



Q2 2011 Quarterly Investment Commentary

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Summary

Securities markets entered 2011 in Goldilocks fashion as investors enjoyed a placid “not too hot, not too cold” upward trend in the value of their risk assets across the globe. Daily price swings stepped up significantly in March and—exacerbated by the Tōhoku earthquake/tsunami and the subsequent disruptions to global economic output, and developed market sovereign debt concerns—continued throughout the second quarter. Despite the heightened volatility, markets were overwhelmingly positive in April, before retrenching sharply in May and June.

Overall, broader U.S. equity market returns ended up flat for the quarter and remain quite positive for the year. Across our borders, developed international stocks fared modestly better despite the headwinds of Greece’s looming default and its ramifications. Meanwhile, emerging economies fared modestly worse, as some countries grappled with too much growth stoking an inflation fire. Commodities, which are a critical input to emerging market expansion, fell sharply. Bond yields dropped, generating positive performance despite extremely low absolute coupon payments. REITs continued to do well and, in our judgment, are expensive.

Our portfolios remain positioned slightly conservatively to our benchmark index, our fixed income exposure is extremely diversified, we have a moderate allocation to commodities, and we remain convinced that our emerging markets allocations will create long-term value. We are well positioned for the scenarios we see as having the most likely outcomes, and discuss in detail below.

Second Quarter 2011 Market Performance

Asset Class	Index	Q2 2011	YTD
REIT	Wilshire REIT Index	3.88%	10.86%
Fixed Income- Foreign	BarCap Global Aggregate	3.10%	4.20%
Fixed Income- U.S.	BarCap Aggregate	2.30%	2.74%
Developed International	MSCI EAFE Equity Index	1.83%	5.34%
Largu U>S. Growth	Russell 1000 Growth	0.76%	6.83%
Mid Cap U.S.	Russell Midcap	0.41%	8.08%
U.S. Stock Market	S & P 500	0.10%	6.03%
Cash	30-Day Money Market Yield	0.03%	0.06%
Large U.S. Value	Russell 1000 Value	-0.51%	5.91%
Emerging Markets	MSCI Emerging Markets	-1.05%	1.03%
Small Cap U.S.	Russell 2000	-1.61%	6.20%
Commodities	Dow Jones Commodity Index	-6.73%	-2.58%
Commodities (GSCI)	S&P GSCI Index	-7.95%	2.70%

In the 2nd quarter, U.S. returns centered around break even. U.S. and Global Fixed income were strongly positive and Developed International beat out Emerging markets. The S&P returned .1% for Q2, Large US Growth was .76%. Large US Value declined .51%. Small Cap was at -1.6%, and Mid Cap finished at .41%. Developed international returned 1.8%, Emerging -1.1%. REIT’s were positive 3.9%, while Commodities fell lower by -6.7% and -7.95%, depending on the index.

Of Debt Limits and the End of QE2

Markets hate uncertainty. Investors who cannot tolerate even a modicum of it flock to U.S. Treasuries because they boast a long history of impeccable reliability and readily available liquidity. Of course, the assurance that holders of U.S. debt will receive a return *on and of* their capital in a timely fashion comes at a price. Generally, the total investment return is not particularly exciting—only marginally higher than the rate of inflation over the long run. But Treasuries have been the unmistakable, unshakeable asset of choice in times of tremendous upheaval and deliver solidly positive returns during such periods. Our status as the world’s safe haven security will be tested next month.

We believe a deal will emerge as the alternative carries too high a cost. The difference between always paying obligations on time and even once delaying payment is the difference between a risk-free investment and a risky one. Confidence will be irreparably damaged for the simple reason that, if it happened once, it can happen again. Investors will demand higher returns (read: interest income) in exchange for putting their capital at “risk.”

