

**The overall environment has improved, but plenty of problems remain.**

**Macro issues are unusually important in this environment, and there are several key areas we are assessing to help us make portfolio-level decisions.**

**Highly significant questions include when housing will bottom, what the longer-term impact will be of government stimulus and other policy actions, and whether investors will remain risk averse in the years ahead.**

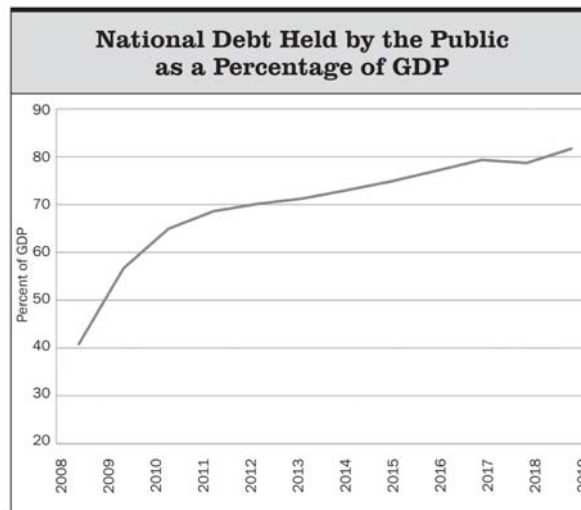
**Our current portfolio positioning has a modestly conservative bias.**

## Quarterly Investment Commentary

As we look back on a tumultuous first half of the year, we are struck by the degree to which conflicting signals characterize the investment and economic environment. After a horrendous 2008 and a dismal first quarter in 2009, the second quarter saw robust gains – stocks in fact had their best quarter in more than 10 years.

### The Market and the Economy – Uncertainty Reigns

The conflicting signals on the economy include several positives that helped drive the market's rebound from its March low. The prospect of a meltdown of the financial system appears to have subsided; the government has demonstrated it will do whatever is necessary to avoid a disaster of this scale. As economic activity continues to worsen, it is doing so at a slower rate, which suggests that we are getting closer to an economic bottom. However, the global economy remains in a fragile state as the effects of massive wealth destruction and the unwinding of huge debt bubble continue to play out. The ultimate result will likely be lower spending by both consumers and businesses in the years ahead, as the economy in effect resets to the

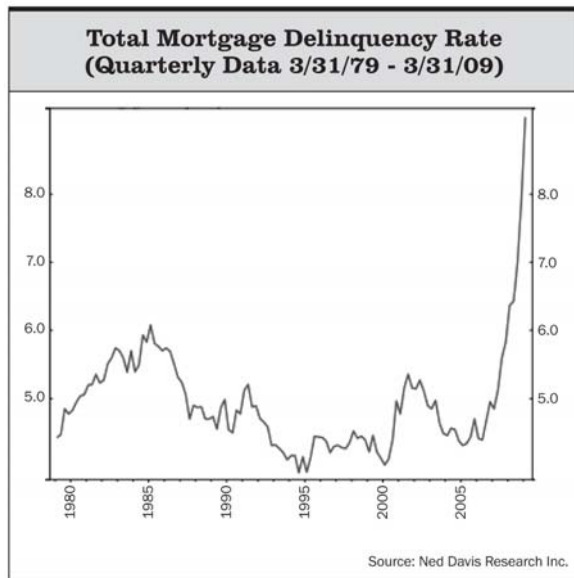


level where it might have been without the artificial boost of the credit bubble. The massive federal bailout and stimulus spending (along with longer-term demographic factors such as spiraling health care and other enti-

tlement spending) probably allowed us to avoid a depression, but may also cause the federal deficit to balloon, which could lead to further weakness in the dollar and increased inflation down the road.

There are other economic concerns that will influence how the environment unfolds in the years ahead. One of these is housing, which started the cycle of damage we are now in. There have recently been a few positive signs including stronger demand and historically high levels of affordability.

That brings us to another issue, which is the tight-rope that policy makers have to walk with respect to stimulus. We believe that in aggregate, government But a wave of new supply from foreclosures over the next two years suggests the market will continue to struggle. (There are more than a trillion dollars in adjustable mortgages that are underwater and that have yet to reset to higher payments, and high unemployment will make things worse.)



Higher points indicate greater affordability.

Another question is whether we should be worried about inflation or deflation. At present, there is an enormous amount of excess manufacturing capacity and available labor so it is unlikely there will be higher costs to pass along. Demand-driven inflation is also unlikely. Over the intermediate-term there is even some concern that deflation could take hold if the global economy doesn't experience a sustained rebound. However, looking out a few years, the bigger risk is that policy makers' ef-

forts to avoid a deflationary cycle are too successful and trigger a run up in the inflation rate to modestly high levels or worse.

Government intervention probably saved us from an economic depression, but have we dodged the only bullet? Given the actions to date, the Fed and the Treasury are clearly committed to doing whatever it takes to help the economy find a floor so that it can grow again. On the other hand, if there are no more bullets to dodge, it will be difficult to know when the timing is right to taper the stimulus. If it is decreased too early the economy could relapse (as happened in the U.S. in the 1930s and Japan in the 1990s) and if it is extended too long it will add to budgetary woes. In any event, there will be great political pressure to deal with on both sides of the issue.

