Q3 2010 Quarterly Investment Commentary

Authored by Mark Duvall, Chief Investment Officer, CFA® and David Firth, Vice President, Investment and Client Services, CFP®

Autumn brings changes in nature as well as in the financial markets. In nature we see leaves changing colors and then falling, golden light, cooler breezes, and the beginning of the transition to winter. Historically, the markets also begin shifting, moving their attention to the following year while reconsidering their earlier (lofty) expectations of the current one. These shifting concerns generally translate into more significant price swings during September and October than is typical for other months.

Summary

With memory of the last downturn still fresh in people's minds, and some big long-range issues still to be resolved, market expectations have been low. We have had market volatility, fortunately in the positive direction. The S&P 500 rose 7% in July, fell 4.5% in August, and then more than rebounded in September, rising almost 9% for the month. October has continued the positive recent trend

We expect the economy to continue to grow at a modest pace with the Fed attempting to stimulate activity by buying Treasuries and issuing currency. These measures are aimed at putting more money into circulation and keeping long-term interest rates near their historic lows. Another probable consequence is continued pressure on the dollar, the reverse side of U.S. complaints about China's currency. We see both positive and negative attributes to the current economic environment which is likely to keep volatility in the markets moderately high, and lead us to be careful and deliberate in how we position portfolios.

Third Quarter 2010 Market Performance

Index	Q3	YTD
MSCI Emerging Markets	18.16%	11.02%
MSCI EAFE Equity Index	16.53%	1.45%
Wilshire REIT Index	13.34%	18.86%
Russell Midcap	13.32%	10.98%
Russell 1000 Growth	13.00%	4.37%
Dow Jones Commodity Index	11.60%	0.89%
Russell 2000	11.29%	9.11%
S & P 500	11.02%	3.39%
Russell 1000 Value	10.13%	4.50%
S&P GSCI Index	8.27%	-3.70%
BarCap Global Aggregate	7.30%	6.85%
S&P 50% / BarCap Agg 50%	6.86%	6.05%
BarCap Aggregate	2.49%	7.85%
30-Day Money Market Yield	0.03%	0.11%

The markets rebounded sharply in Q3, with the S&P positive by 11%, its best September performance since 1939. Emerging markets rose a very solid 18.2%, with non-US developed markets (EAFE) at +16.5%. All US indexes were positive, with Large US growth exceeding Large US value in the period. The broad commodity index (Dow Jones Commodity Index) returns of 11.6% exceeded the more energy concentrated S&P GSCI at 8.3%. Bonds also performed well, with the BarCap Global Agg positive by 7.3%, and the US BarCap Agg up 2.5%. Cash continues to yield almost nothing.

A Tale of Two Futures: The Positives and The Negatives

While the National Bureau of Economic Research recently announced that the "Great Recession" officially ended in June 2009—marking the country's longest and deepest recession since the 1930s—our big-picture view of the economic environment in the United States remains cautious and is largely unchanged from what we have been describing over the past year. We continue to see both positives and negatives, with market and voter sentiment swaying from side to side in the midst of the economic winds that are blowing. Let's start with the negatives.

Ongoing "structural" headwinds such as consumer deleveraging, high levels of unemployment and underemployment, weak wage and income growth, tight credit availability to households and small businesses, weak housing markets, higher taxes, and cuts in local, state, and federal government spending in response to their financial difficulties all imply that aggregate demand, and ultimately corporate revenues and earnings growth, are likely to be under pressure for a while. On top of that, high fiscal deficits and an aging population expecting more services portends some significant challenges, not to mention the lingering concerns of high government debt and deficits in Europe.

The likely consequence of these challenges is a sustained (multiyear) period of subpar economic growth for the United States. And eventually we get inflation due to all the government debt.

A recent negative in the news concerns the mortgage foreclosure process. Given the ease with which anyone with a heartbeat was given a mortgage 5 years ago, it is not surprising that certain investors may have been deceived. Faced with the hundreds of billions in losses incurred on real estate debt in the ensuing years, the bond owners are beginning to take action. Large institutional mortgage holders are gathering together to sue the packagers of those loans based on the representations and warranties that went with the securitized mortgage bond sales. These kind of mortgage packages were created by the likes of Countrywide and Merrill (now part of Bank of America), Goldman Sachs, and Citigroup. An already weak housing market now must face even more uncertainty from the litigation and potential additional losses those banks may incur. Once again, the mistakes of the past are proving difficult for this economy to shrug aside.

But it isn't all doom and gloom. In the midst of these dour issues, there are a number of solid positive signs. Consumers are finally facing the reality that they have been overly leveraged. And they are responding accordingly. Savings rates, once negative, are now at 6.1% and low interest rates are providing an opportunity for some to substantially reduce their long-term debt carrying costs; household debt contracted by $57 billion in the second quarter (a 2.3% annual rate), marking the ninth consecutive quarterly decline. Even state and local government debt declined slightly in the second quarter after five consecutive quarterly increases. (Unfortunately, the federal deficit remains disturbingly large).

Overall unemployment is clearly high, but unemployment for the college educated is actually at reasonable levels at 4.6% in August vs. 10.4% for workers with only a high school diploma and 14% for those with no high school diploma. The problem isn't just too few jobs, but too few educated workers. Additionally, private industry has been hiring at moderate rates; while that positive has been offset by state and local government layoffs, moderating the growth of government will provide

opportunities for stronger future economic growth. Tax rates will rise at some point to moderate the deficit, yet at the same time a national debate has begun on addressing long-range underfunded pensions and increasing the retirement age for government employees. Addressing these long-range problems is very important for the long-term health of the U.S. economy, and beginning the debate is a first step toward change.

