Equity markets continued their strong momentum off the recent lows in March and staged a powerful rally in Q2. Despite flat performance in June, double digit returns were the norm for most major indexes and category averages. The Dow Jones Industrial Average closed the quarter at 8447, up 12%, but still down 2% for the year. Although it remains 40% down from the all-time highs set in October 2007. This was the best quarterly performance for the Dow since 2003. The rally in stocks has been remarkably steady without the start and stop action that characterizes so many up trends. The largest pullback in the Dow was a mere 3.6% in late April. The S&P 500 (+16%) and NASDAQ (+20%) performed even better in Q2 with the latter the clear performance leader among the broad averages in 2009. There are several popular theories for the NASDAQ’s resurgence in 2009. Due to its heavy weighting in technology stocks, the index has benefited as investors have rediscovered their love affair with high tech. Stocks such as Apple and Google are seen as safe havens (if you can believe it) due to their cult like followings and strong financial positions. Technology companies in general have done a good job in controlling costs and surviving in a very tough environment. Unfortunately, this has been accomplished through cost cutting and staff reductions, not organic growth. With no quick turnaround in corporate spending on the horizon, one has to wonder how long the tech companies can keep investors happy.

Foreign markets rebounded in tandem with those here at home. Year-to-date, most foreign equity categories are showing superior performance. Much of the renewed enthusiasm for foreign stocks comes courtesy of the emerging markets. Investors looking for near-term GDP growth as a prerequisite for investing have very few choices these days. The emerging market economies will be showing growth this year and next (although down considerably from two years ago) while developed economies in the US and Europe will show flat to negative growth in 2009. Most analyst estimates peg emerging market growth for this year at a very healthy 6%. This kind of growth is rare and attracts much attention. For the quarter, the emerging markets fund category from Morningstar soared higher by 35%.

Commodity prices surged across the board in Q2 led by oil. The price per barrel finished at $69.68 for a 41% gain and the biggest quarterly percentage move since 1990. This price represents double the early 2009 low of $33.98. Copper, often viewed as a

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**This Quarter...**

- **Market Review**
- **Popular New Phrases**
- **Emphasizing Alternatives**
- **Survey on Financial Literacy**
- **Our Portfolio Strategy & Allocation Outlook**
- **Market Scoreboard**

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Matthew H. McPhail, CFA
Chief Investment Officer
barometer for economic growth, rose by 23% in the quarter, for a gain of 62% year-to-date. The broad Dow Jones-UBS Commodity index gained nearly 12% for the quarter. Indications that the economic situation was stabilizing or getting less bad (more on this below) led investors back to commodities as a way to participate in the recovery. Once the sector caught momentum, cash that had been burned in 2008 and was sitting on the sidelines, seemed to come racing back into the market. In addition, inflation fears are starting to come back into the investment conversation. The classic hedge against inflation is commodity exposure. With the massive amounts of spending and new debt issuance on the way from Uncle Sam, future inflation is likely coming our way. As long-term investors in this sector know all too well, volatility is the price you pay for participating in commodities. We continue to advocate a small portion of a long-term portfolio be invested the commodity sector. Broad index exposure is our preferred way to invest.

**Popular New Phrases**

For anyone paying close attention to the media or communiqués from various investment firms, Q2 has delivered the clear leader in terms of the most annoying and overused financial phrase for 2009. The phrase is “green shoots” and was delivered to us by Federal Reserve Chairman Ben Bernanke. Essentially, any piece of economic data that hints at a sign of recovery is interpreted as a positive and thus dubbed a green shoot. Think of a new lawn or young plants, they all start as tiny green shoots until they blossom into maturity. There has been a major tendency for analysts, portfolio managers, economists, etc. to see numbers or statistics that are “less bad” and interpret them as signs that we are in recovery or at least on the cusp of a new upturn. These analysts look back to prior economic recoveries and see similarities to how past recoveries began in terms of improving data. They then use this as a rationale to buy stocks.

The problem with this line of thinking is that we’re not dealing with a typical textbook recovery out of recession. What we’re dealing with is the aftermath of a massive credit bubble, the likes of which doesn’t match up well in comparison to any post WWII economic recovery. So the frequent comparisons made in the media (and by others who should know better) are problematic at best. The fact of the matter is that we’re in uncharted waters from an economic perspective. To expect a normal recovery cycle based on revivals in corporate and consumer spending just isn’t reasonable. The debt burden remains too large and will hamper economic growth for the foreseeable future. This may be one of those times in history where it’s appropriate to say, “this time its different”.

