

Q2 2010 Quarterly Investment Commentary



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Summer is here at last! In Northern California we had one of the wetter Spring seasons we have seen in a long time, but suspect our clients on the East Coast would love some of that cooler weather right now. We have made a slight formatting change in our quarterly letter, beginning the letter with a summary, followed by the detailed analysis and grounding for our thinking. Please let us know what you think of the new format.

Summary

Since our last quarterly letter in April, markets have continued to experience turbulence. As the European debt situation worsened, equities retreated and a global “flight to safety” strengthened the U.S. dollar and drove the ten year Treasury below 3%. Later in the second quarter, signs of a slowing U.S. economy began to emerge, leaving the U.S. stock markets retracing about 15% from their highs. Disappointing economic growth news from China resulted in a selloff of the Chinese markets by approximately 25%. We could well see a recovery of some of the recent losses as earnings season progresses, but our expectations for global markets remain tempered given developed markets slow economic recoveries in the midst of de-leveraging.

One of the primary concerns we are facing is the level of debt in the developed markets. The timing and aggressiveness with which the public sector accumulated debt and the manner in which current deficits are addressed will be extremely tricky to get right given today’s economic headwinds. The process is further complicated by aging populations—a reality most of the developed world faces to varying degrees.

Our 2010 & 2011 investment themes emphasize emerging markets for their continued growth, careful investment in U.S. and developed stock markets, diversified fixed income positions, and increased use of alternative investments. Our investment moves are designed to produce added long term returns or to control risk, and experience has taught us the difficulty of making changes at exactly the right time. Market excesses, whether driven by exuberance or fear, usually last well past a logical end time. Our recent decision to increase exposure to emerging markets slightly is just such a move that only the passage of time will validate.

While we are not happy when markets decline, we are pleased that Opes clients experienced lower volatility and considerably smaller losses in the second quarter. Diversification has provided returns in excess of the indexes and our benchmark as we have been positioned to protect on the downside with our current overweight in fixed income. We continue to invest cautiously, protecting assets wherever it is possible; while maintaining the potential for growth needed to achieve our clients’ goals.

The following pages are the details that more fully delve into the causes and effects of what happened in the markets over the last quarter, and the positives and negatives going forward.

Thank you for allowing us the opportunity to work on your behalf. We will continue our focus on adding value through our rigorous investment discipline, meaningful planning conversations and overall financial advice.

Second Quarter 2010 Market Performance

The markets fell in Q2 as the S&P lost -11.6% to move into negative territory for 2010. All U.S. asset classes, except U.S. Growth, beat the S&P. Developed International was hurt the most, losing -13.8% in Q2 and falling to -12.9% YTD. Emerging International fell -8.3%. REITs were the top performing equity asset class with a -4.5% return, while the CSCI Commodities index (70% energy) lagged. U.S. Fixed Income had positive returns, while Foreign Fixed moved to the negative as the U.S. dollar strengthened.

Index	Q2	YTD
BarCap Aggregate	3.49%	5.23%
30-Day Money Market Yield	0.03%	0.08%
BarCap Global Aggregate	-0.15%	-0.42%
Wilshire REIT Index	-4.51%	4.87%
Dow Jones Commodity Index	-4.81%	-9.60%
MSCI Emerging Markets	-8.29%	-6.05%
Russell Midcap	-9.87%	-2.06%
Russell 2000	-9.93%	-1.96%
S&P GSCI Commodity Index	-10.41%	-11.06%
Russell 1000 Value	-11.14%	-5.11%
S & P 500	-11.63%	-6.87%
Russell 1000 Growth	-11.74%	-7.64%
MSCI EAFE Equity Index	-13.75%	-12.94%

Developed Market Debts

It used to be that global bond investors worried about the finances of developing countries whose banking systems were undeveloped, whose government corruption pulled money out of the economy, and whose consumers used their extra funds to buy imported consumer goods. Argentina's frequent defaults over the last 60 years are emblematic of that situation. After the Asian debt crisis

of the late '90s, however, many developing countries shifted their actions. Many governments became more responsible. As economic growth continued, savings rates rose, which then increased investment into infrastructure and more productive capacity, which in turn increased incomes. As a result, most of the largest developing economies have paid down their government debt and are sitting on large piles of foreign exchange reserves. They have relatively low debt inside their economies with either consumers or governments.