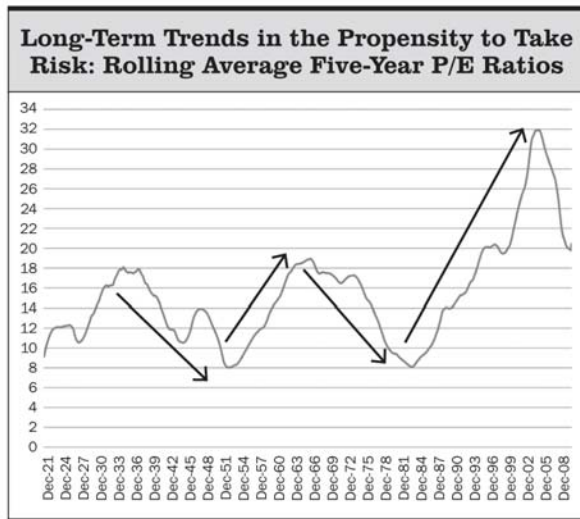
Investment returns will also be influenced by investors' willingness to take on risk, which tends to build during bull markets and break down in bear markets. The degree of investor risk aversion is an unknown that will impact returns in the years ahead. Our working assumption is that it is more likely than not that higher-than-normal risk aversion will subside very gradually and that stock P/E multiples in five years will be average or below average relative to the last 50 years. If we look beyond five years we can anticipate a gradual return of normal risk-taking leading to higher returns.

### **We Consider a Range of Outcomes in Making Portfolio Decisions**

Broadly speaking, these conflicts create a very wide range of possible outcomes. Our intellectual honesty demands that we recognize that no amount of analysis will allow us to determine exactly how the coming years will unfold, so we direct our analytical effort toward thinking carefully about what would happen across a range of outcomes. This process of scenario analysis gives us important insights about how to position our portfolios.

While asset class opportunities are less compelling than they were earlier this year, we believe that we will experience further periods of high volatility that could provide us with additional tactical opportunities. Here is a quick review of some of the asset classes we are watching closely and how

they would fit into our portfolio strategy and macro-level thinking.



Looking at 5-year average P/Es makes it easier to see the tendency for multiples to go through lengthy periods where they rise and fall.

**Emerging-Markets Currency Exposure:** This would be through an emerging markets bond fund of some sort—possibly PIMCO Developing Local Markets (which we’ve owned in the past) or PIMCO Emerging Local Bond (whose duration is not as short as its sibling). We believe the dollar is likely to weaken over time versus many emerging-markets currencies. So this investment would provide us some dollar hedge, though the primary driver of our decision will be the potential returns from interest income. Based on our current analysis, returns could range from high single-digits to very low double-digits. From a return standpoint the asset class already looks attractive to us, but we are still in the process of assessing the risk in these markets from the global recession.

**Commodities:** Commodities futures, which we have owned before, could become attractive as an inflation hedge. Investment in this area is not imminent but if we become more concerned about very high inflation, or our assessment of their potential return increases, that could change.

**Non-Agency Mortgages:** This is an area that was at the center of the bubble that triggered the global economic collapse. Our research suggests that very high-quality non-agency mortgages (bonds issued by commercial entities such as banks versus government-sponsored agencies such as Fannie Mae) are now priced at levels that should deliver

attractive returns (high single-digits and potentially quite a bit better) for investors willing to brave potential near-term risk if the housing market proves more disappointing than investors already expect.

However, there is also risk that protracted weakness from here could result in government intervention that could impair the investment value. Even in this case, given prices that are already well below par, returns look likely to be positive over a several-year period and probably competitive with the bond market, and we consider an extreme version of that scenario to be unlikely. We are still assessing the risk/reward potential of this asset class.

**Opportunistic Fixed-Income Funds:** There are still portions of the bond market that appear attractive. The active managed bond fund we own is taking advantage of opportunities but we are also researching several other funds that can be even more opportunistic and invest more heavily in inefficient niches of the market. Some of these are hedge-fund-like with flexibility to move aggressively into and out of bond sectors and the ability to short portions of the bond market that are overvalued.

**Treasury Inflation-Protected Securities (TIPS):** TIPS are designed to protect investors from inflation by adjusting the outstanding principal by the inflation rate. An investment in TIPS would not be driven exclusively based on their current valuation. Rather, our longer-term concerns about inflation suggested it would be prudent to seek out some inflation protection in portfolios with large fixed-income weightings. These would likely be longstanding positions in our bond-heavy portfolios.

Overall, our portfolios have a modestly conservative bias. Our equity exposure is a bit below that of our benchmark, though several factors offset some of that risk reduction. Our emerging-markets equity exposure has the potential to be more volatile than the standard U.S. large-cap equity exposure from which it is funded. The flexible fixed-income managers we use could experience more short-term volatility than the overall bond market, but we are willing to make this trade-off because we believe our holdings offer much better long-term value. So this all nets out to somewhat be-

low-benchmark risk exposure but not as low as it may appear on the surface.

Looking ahead, we believe that prudence is called for given the high level of uncertainty in the economy and financial markets, but that good investment opportunities do exist.

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