Another new phrase on the investment scene this year which rings much more true (in our opinion) is “new normal”. This phrase was first coined by Mohammed El Erian at PIMCO and has been also extensively adopted by the masses. We are now at the end of a cycle of ever increasing public debt that ended in an overly leveraged society. The process of reducing leverage and increasing savings will take a long time and have far reaching impacts. Thus, we’re entering a new normal environment where the economy of the next few years is unlikely to resemble anything in recent memory. Essentially we’re witnessing a massive transformation of our economic world. This new normal will likely feature less of a consumer driven economy powered by debt and leverage. We likely won’t need the same number of factories, malls or car dealerships to satisfy the reduced (new normal) level of consumer wants and needs. Businesses are much less likely to invest in more capacity (stores, plants and jobs) in the face of reduced demand across the economic landscape. The savings rate in this U.S. (which had been nearly nonexistent for years) recently has shot up to 6% in very quick fashion. Judging by long-term historical savings rates, it wouldn’t be unreasonable to see this figure climb to 9% or
more. This would be 9% taken directly out of consumer spending. Since the consumer has recently represented 70% of GDP, a new lower level of growth will likely become our new normal.

Emphasizing Alternatives

For several years now we’ve been a proponent of including “alternative” strategies within our client portfolios for both retirement and non-retirement investors. As you’ll read below, our plan is to continue adding exposure to this segment within client portfolios. What are alternatives? In essence they are unique asset classes or strategies that add meaningful diversification and risk control to a portfolio. A simple way to think of this is any investment outside the traditional stock or bond mutual fund. Alternatives may follow an index approach. A commodity index fund is an example here. Or a fund that pursues opportunities within a niche asset class, like real estate, would qualify too. While there’s a place for these examples within a portfolio, they’re highly vulnerable to market risk (the index or sector in question declining at the same rate, or faster, than the broad stock market). Thus, the diversification benefits you hope to receive from these types of investments are becoming smaller.

Over the years, correlation between asset classes has risen dramatically. Correlation is simply a statistical measure of the degree to which investment returns move together. A correlation of 1 means that returns between two asset classes move perfectly in sync, while a correlation of negative one (-1) means that two asset classes always move in opposite directions. In the early 1990’s, many asset classes had low correlations to the S&P 500 (stocks). For example, high yield bonds showed a correlation of 0.3, international stocks 0.4 and commodities 0.0 or slightly negative. Remember, the closer you get to 1, the more closely the asset class moves in tandem with stocks, which is what we’re trying to guard against by diversifying into other areas outside of stocks. Fast forward to early 2008, most asset classes were moving in sync with the S&P 500 as evidenced by correlations rising to 0.7 or 0.8. So the benefits of adding additional asset classes to compliment stocks were starting to fade. This is why many have proclaimed that the concept of diversification is dead and that it failed miserably in 2008. While we’ll concede the latter, the former isn’t true. The reality is that there are appropriate vehicles out there for investors to use that will provide diversification, but it’s not a static exercise where the portfolio is constructed and left alone for years. The relationships between the funds in your portfolio and their benefits must be continually managed.

Utilizing alternative investments in a portfolio requires the investment manager (us) and the investor (you) to embrace “outside the box” thinking. Even after what happened in 2008, very few of our peers are using or discussing alternative investments with their clients. We know this because we see the portfolios that new clients bring to us. For the most part they contain the typical mix of basic funds (some good, some bad) with very little in the way of unique strategies. We should emphasize again that just adding a unique fund or investment for the sake of being different does no good. There’s plenty of junk out there that sells well, but does nothing for the investor. 130/30 funds (if you’ve never heard of these funds you’re in good shape) come to mind. In addition to seeing client portfolios, we hear from our primary managers in the alternatives space that advisors are very slow to embrace these concepts. Instead, they cling to the old notions of “stocks for the long run” or the traditional balanced portfolio of stocks and bonds. Similar faulty logic is espoused by fund companies all the time. One major fund manager recently issued a report to clients defending traditional asset allocation. “Diversification didn’t fail in the recent market downturn. It worked….just to a lesser degree,” the report said. Such a quote, from a firm with all the resources in the world, is beyond stunning. They’ve yet to launch any investment vehicles that could be termed as an alternative while continuing to espouse the same old broken arguments about diversification that worked in the last bull market. Unfortunately, such a lack of imagination doesn’t work in the challenging environment we now find ourselves in.