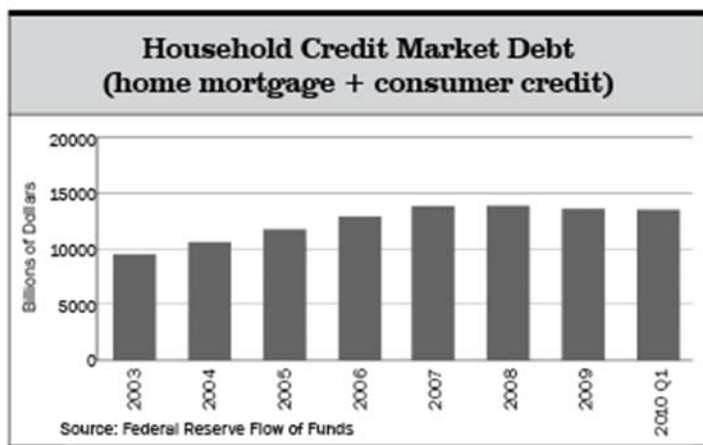
The same cannot be said of the developed world, however. Whether in Japan, Greece, Portugal, Italy, Ireland, Spain, or the United States, increasing levels of debt fed economic growth for many years. The last three years have shown that seemingly virtuous cycle is coming to an end. The willingness to take on high levels of debt by both investors and consumers led to ridiculous loans on homes, the fallout from which triggered the significant market declines and deep economic recession of 2008 and early 2009, the results of which we are still working through. Greek government and consumer spending rose dramatically once Greece joined the Eurozone; everyone acted as though the lower borrowing costs meant they wouldn't actually have to live within their means anymore. The bond markets have called Greece on the proverbial carpet over the last eight months, leading to a Euro wide bailout, significant austerity programs, and rioting on Greek streets.

Developed market debt levels spiked significantly higher as a response to the bank implosions and seizing up of the lending markets that began in late 2008. With consumers and governments already deep in debt, we narrowly avoided a financial meltdown which would probably have resulted in the loss of trillions of dollars of wealth and significantly higher unemployment than even the U.S. 9.5% reported recently. European and U.S. existing heavy debt loads ratcheted upward with stimulus and bailout programs, and the worldwide financial system was stabilized. Consumers in many developed nations are overleveraged and struggling with higher unemployment, reduced wealth, volatile markets, and a limited ability to borrow further.

So much has been written about these issues that some in the investing press take it for granted and are no longer concerned. Identifying an issue, however, doesn't lessen the challenge. In coming years the developed world must walk a tightrope as it deals with the pressing need to slow debt growth and ultimately shrink outstanding debt without seriously harming economic growth and people's living standards.

The United States and other countries with excessive household sector debt are in the early stages of what is likely to be a long process of deleveraging. While declining, the ratio of household debt to income remains problematic. Unfortunately, many of these countries must also dramatically reduce public sector (government) debt growth and in some cases they will need to reduce the absolute amount of debt. This huge challenge has only just begun in some European countries, and is just starting to get the attention of political leaders in the U.S. (Some countries that don't have high private sector debt have huge public sector debt that must be reduced—Japan is the most prominent

example.)



Credit is contracting but it's been a drop in the bucket in terms of total debt outstanding (shown here) and also relative to household income (not shown).

The timing and aggressiveness with which the public sector accumulated debt and the current deficits are attacked will be extremely tricky to get right given today's economic headwinds. On the one hand, too much austerity coming from very tight fiscal policy can be counterproductive by smothering already weak growth, which in turn reduces tax revenues and increases social safety net spending. Such an outcome then could weaken the political will that is needed to follow through on spending discipline. The big risk is that some or all of the benefit of reduced government spending is offset by other

added costs and lower revenues, thereby undermining the goal of reducing debt while simultaneously resulting in more short-term economic stress.

