterize the market as quite expensive. In addition, one measure of overall market risk that we use internally compares the valuation of small cap stocks to large cap stocks. This metric now resides in the top forty richest out of over 600 weekly data points we have witnessed going back to 2000. The forward P/E of the Russell 2000 is extremely high at 19.

The massive ECB lending program noted in last month's letter was a big driver behind January's rally. The current ECB program allows banks in the region to buy the debt of weak sovereign nations and immediately turn around and use those same low quality bonds as collateral for attractive loans from the central bank. (If this sounds like a Ponzi scheme to you, we will not argue the point.) In the end, the ECB is simply financing the fiscally imprudent EU members in a backdoor fashion. While this provides needed liquidity, it does not improve solvency or credit quality. Importantly, recent reports from Europe are showing that banks sharply curtailed lending at the end of 2011. In an ominous portent, Portugal's 10 year rate breeched 15% in January and is trading around levels where Greece debt traded six months ago.

Needless to say, Greece remains on the verge of a messy default (but we hear daily announcements that they will have a final plan for the markets either 'tomorrow' or 'next week'.)

Over on our side of the pond, fourth quarter GDP would have been only 0.8% without an additional 1.9% of growth from inventory building. Real final sales remained anemic and production will likely have to slow early this year to work off excess inventory. The U.S. Purchasing Managers Index remains below its 12 month moving average and its level from a year ago.

Importantly, as we have noted in previous letters, profit margins remain near record highs, (around 50% over their average) and now some data points are suggesting they may have peaked. The Wall Street Journal reports, "In the second quarter of 2011, the profit margin for the S&P 500 companies, excluding financials and utilities, hit 8.95%, the highest since at least 2006 and up from a low of 5.77% in early 2009. But since then, the S&P 500 profit margin has fallen back to 8.23% for the companies in the index that have reported fourth-quarter 2011 profits so far, according to Brown Brothers." The Journal continues, ""Margins clearly reached an inflection point," said Barry Knapp, chief equity strategist for Barclays Capital. He said seven of the S&P 500's 10 sectors are on track for margin contraction this quarter. That's an ominous sign "because margins typically peak two to three quarters before recession."

Also, the percentage of companies in the S&P500 that are beating analysts' expectations has collapsed to about 60% from a more typical 70% in recent quarters. It appears that S&P500 companies' revenues will be up 7% while their earnings will only be up a modest 5% once all the fourth quarter reports are in. Take AIG and Apple out of the index and earnings growth would be only about 1%. Obviously, the Fed is somewhat concerned as well, as they just pledged to keep rates zero bound at least through 2014.

Given this set of conditions, we find it strange to see cyclical equities and small caps priced at multi-year high valuations and at a significant multiple premium to recession resistant equities. Normally, cyclical stocks trade at lower multiples to discount uncertainty. We hope to profit from a more typical relative valuation.

Our longs added 4.1% while our shorts cost us 5.8% in January. We are currently 125% long equities and 90% short with a risk-adjusted market exposure of minus 17%. As profit margins revert to mean, and tighter lending and government austerity programs bite into economic activity, current optimistic earnings estimates should prove elusive. As this dynamic becomes clearer to the market, our portfolio structure should shine brightly.

Finally, please check out our website at StrategicBalanceLLC.com and use the password "balance." We have added some interesting charts and other information and plan on using it as another means of providing you with timely updates. However, please keep in mind that due to industry regulation only accredited investors are permitted to explore the site. Please call with questions and comments.

Sincerely,

Scott E. Brown, CFA

Spalding Hall

P.S. As we finish this letter, the January Non-Farm Payrolls number and current level of Unemployment have come out, and the markets are celebrating a reasonably strong headline number on both metrics. Although we honestly hope for these metrics to reflect positive developments (on a moral basis), we must point out disturbing trends behind the headlines. Non-seasonally adjusted payrolls actually declined by 2,689,000 jobs in January. It is a normal occurrence for the economy to lose jobs in January. The BLS is essentially saying that the job loss wasn't as bad as the 'normal' decline so the economy really gained 243,000 jobs. Trim Tabs tracks federal tax withholdings as it tends to lead the government jobs numbers. They are not seeing employment strength in that data and are saying that the last time the discrepancy between their data and a jobs number was this high was the last recession. When one looks at the Household Survey, one finds the largest jump in temporary workers ever, with temporary jobs making up a full 90% of the jobs created. Also, the BLS used the new 2010 census data for the first time in this report. This adjusted the labor force quite a bit and took the participation rate to 64%, a level last seen in 1984. Were it not for people dropping out of the labor force, the unemployment rate would be much higher.