So what is our litmus test for including an alternative style fund in our client portfolios? First, readily obvious diversification benefits through the correlation test we described above. Second, and equally important for active strategies, is an emphasis on risk control. This is so important we’ll say it again. An emphasis on risk control is paramount. For example, we currently utilize a fund that offers our investors access to multiple investment strategies (added diversification) within one investment. Each strategy within the fund is run by separate management teams from different firms. The strategies employed run the gamut from traditional stock and bond purchases to highly complex
trades within niche markets. Every manager within the fund makes capital preservation a priority and pursues what the fund terms “asymmetric” investment opportunities. This is a fancy way of saying investments with upside potential if they’re right far in excess of the downside potential if they’re wrong. To make this strategy work requires patience. So if the opportunities aren’t presenting themselves, the managers in this fund will hold on to cash and wait patiently for the trade to set up in their favor. When that opportunity arrives, they’ll invest. This is what’s meant by risk control. Not investing based on a narrow mandate or within the limits of a style box, but investing based on a firm grasp of the risk / reward profile for each security they purchase. Does this guarantee an investor in this fund against loss? No, but we take comfort in the fact that the managers in this fund have a healthy respect for risk. The bottom line is that we continue to search for ways to get our investors access to unique strategies and managers. We’ve made an initial foray into the alternative segment over the years, but now is the time to increase allocations to this area as we continue to navigate through a very challenging time in the markets.

**Survey on Financial Literacy**

We ran across the results of an interesting survey at www.functionsalarmed.com (an interesting website for mutual fund investors). The National Foundation for Credit Counseling has released their 2009 survey of American’s financial literacy and the news is not good. Here are the sobering findings from the report:

- 32% of Americans have no savings outside of retirement, which is slightly better than the 36% with no savings a year ago. Among young adults, 48% have no savings.
- 33% of Americans have no retirement savings, worse than the 28% with no savings a year ago. By implication, the number dropped because folks began liquidating their retirement accounts as a result of the economic downturn.
- 64% haven’t checked their credit report in the past year, slightly worse than a year ago.
- Among folks who cut back on spending because of the recession, about half of respondents suggest they’ll keep spending down when times improve and about half will "resume spending as much as last year."
- Less than half of us "keep close track of our spending." When asked why they don’t keep track, common responses include "it’s not useful" and "I don’t want to be restricted in my spending."
- Of those with children at home, half have no plan for paying for their children’s education.

Perhaps most surprising, most people grade themselves as solidly above average on their knowledge of personal finance; 58% would give themselves a grade of "A" or "B." Needless to say, a large percentage of the population is in dire need of basic financial education.

**Our Portfolio Strategy & Allocation Outlook**

Within our individual client portfolios, we’ve made some modest allocation changes at quarter end. The Rydex Managed Futures fund has been moved from the “Tactical” segment of the models to the “Alternatives” segment. Based on our research and several meetings with Rydex, we feel that this fund is better thought of as a core alternative strategy as opposed to a shorter-term tactical play. As you’ll recall from last quarter’s review, we described the “Tactical” segment of our portfolios as investments that we feel are particularly compelling at the current time, but not necessarily long-term holdings. The managed futures strategy is certainly better viewed as a long-term portfolio diversifier that has the potential to perform well in a variety of market conditions. The reclassification of the Rydex position had two main impacts. First, we’ve increased the allocations to alternative funds across all strategies. The increase was modest and was accomplished by scaling back positions in the “U.S. Equity” segment. Over time, we expect to continue increasing our allocation to the “Alternatives” segment of the portfolio across all strategies. Investors in our Conservative and Moderate strategy portfolios will now notice a new position in the Rydex fund. Secondly, the removal of a fund from the “Tactical” segment of the portfolios means we have an open slot to fill. For the time being, we’ve chosen to hold cash as opposed to putting this money immediately to work. While we have several candidates to consider, we’re taking a cautious approach due to the large rise in Q2 across all asset classes and the fact that Q3 tends to be the seasonally weakest from a performance perspective. At this point, each portfolio holds approximately 5-8% in cash. Don’t hesitate to contact us if you’d like to discuss your personal situation.

Matthew H. McPhail, CFA
Chief Investment Officer

**Market Scoreboard**

<table>
<thead>
<tr>
<th>Index</th>
<th>Total Returns</th>
<th>Q2 2009</th>
<th>YTD</th>
<th>1 Year</th>
<th>3 Year</th>
<th>5 Year</th>
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<tr>
<td>DJIA</td>
<td>11.96</td>
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<td>-23.00</td>
<td>-6.34</td>
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<td>NASDAQ</td>
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<tr>
<td>Barclays Aggregate Bond</td>
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<td>DJ-UBS Commodity</td>
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<td>-8.30</td>
<td>-3.25</td>
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Total Returns excluding Dividends  Source: Morningstar