However, waiting too long to tackle rising debt levels digs an ever deeper hole and risks a lenders' strike, which could result in governments being forced to pay a much higher interest rate to finance their debt. As the Greek extreme demonstrates, debt levels can become unmanageable as borrowing costs become untenable, resulting in a crippling crisis for Greece and a ripple effect across the global economy reaching far beyond Greece's borders; all this for a country whose overall GDP is only a small fraction of Europe's. A critical unknown is whether enough countries (including the United States) can thread the economic needle so that a recovery has time to gain steam while maintaining lender confidence that the current deficit and accumulated debt problems will be addressed over time.

Slowing and ultimately reversing the growth of debt is further complicated by aging populations. This is a reality that most of the developed world faces, though to different degrees. An aging population presents several challenges. Savings rates will face downward pressure as more of the population moves from working and saving to retiring and depleting savings, while tax revenues will decline given lower earned income. More retirees also mean more government retirement and health care expenses (Social Security and Medicare in the United States). The early repercussions of aging are part of the reason Japan has found economic growth so elusive over the last two decades and is part of the underlying issue with high government debts in Europe and the U.S. If retirement plans were fully funded, then Social Security type payments would be fine. Instead, most countries are like the U.S. and simply incur taxes as they go to pay for retiree benefits. More retirees and fewer working people

will necessitate changes to the existing promises that make up the U.S. and other countries' retirement programs.

Investment Themes for 2010 and 2011

Investing in emerging markets while reducing volatility through strategic diversification

It is generally accepted that emerging markets will provide significant economic and market growth, not only for the region but for companies worldwide. Currently, emerging markets are providing well over half of the world's growth. Within the next couple of years, emerging markets will represent over 50% of the world's Gross Domestic Product; in such a situation, the majority of the world's economic output will be coming from emerging economies rather than the developed economies of Europe, North America, and Japan. This is a huge shift from a generation ago. The potential investment gains are not without risk, however. As the table below shows, volatility has come with that growth. Holding emerging market stocks from 1994 – 1999, for instance, resulted in an annual return of -9.3%. Our emerging market portfolios are extremely diversified and combine an index tracking exchange traded fund (VWO) with a very conservative active manager (Matthews Asia), and a moderate risk active manager (Lazard). With this diversified approach in place, we have been increasing our emerging markets exposure through both stocks and bonds over the last several years. While we have trimmed back that exposure at times, on average we have been increasing it due to the opportunities and the risk diversified managers we have in place.

MSCI Emerging Markets Annual Returns http://financeandinvestments.blogspot.com/					
Year	Returns	Cumulative Returns	Annulized Returns	5-Year Annualized Return	10- Year Annualized Return
1989	64.96%	64.96%			
1990	-10.55%	47.56%	21.47%		
1991	59.91%	135.96%	33.13%		
1992	11.40%	162.86%	27.33%		
1993	74.83%	359.55%	35.66%	35.66%	
1994	-7.32%	325.91%	27.32%	20.89%	
1995	-5.21%	303.72%	22.06%	22.30%	
1996	6.03%	328.07%	19.93%	12.65%	
1997	-11.59%	278.46%	15.94%	7.56%	
1998	-25.34%	182.55%	10.95%	-9.27%	10.95%
1999	66.49%	370.43%	15.12%	2.01%	11.05%
2000	-30.83%	225.39%	10.33%	-4.22%	8.23%
2001	-2.61%	216.90%	9.28%	-5.84%	2.99%
2002	-6.17%	197.35%	8.09%	-4.71%	1.24%
2003	55.82%	363.33%	10.76%	10.40%	0.08%
2004	25.55%	481.71%	11.63%	4.34%	3.17%
2005	34.00%	679.49%	12.84%	19.09%	6.80%
2006	32.17%	930.25%	13.83%	26.59%	9.18%
2007	39.39%	1336.06%	15.05%	37.02%	14.27%
2008	-53.33%	570.21%	998.00%	7.66%	9.02%

Seeking to offset lower equity returns in the U.S. and Europe

Average annual returns for the S&P 500 from 1950 to 2009 averaged 11%, with 3.6% in dividend yield and the remaining 7.3% in price appreciation. There have been entire decades when returns were much lower; the 1960s return averaged 7.8% when 3.3% was dividends, and the 1970s returns averaged 5.8% with 4.3% in dividends. Our expectation is that U.S. returns for much of this decade will be at the lower end of historical ranges. For the first few years we expect inflation to be low, with moderate returns that are not eaten away by significant inflation. If consumer and government debt is not successfully reduced, we anticipate higher interest rates and commensurate low equity returns will probably follow. Current income through dividends and interest will be a significant source of return and we will be exploring how to best implement this strategy through both active and passive management in the future.

