

Q2 2009 Quarterly Investment Commentary



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Just as the warming weather of Spring follows cold winters, so we have seen a thawing in the markets over the last several months, as well as initial signs of a recovery in the economy. While we don't anticipate the market to repeat its strong second quarter performance, the initial warm weather days of Summer are accompanied by a renewed vigor in the markets as corporate earnings exceed expectations.

June Benchmark Returns (Preliminary)			
Large-Cap Benchmarks	Jun	2Q	YTD
Vanguard 500 Index	0.2%	16.0%	3.2%
Russell 1000 iShares	0.2%	16.4%	4.3%
Russell 1000 Growth iShares	1.1%	16.2%	11.4%
Russell 1000 Value iShares	-0.7%	16.7%	-2.8%
Mid-Cap Benchmarks			
Russell Midcap iShares	0.3%	20.7%	9.9%
Russell Midcap Growth iShares	0.5%	20.6%	16.5%
Russell Midcap Value iShares	0.2%	20.9%	3.2%
Small-Cap Benchmarks			
Russell 2000 iShares	1.5%	20.7%	2.7%
Russell 2000 Growth iShares	3.3%	23.3%	11.3%
Russell 2000 Value iShares	-0.3%	18.0%	-5.2%
Other Benchmarks			
Vanguard Total Int'l Stock Index	-1.3%	27.3%	10.7%
Vanguard Emerging Mkt Stock Index	-2.3%	34.2%	34.2%
Vanguard REIT Index	-3.3%	30.0%	-11.7%
Vanguard Total Bond Mkt Index	0.5%	1.8%	2.1%
Merrill U.S. High Yield Cash Pay	3.0%	22.5%	29.0%
Barclays 7 Yr Muni Bond Index	-0.9%	0.7%	3.0%
Citigroup World Govt. Bond Index	0.1%	3.5%	-1.5%
J.P. Morgan ELMI+	1.1%	10.2%	5.8%
DJ-UBSCI (Commodity Futures)	-1.9%	11.7%	4.6%

Second Quarter Market Performance

From the bottom on March 9 through June 30 the S&P 500 gained 35.9%. The 16% portion of that gain in the second quarter was the biggest three-month gain in over 10 years. Large cap growth and value stocks performed similarly, but large value's poor performance for the first quarter leaves growth ahead significantly for the first half of the year. Other asset classes also did well this Spring. The small-cap Russell 2000 index surged by almost 21%, while the Vanguard Total International Stock Index fund, which represents a broad international index, soared 27.3%, bringing its year-to-date gain to 10.7%. Emerging market stocks generated 34%. High-yield bonds (based on the Merrill Lynch U.S. High Yield benchmark) gained 22% in the second quarter and 29% so far this year. The extreme vola-

tility we've noted in REITs is exemplified by the performance of the Vanguard REIT Index fund that finished the second quarter with a 30% gain, yet is down almost 12% year-to-date. The Vanguard Total Bond Market Index Fund, a proxy for high-quality, intermediate-term bonds, gained 1.8% over the second quarter, and is up 2.1% for the year through June. All of our portfolios ended the second quarter well and generally exceeded their blended indexes. Returns above comparative indexes were primarily due to active manager outperformance and exposure to high yield bonds.

The Economy

Early signs of bottoming in the U.S. economy are emerging, although challenges to renewed growth remain. The Leading Economic Indicators, which typically indicate the direction of the economy six months into the future, have risen slowly over the last couple of months. Corporate earnings have been coming in higher than analysts' projections for this difficult period. Several big questions remain unclear, however, and will impact economic growth prospects over the next few years.

Housing: Since lower housing prices triggered this recession, an improving housing market is critical to an economic recovery. Low interest rates and lower home prices have dramatically improved affordability, jumping the affordability index to its highest level since the early 1970s. New construction has ground almost to a halt, thereby limiting new home supply while overall inventory slowly declines from a very high level. Home sales have been increasing relative to the depressed levels of a year ago. These factors are all good news. However, there are more foreclosures coming as about \$3 trillion in Alt-A and Option ARM loans will reset over the next 3 years, and many of those homeowners no longer qualify to refinance at today's low rates. Job losses and underemployment will restrict the ability of many to afford the new payments, causing increased foreclosures. Many housing experts expect home prices to bottom within the next 6 to 12 months though a quick rebound is unlikely. The coming foreclosures and price declines will continue to weaken the capital strength of many banks, further crimping consumer and business lending that is important to revive the economy. With such conflicting positive and negative aspects, we are paying close attention to how the national housing market shifts.

