



Tarpley & Underwood

Financial Advisors, LLC

Quarterly Investment Commentary

First Quarter 2010

Following a strong March, all domestic equity asset classes are now well into positive territory year-to-date. The large-cap Vanguard 500 Index was up 5.4% for the quarter, while the iShares Russell Midcap benchmark gained 8.6% and the small-cap iShares Russell 2000 gained 8.8% for the first three months. Foreign stocks also posted strong gains in March and are now in the black for the year so far, with the Vanguard Total International Stock Index and the Vanguard Emerging Market Stock Index up 6.7% and 8.2% for the month, and 1.5% and 2.5% for the quarter, respectively.

Turning to fixed income, the domestic intermediate-term, investment-grade Vanguard Total Bond Market Index gave up a bit of ground (-0.1%) in March, though posted a positive 1.7% return year-to-date. Developed foreign bonds (as represented by the Citigroup World Government Bond Index) slid 1.7% in March and are down 1.3% for the year so far. Emerging-markets bonds gained an impressive 4% for the month (as measured by the JPMorgan GBI-EM Global Diversified Index), ending the quarter with a 5.4% return. High-yield bonds posted a 3.1% gain in the month, ending the quarter up 4.8%.

We talk more about our current views and the investment implications in the commentary below.

Looking Down from 30,000 Feet, the Landscape is Dominated by Mountains of Debt

A year ago the stock market had just started its rebound from the depths of the worst bear market in over 70 years. The powerful rally in "risk" assets over the past year is certainly comforting. While we take some satisfaction in the returns we've achieved for our clients (and ourselves) since that time, we remain quite concerned, and our assessment of the key macro issues and risks that the global economy must deal with in coming months and years has not changed. Though the worst case of a great depression and financial armageddon has been avoided, the global economy continues to struggle in the aftermath of massive wealth destruction and a hard stop to the decades-long trend of expanding indebtedness.

More so than in past periods, the investment climate in the years ahead will be highly influenced by how the key macro components of this environment unfold. We've seen massive growth in debt throughout society, reaching binge levels in the last decade. Think of all that debt as a form of borrowing against future consumption – now we must pay it back in the form of less spending. This suggests a sluggish economy, possibly for many years to come.

Government spending has kept the economy from falling off a cliff, but at a longer-term cost of massive deficits that will be difficult to fix without causing more damage – including the possibility that shifting gears to cut budget deficits too early could throw the economy into a significant and ugly decline.

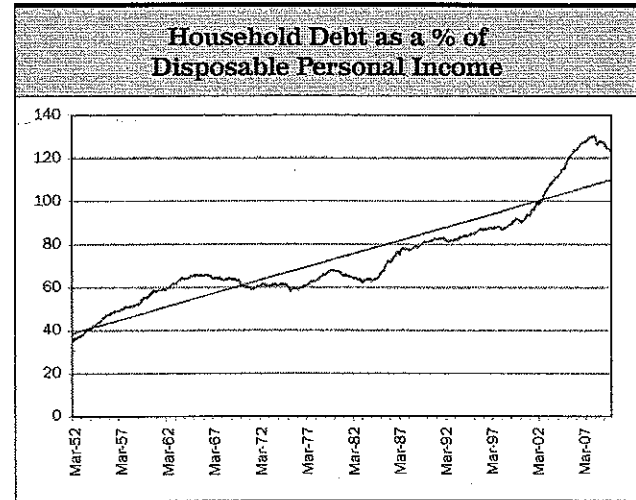
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The recent economic strength stems mostly from this stimulus spending and smaller inventory draw-downs (companies are still drawing down inventories – selling more than they are producing so that inventories decline – but the drawdown has slowed). The problem is that both of these factors are temporary.

