

Asset Allocation Portfolio Review 2Q10 – June 2010

Recap

Though the economy is recovering/growing, investors in equity markets seem to disagree. After beginning the year with anticipation for growth, domestic markets were derailed by debt problems in the EU and the oil spill in the Gulf of Mexico. Add to these prominent stories of persistently weak employment data, high US debt levels and following the high GDP level reached in 4Q09, prospects for 2010 became more tentative.

We continue to see strength in the economy but GDP comparisons to previous recoveries show this time around to be relatively weak, leaving doubt about sustainability and the ability to create jobs. Because of this, we are reading investor sentiment to be waning. We should experience increased volatility, trending positive toward year-end as growth numbers stabilize. It won't be high growth - but it will be growth.

Countervailing thoughts are driving volatility as investors search for that single piece of data that confirms or dispels their theory. Growth won't manifest in one or two data points but will be a process to be worked through. Volatility and low stock growth should ensue.

The S&P 500 is up 14.4% YOY but fixed income has taken a more prominent position on the front line YTD as the Fed vows to continue their low interest rate policy until such time as they see strong GDP and increasing CPI. A flattening yield curve is giving pause as this generally signifies slowing in the economy.

A case has already been made for investing in the general market when PE ratios reach low points. Robert Schiller's studies of 10-year annual returns at differing PE levels state that the lower the PE, the greater the forward 10-yr annualized return. Also, corresponding data suggests that long-term returns are greatest during periods of low interest rates – a period we currently enjoy.

Asset Allocation moves made during 2Q10:

April 2010 – No moves

May 2010:

Removed Sectors – Basic Materials (All Models) & Financials (only Agg Gr Model)

Exchanged out of Rydex Funds (No Load MF Model and SB Advisor Designs)

Purchased Technology (Agg Gr Model)

Transferred International Equity to Mid Blend (All Models) and TIPS (All Models except Agg Gr and Growth)

June – No Moves

Performance

Domestic Equities:

Throughout the first half, lower caps outperformed larger both during 2Q and YTD – and lower cap Growth decidedly outperformed Value as well as Large in each asset class.

We do not try to outguess the market – we try to manage with statistical certainty. It might not always work to our liking, but it does help us avoid most pitfalls.

<u>Domestic Equity Rates of Return</u>	<u>2Q10</u>	<u>YTD 2010</u>	<u>1 Yr</u>
S&P/Citi Large Growth	(11.28)	(7.99%)	12.59%
S&P/Citi Mid Growth	(9.26)	(0.70)	24.34
S&P/Citi Small Growth	(6.97)	(0.18)	23.83
S&P/Citi Large Value	(11.57)	(5.30)	16.40
S&P/Citi Mid Value	(9.90)	(1.99)	25.54
S&P/Citi Small Value	(10.41)	(1.51)	23.51

(source: Standard and Poors)

International Equities:

The global financial meltdown continued to leave scars during 2Q10 as the EU faced one “crisis” after another. Once investors were placated with bailout packages and the multiple crises were averted, international markets were free to grow again.

The IMF recently raised their estimates for global growth in 2010 from 4.2% to 4.6%, keeping 2011 estimates at 4.3%. The EU is expected to grow 1.0% in 2010 while China’s forecast was raised to 10.5% and Brazil to 7.1%.

World ex USA remains our international benchmark, so we are pairing back Developing while looking for bounce-back opportunities. Future profitability appears to be in higher growth countries and Emerging Markets seems to be the wise choice.

<u>International Rates of Return</u>	<u>2Q10</u>	<u>YTD 2010</u>	<u>1 Yr</u>
World ex USA	(13.63%)	(12.47%)	7.03%
Emerging Mkts	(8.37%)	(6.17%)	23.15%

(source: MSCI/Barra)

Fixed Income:

Many economists believe the Fed will not start raising rates until sometime next year, believing that the severe recession of 2007-2008 will keep inflation a no-show for the rest of 2010. A still-considerable amount of excess capacity in the economy should also help to keep price pressures modest.

Consumer and business spending is slowly picking up and the job market is improving slightly, while inflation remains in check. That recipe lends support to the Fed's pledge to keep its benchmark interest rate ultra-low for an extended period - until we see price pressure increasing (rising CPI) or dramatic increases in GDP. Given that GDP announcements are a quarterly event, this will not be evident for another 6-9 months.