Annual Averages Per Decade- S&P 500						
The following table shows average annual results for each decade:						
	Price	Dividend	Total		Real	Real
	Change	Dist. Rate	Return	Inflation	Price Change	Total Return
1950s	13.20%	5.40%	19.30%	2.20%	10.70%	16.70%
1960s	4.40%	3.30%	7.80%	2.50%	1.80%	5.20%
1970s	1.60%	4.30%	5.80%	7.40%	-5.40%	-1.40%
1980s	12.60%	4.60%	17.30%	5.40%	7.10%	11.60%
1990s	15.30%	2.70%	18.10%	2.90%	12.00%	14.70%
2000s	-2.70%	1.80%	-1.00%	2.50%	-5.40%	-3.40%
1950-2009	7.20%	3.60%	11.00%	3.80%	3.30%	7.00%

Fixed income overweight and diversification

Fixed income is an important source of stability and current income. With any longer dated fixed income components comes the inherent risk of rising rates eating into principal either directly or through devalued return of principal later. Although we expect rates to stay low for more than a year, if rising government debt levels are not brought under control, lenders to the U.S. will require higher interest payments in exchange for putting their capital at risk. We will continue to stay diversified by holding U.S. as well as foreign fixed income both hedged and unhedged to the U.S. dollar. These holdings will be exposed to a variety of interest rate, currency, and economic factors, thereby lowering the exposure to eventually higher U.S. interest rates.

Alternative investments

Over the past few months we have done significant research into alternative asset investment strategies. Once comprised predominately of illiquid hedge funds, alternatives are now available through mutual fund and Exchange Traded Funds (ETF), with long term historical return data to model the potential value in our portfolios. The purposes of adding these new strategies are diversification,



lower equity market risk, and lower interest rate risk for the portfolios. The diversification comes from strategies that don't rise and fall due to the same economic factors that affect other portions of the portfolio. Hedged equity strategies avoid standard equity market risk, while convertible and other bond strategies move away from standard interest rate risk. The actual strategies can mix long and short stock positions, find value when companies are acquired, or replicate the overall asset class factor positioning of hedge fund indexes. All of these publically traded funds avoid the illiquidity problems with traditional hedge funds, while also providing significant government oversight to help prevent the kinds of fraud committed by people like Bernie Madoff or R. Allen Stanford. Expect to see two new mutual funds purchased in the upcoming few weeks along with a white paper on our research findings on this space.

Getting It Right.

Investing is all about getting it right over time. In the interim periods there is considerable "noise." Greed and fear come and go, leaving in their wake investors who went for it all or panicked and headed for the proverbial hills. Choosing the exact right time to make a portfolio move is next to impossible. We know that we won't get it right every time but that being slightly wrong and missing some gains is not nearly as damaging as getting it completely wrong and suffering large losses. This quarter we sold off the Pimco Investment Grade Bond fund (which had gained over 5% this year) and a portion of an energy dominated ETF to increase our emerging markets allocation. To implement this, we chose Lazard, an active manager with a track record of over 13 years. Our research indicates that much of the future's growth will be produced in the emerging markets, not necessarily this year, but over time. We will "get it right" by investing prudently in emerging markets, seeking ways to offset slower growth in the U.S., Europe and Japan while owning diversified fixed income and alternatives in an effort to moderate risk and add additional diversification.

As always, if you have any questions or concerns regarding our strategy or your portfolio, please don't hesitate to call or email.

Best regards,

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Chief Investment Officer

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Attached are your portfolio statements. We urge you to compare the comprehensive reports we provide with your Schwab statements. The custodian for your accounts is Charles Schwab, 3133 E Camelback Road Phoenix, AZ 85016