Raising the debt ceiling has never been so contentious. Congress has done it 102 times since 1917, and 10 times in the last decade. Republicans and Democrats are playing a dangerous game of “chicken” in an effort to begin in earnest addressing the looming longer term concern for our country—that our debt levels are quickly approaching untenable proportions. To be clear—this is a massive issue. But compromise is necessary and we think this will happen. If it doesn’t, the game completely changes, as uncertainty will rule the day at precisely the same time investors find they have no safe haven upon which to rely. As we approach the deadline, we expect reason to reign.

Coincident with the debt limit negotiations is the ending of the Fed’s attempt to stimulate the U.S. economy and stave off deflation via its purchase of large amounts of U.S. Treasuries. If the objective was to reduce interest rates and push timid investors into riskier assets, it met with some success. Small cap stocks are up more than 35% over the past 12 months. And, although yields on 10-year Treasury Notes are roughly where they were at this time last year, cash and near-cash yields can’t get meaningfully closer to 0%. This encourages people and institutions to seek higher returns elsewhere.

Assessments and Portfolio Responses

1. The substantial advance of small cap stocks since March 2009 has outpaced sustainable earnings levels of those types of companies. Side-by-side, large domestic company pricing is more attractive.

	Returns Since Mar 2009 Low	Price/Earnings as a % of 20-Yr Average
Large Sized Companies Russell 1000	105%	81%
Mid-Sized Companies Russell 1000	152%	98%
Small Sized Companies Russell 1000	149%	101%

Source: JP Morgan Asset Mgmt, Russell Inv Group, FactSet, S&P, IBES.

Stocks prices have a tendency to revert to the mean relative to their earnings.

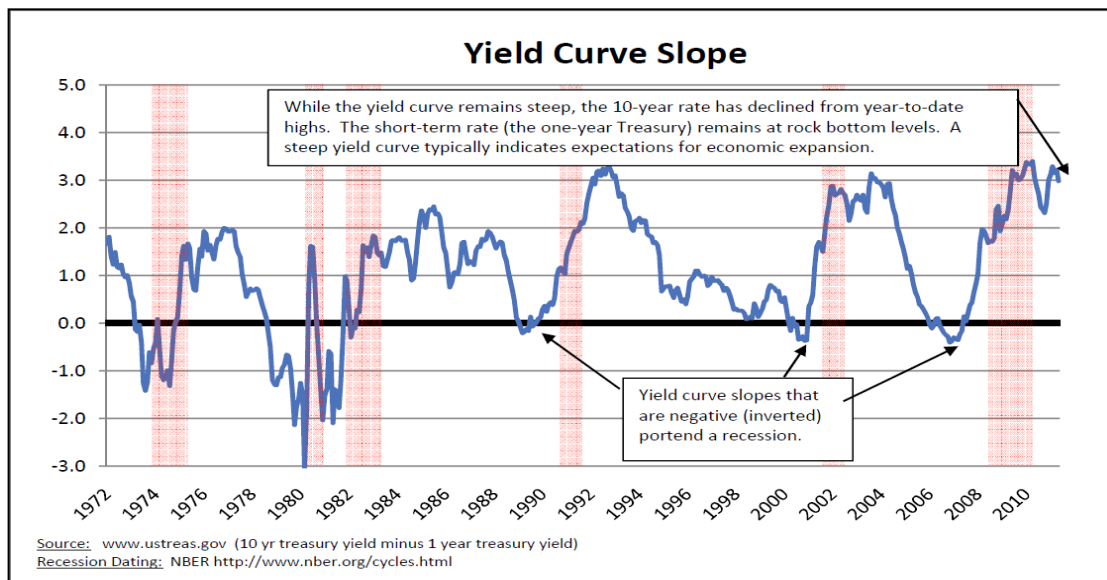
Conceptually, this makes sense. As prices become lower and lower, certain buyers become attracted to them. And as prices rise higher and higher, competitors enter the market, predictably putting downward pressure on profits. Relative to history, large company stocks appear more compelling than their small company counterparts.