Interest rate volatility will cause some fluctuation, but Fixed Income products may again be our total return champions for the remainder of the year.

<u>Fixed Income Index Rates of Return (category)</u>		<u>2Q10</u>	<u>YTD</u>	<u>1 Yr</u>	<u>Duration</u>
Short	(treas)	1.20%	1.91%	2.74	1.90
	(corp)	0.67	2.15	6.68	1.95
Intermediate	(treas)	4.38	5.88	7.51	4.60
	(corp)	2.41	4.82	13.00	4.30
Long	(treas)	7.74	9.39	9.70	7.30
	(corp)	3.27	5.62	14.68	6.10
Mortgages		2.87	4.46	7.47	2.20
High Yield		(0.13)	2.87	22.15	4.20
International Treasuries	(short)	(4.93)	(7.76)	(3.81)	1.80
International Treasuries	(long)	(4.26)	(6.44)	(1.35)	6.40
Emerging Market Debt		1.17	5.44	18.69	7.00

(source: iShares)

Sectors:

As our outlook on equity markets in general cools, we draw back from sector investing and look to broader asset classes to produce results. We will continue our exposure to Technology in Aggressive Growth for the third quarter, continuing to bet on the slow, steady growth of the tech cycle.

<u>S&P 500 Sectors</u>	<u>2Q10</u>	<u>YTD 2010</u>	<u>1 Yr</u>	<u>S&P 500 Sectors</u>	<u>2Q10</u>	<u>YTD 2010</u>	<u>1 Yr</u>
Consumer Discretion	(11.2%)	(2.3%)	26.1%	Industrials	(12.8%)	(1.9%)	25.6%
Consumer Staples	(8.8)	(4.2)	10.3	Information Tech	(12.5)	(11.0)	14.7
Energy	(13.2)	(13.2)	(0.1)	Materials	(15.7)	(13.7)	11.6
Financials	(13.6)	(4.2)	15.5	Telecom Services	(5.6)	(11.0)	(2.0)
Healthcare	(12.3)	(9.8)	6.7	Utilities	(4.8)	(9.2)	1.1

(source: Standard and Poors)

Outlook: Caution

Caution is the watchword. The market has faltered lately, GDP has slowed from quarter to quarter, and job growth continues to be a question mark. We are trending negative and it seems that a bearish outlook among some economic watchdogs has become pervasive, tilting perspective about a recovery toward gloomy.

In September 2009, we wrote: First the market, then GDP, then employment – recovery follows a pattern. We still believe that this is our charted course and continue to see positive trends within the mass of data that dominates investor thinking and political discourse.

Federal Reserve Chairman Ben Bernanke said, "The economy appears to be on track to continue to expand through this year and next." However, the pace of the expansion (Fed estimates of 3.5%) won't be strong enough to quickly bring relief to the 15 million Americans who remain unemployed.

Currently, the economy seems to be dependent on the support of the federal government and much of the gloom has been centered around the growing federal deficit and burgeoning debt levels. When the government spends large sums of money, it becomes a huge boost to profits. It seems to us that if we are going create debt, we should be adding assets at the same time. Of course, it will take time for this to trickle down to a sustainable economy, create lasting employment and eventually provide long-term growth.

First the Market: earnings estimates project strong stock market performance

Then GDP: 2.7% in 1Q10; normally, this would be considered healthy growth but is relatively weak after a steep recession. After the last sharp downturn in the early 1980s, GDP grew 7% to 9% for five straight quarters

Then Employment: Initial Claims for Jobless Benefits reached 472,000 with a four-week average of 463,500. Economists want to see a four-week average of 450,000 or less for signs of sustainable economic growth. Doubts about the underlying strength of the economic expansion can be tied to job growth

Manpower's survey, considered a leading indicator of labor demand, suggests an employment recovery will continue in much of the world, but employers remain cautious. In the US, large-scale job creation is unlikely in coming months. The global employment services company said that its seasonally adjusted US net employment outlook was plus-6 for the third quarter, up slightly from plus-5 in the previous survey. It was negative a year ago.