U.S. Consumer Spending: Much has been written in the financial press about the changing consumer. Over 30% of mortgage equity withdrawals over the last decade fueled consumer spending. That is over. With China growing their manufacturing base and increasing employment, they were willing to recycle their foreign exchange earnings into U.S. Treasuries, thereby keeping our interest rates low and boosting our economy; they are now advocating a world currency of some sort through the International Monetary Fund (IMF). With sharply lower stock and real estate asset values and a deep recession, U.S. consumer spending via leverage has been brought to a grinding halt. As a country we are in the middle of deleveraging, with an accompanying drop in consumer spending. The U.S. national savings rate has risen from -1% to 7% in a year. Capacity utilization has dropped from a typical 85% to below 70%, the lowest in over 30 years. Retail stores are closing and more people are losing their jobs. No one yet knows where this balances out. If consumer spending continues to decline (and the savings rate climbs considerably higher), we are likely to see another major downturn in the economy. We think this is unlikely. On the other hand, if consumer spending comes roaring

back as the economy begins growing solidly, we will probably see uncomfortably high inflation. Finally, if consumer spending levels off and the national savings rate settles in the general vicinity of 10%, we will have dropped consumer spending as a percentage of the economy and will see non-inflationary economic growth begin again; this is what we anticipate and clearly prefer.

Global Economies: The strength of the Global Economy is another question yet to be answered. Global trade and industrial output have suffered their biggest declines of the post-WWII era. Unemployment is high and rising, and usually doesn't peak until many months after the end of a recession (the post-WWII median is 10 months after the recession's end). High unemployment feeds back into the housing market through increased foreclosures, clearly a continued threat to a recovery in that market. The government stimulus, which likely saved the economy from a much deeper slide, will subside as the year progresses and, without an extension, will be mostly done in a year thus removing a powerful tailwind supporting the economy at this time.

Examining Asset Allocation

Asset allocation and diversification strategies are the foundation of modern investing and the core of Opes' investment philosophy. Combining investments whose returns don't move up or down at the same time or to the same degree smoothes out overall returns. In the recent economic and market crisis however, most asset classes fell dramatically and asset allocation's diversification value was reduced. This has led us to think deeply about the future effectiveness of asset allocation and possible changes to our portfolios. This topic has been widely discussed in the press as industry speakers opine. Since the fundamental calculations that create a diversified portfolio rely on data from the past, we asked ourselves what has changed in the markets that would invalidate or reduce the reliability of past asset class correlations and what changes do we need to make to help protect our client's assets in the future. Our extensive research led us to conclude three major changes have increased asset class return correlations: globalization, the growth of Exchange Traded Funds (ETFs), and the growth in hedge funds and wirehouse trading desks. Details of our findings follow:

Globalization: As information availability has increased through the web, international accounting standards and business methodologies have become more standardized. Combined with an increasing ease of investing internationally, markets around the globe have begun and will continue to act more similarly. Correlation data shows that developed international stocks have been acting more like their U.S. counterparts for some time, and this trend is expected to continue and extend into the emerging markets.

ETFs: Traders can instantly trade in and out of asset classes that were once less liquid through ETFs. Real estate and commodities are two examples where investors previously had to buy actual real estate, gold, or oil in order to invest to any significant degree. All that is needed now is a computer and cash. ETFs allow institutional and individual investors to include asset classes in their portfolios that were formerly difficult to obtain. As a result, momentum traders flow money into a hot asset class much more quickly, increasing the price more rapidly. In the face of more market uncertainty, those trades can be reversed immediately and prices can cascade into a swift downward spiral. Asset classes that were formerly more conservative are now demonstrating increased volatility and performance more correlated to stocks than they formerly were.

Hedge funds and trading desks: Macro funds and trading desks are regularly trading billions of dollars and are focused on moving in and out of different asset classes daily. Although data is not readily available as to the total share volume or volatility created by these entities, most major financial firms now report significant profits from proprietary trading and speculation, and this activity has almost certainly increased volatility in many asset classes.

Our analysis and assessments from our research led us to re-engineer our strategic allocations (the basic asset allocation models from which we tactically tilt when appropriate). Asset classes where diversification benefits have decreased and volatility increased have been reduced in our new strategic allocations, such as REITs and commodities. Our allocation to core fixed income has been increased in our portfolios, while making certain much of that allocation is invested in Treasury and investment grade corporate and Agency bonds. We are also reviewing the amount and frequency of our tactical tilts. With the strong potential of a slow economic recovery and moderated returns over the next few years, it is important we extract additional returns where possible without increasing the risk to the portfolios. We have further refined our processes for recognizing market opportunities and threats and will be acting more quickly on them. We are more willing to lower risk dramatically if necessary, since this last market downturn has demonstrated so strongly that risky asset correlations go way up when the market is under high pressure.

Third Quarter and Beyond

While we anticipate a slow economic recovery beginning later this year, we also believe the economy is fragile enough, and the government intervention significant enough, that it is likely we will experience more periods of market volatility over the coming years that could provide us with compelling tactical opportunities. We don't expect dramatic market returns but anticipate our tactical changes



and effective mix of active and passive managers will add value in such a market. Our research efforts will continue to focus on identifying these asset class opportunities and consistently monitoring our managers as we seek to earn the best risk adjusted returns possible given the potential market and economic risks we see.