Portfolio Response: During the quarter, we reduced our exposure to domestic small cap stocks and added to our large cap holdings.

2. With interest rates actually lower than at the start of the year, hovering near the lowest levels on record, and no longer supported by the Fed, rates are more likely to rise than to fall. Even if we are wrong and rates stay where they are or go even lower for a long time, the incremental return forgone holding the shorter maturity positions we are taking will be smaller than the potential losses if we remained neutral. To be clear: We'd rather be where we are and be "wrong" than the other way around.

Portfolio Response: Our bond allocations are diversified, and continue to emphasize shorter maturities over longer ones.

3. The U.S. and global economies face several significant challenges—a depressed housing market, 9%+ unemployment, dangerous debt levels, etc. Even so, the yield curve, which illustrates the relationship between the interest rate (cost of borrowing) and the time to maturity, remains remarkably steep. The graph below charts the slope of the curve over the past 40 years. The periods when the country was in recession are highlighted in red, and have always been preceded by a negatively sloped (inverted) yield curve. This is one metric that suggests to us that a recession is not imminent in the near term.



Portfolio Response: We are positioned for slow growth in the U.S. economy and, at times, volatile stock markets.

Portfolio Performance

Unlike many other advisors, we measure the performance of our client's portfolios every quarter against a group of standard indexes.

The following themes are reflected in our portfolios, all of which are influencing their absolute and relative performance:

1. Global fixed income exposure. A portion of our bond allocation is dedicated to foreign debt instruments to provide additional diversification and benefit from the prospect of a falling dollar. In periods when foreign bonds lag their US counterparts, we would expect a temporary drag on performance.
2. Interest rate exposure. As described earlier in this commentary, interest rates are at historic lows and these low rates are only possible because of the "reserve currency" status of the U.S. and the liquidity of our markets. There is a high probability they are headed higher. When that happens, longer-term debt instruments will suffer disproportionately to shorter-term ones, which is why we are emphasizing the shorter portion of the curve at this time.
3. Emerging markets exposure. Emerging markets remain a notable bright spot in the global recovery story. With record levels of foreign exchange reserves, improved public and external debt ratios, greater policy flexibility and transparency, and continued access to the balance sheet of foreign banks, many emerging markets are well positioned to take advantage of the shifting economic landscape of a post-crisis world. Emerging markets comprise only 13% of global equity market capitalization, yet they account for nearly 50% of the world's economic output and continue to grow. We believe these markets deserve a significant allocation, even though the indexes we compare against has limited emerging market exposure.
4. Slower growth and volatility. Volatility can be a severe drag on portfolio growth. If an account loses 20% of its value, it has to increase more than that (in this case, 25%) to get back to its high water market. To temper the degree to which our portfolios zig and zag, we include a sizeable weighting (about 10%) to *strategies* that seek to make money in rising and falling environments. These (alternative) strategies can lag the broader markets for extended periods, and have thus far in 2011. It is our expectation, however, that their low volatility and conservative nature will be beneficial over the long run.
5. Selective active management. The equity portion of our portfolios includes a mix of passive and active managers. Passive managers track their benchmarks with minimum cost and tax drag. The active management game is more challenging. These managers are used only when a strong likelihood of achieving higher than benchmark returns can be identified. Since they are "active," by definition there will be periods when these managers underperform their benchmarks and are a drag on overall performance.



Summary

We live in an uncertain world. At times, that uncertainty takes on larger implications than many other times. Since we assess various current risks are heightened (i.e., unemployment and sovereign risk), we are positioned somewhat conservatively overall. Thus far, however, those risks have not adversely affected the markets this year; eventual resolutions have seen the proverbial can kicked down the road. We continue to research investments and make shifts while keeping careful watch on the world economy and markets. We think underlying economic factors will play out over time and reward our holdings. And we stand ready to make shifts based upon the constantly changing economic, political, and market environments.

Best regards,

Mark, Dave and Adam

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