Subnormal domestic demand presents challenges to revenue growth for U.S.-based companies, yet emerging economies will continue to grow at a fast pace, expected to still be 6.5% or greater in 2011. This is helping U.S. multinationals, which are beating analysts' earnings estimates and trading at moderate prices despite recent increases in the overall market. As the emerging economies further develop, they will become larger consumers of goods and services that are produced in the U.S., whether they be financial services from Citigroup, investment banking from Goldman Sachs, trucks from Caterpillar, or agricultural products from the Midwest. All of this is underpinning stock markets, providing support to current market levels and the rationale for continued potential increases.

Given these two conflicting tales, we are conservative relative to our strategic asset class weights with a larger allocation to fixed income and our two new alternative managers. However, we are over weighted to emerging international, where we see solid long-term growth potential and relatively sound monetary policies, as well as non-U.S. bonds which benefit from a weak U.S. economy and dollar. We will be continuing to add more alternative managers to moderate our exposure to potential future interest rate increases while not taking on too much extra equity market risk.

Currency Wars

U.S. investors in non-dollar denominated investments benefit when the dollar depreciates against other currencies; owning assets in those other currencies becomes more valuable. There are also perceived advantages to a country's economy when its currency drops, since companies can potentially sell more overseas, thereby creating an opportunity to increase employment. Given this dynamic, much of the growth in emerging economies has come from running trade surpluses with countries consuming their goods, most especially the U.S., in turn creating an incentive to keep a lower priced currency. Japan has seen the Yen strengthen from 125 Yen/dollar to the present 82 Yen/dollar, and has intervened recently by selling Yen in an attempt to weaken it. Brazil and South Korea have also intervened in competitive devaluations. Struggling European perimeter countries want the Euro to depreciate, and most countries want China's Yuan to strengthen, which it certainly would if markets were allowed to work freely. Instead, China carefully controls the rise in its currency so that employment stays as high as possible.

However, a weaker currency is not all beneficial. Any imports cost more, so in effect a country becomes poorer as their currency drops in value because their earnings buy less of those goods. Furthermore, as a country's currency depreciates, assets held in that currency drop in value for foreign investors, as they now receive less of their currency when they sell. Since the U.S. depends on foreigners to fund our government deficits, this is a huge potential future problem. Fifty percent of Treasuries are held by foreigners, with China and Japan each accounting for 10% of the total. Not

only are foreign investors getting a very low return on their money (10 year T-bills are now under 2.5%), but further dollar depreciation cuts further into their returns. Dollar depreciation also makes corporate and real assets cheaper in this country; more businesses will be purchased by foreign based companies bringing the dollars they have earned back to the U.S. Finally, the U.S. dollar is the world's reserve currency and the place where investors put their cash when they want absolute safety; should the dollar generate too many losses to investors, longer term efforts to replace the dollar could gain traction, with the result being higher interest rates here in the U.S.

What does this mean for our portfolios and our asset allocation strategy? We expect the Fed to announce more "Quantitative Easing", which should further weaken the dollar against other currencies; our non-U.S. dollar stock and bond positions will benefit. Longer term, continued efforts by countries to devalue their currencies would have significant negative consequences, including triggering increased trade restrictions and aggressive currency trading. Any long term effort to replace the U.S. dollar as the world's "reserve currency" would certainly raise the cost of borrowing in the U.S. and hurt our economic growth. We are watching this closely.

Return Expectations

The range of potential economic outcomes is still unusually wide, with potential bad outcomes a bit more likely than historical experience would suggest. As the academic study from Rogoff demonstrated, economic growth after a financial retrenchment and deleveraging is far slower than normal for up to a decade. Based on our analysis and assessment we remain underweighted to U.S. based risk assets (equities) in our portfolios, and overweight to emerging economies. While this means our portfolios should hold up relatively well in a subpar economic tale, they will likely lag our comparative indices if a bullish U.S. economic story plays out instead.

Election and Taxes

The most likely scenario has Republicans taking the House, while Democrats retain their majority in the Senate. Prediction markets assign a 75% probability that the House majority goes to the Republicans, and a 55% probability that the Senate remains under Democratic control. This suggests a slim Republican majority in the House (i.e. probably no more than about 10 seats) and a slim Democratic majority in the Senate (probably no more than a few seats). Stocks have historically performed well following midterm elections, particularly when no one party controls Congress and the Presidency. However, large gains are already widely expected, and fiscal policy is tightening rather than loosening as it normally does following midterms. The exact outcome of the tax debate is unknown, though the most likely scenario is a compromise following the elections. This could involve an extension of tax cuts for incomes below a certain level, probably at a higher dollar amount than the $250,000 the President has proposed. Capital gains and dividend rates are at least as likely to be extended temporarily at the current 15% rate as the upper income tax rates are, so a compromise there may keep those rates low. We advise you to contact your tax professional before the end of the 2010 to discuss what moves may benefit you prior to December 31st.

Additional Team Member and New CFP®s

Adam Gensler joined our group in mid-September as a Senior Investment Advisor. Adam has worked with a broad range of clients on complex financial planning and tax issues, utilizing both his designations as a CPA and a CFP®. Adam will be working with Opes mortgage advisors and their clients, providing advice regarding investment, tax, estate, and charitable issues. Adam is also a member of the Opes investment committee and provides his thinking and research in the assessment of the economy, markets and money managers.

Congratulations to Kenji Bleicker, our Client Service Associate, and to Ann Timoney, Los Gatos Financial Advisor, for passing their Certified Financial Planner™ (CFP®) exams and earning their CFP designation. Coupled with Adam coming aboard, this brings the number of Certified Financial Planners™ at Opes to 4!

Best regards,

Mark T. Duvall, CFA®	David Firth, CFP®
Chief Investment Officer	Vice President, Investment and Client Services

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