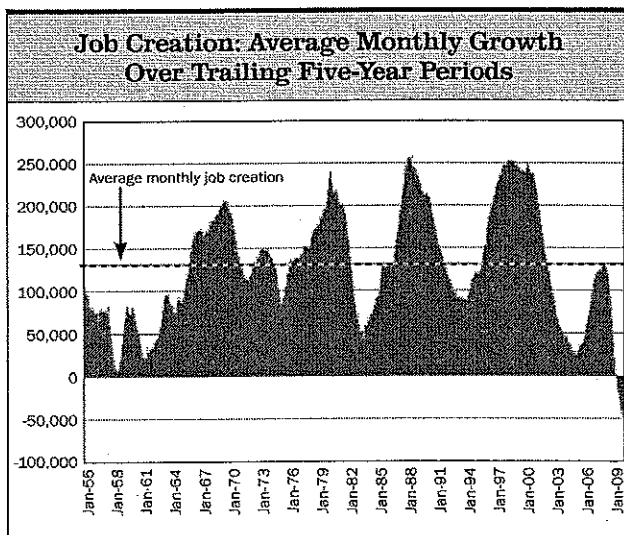
There is still a lot of government spending that will roll out this year but unless there is a new round of stimulus, which is quite possible, it will dissipate in coming quarters. Inventories will be a positive growth driver for a while as they are gradually rebuilt, but this too will pass as the year progresses. Other sectors of the economy are strengthening—manufacturing in particular has been impressive but it is still far below its prior peak and overall, the economy is on fragile footing. What we don't yet know is whether the economy will be on solid enough footing to stand on its own as government supports are withdrawn and inventories stabilize, or whether it will stumble and possibly contract again.



Debt is coming down, but is historically very high relative to income. Source: Federal Reserve.

In normal cycles the consumer is the key to sustained growth. The weakness in this critically important sector suggests to us that a sluggish recovery is the most likely outcome over the next couple of years and that there is still risk of a return to recession if government policies are not skillfully managed.

There are several important variables to a strong and sustainable economic rebound, but jobs are the most important. The big question is not whether the job picture will improve, but how much it will improve and how quickly. But while the labor market remains very weak, monthly job losses likely peaked some time ago, and we appear to be entering a period of net job creation.



According to Ned Davis, if job growth averages 150,000 a month over 10 years, unemployment won't fall below 6% until 2019, or below 7% until 2018. It would break below 10% in 2013. Average monthly job growth since 1950 has been 120,000. The last 20 years, excluding the impact of the recession, job growth has averaged 137,000 per month. Source: Bureau of Labor Statistics.

A strong snapback in job creation at some point would not be shocking. With over eight million jobs lost, there was probably some overreaction on the part of businesses that will be reversed. However, we also believe that businesses are adjusting to a smaller workforce in the face of continued concern about economic growth in coming years. We don't know how this will play out, but the weight of the evidence suggests to us that even with a strong temporary snapback, we shouldn't be optimistic about a return to a strong labor market for several years.

Other big problems include huge amounts of commercial real estate debt coming due, continued



strains in the housing market, and possible high inflation down the road from deficit spending.

There are some positives that could contribute to a better outcome, including continued strength from emerging economies. Domestically, we could see stimulus spending, low rates, and inventory rebuilding create a virtuous circle in which businesses with strong balance sheets add jobs, and consumer and business confidence builds and feeds on itself.

Our Investment Outlook in This Time of Great Uncertainty

Scenario analysis forces us to think about a variety of different macro outcomes over our five-year decision horizon. We then assess the return potential for each asset class in each macro scenario. The valuation work we review is a major driver of the return analysis, though the macro factors are also important. It would not be shocking to find bargain valuations in some asset classes when the outlook is poor—often times risk is more than fully priced into financial assets in negative environments. Unfortunately, that is not the case today—generally speaking, return potential over the next five years is not compelling. However, that does not mean that returns couldn't be decent over the near term.

Global Stock Outlook: We think mid-single-digit returns or worse are more likely for stocks than higher returns over the next five years. Our outlook for developed market foreign equities is similar and for emerging-markets equities is slightly higher across all scenarios. We believe risks are relatively high, but we can't predict timing. We can easily imagine good returns in 2010 if the economy continues to grow, low rates encourage risk taking, and there is no catalyst to cause risk aversion.

We never want to be complacent in our assumptions. We constantly test and challenge our own thinking, and look for new ways to analyze issues. One example is our work to approach the all-important question of what corporate earnings growth will be by analyzing historical sales and margin data. The results are slightly more favorable than our more conventional earnings growth analysis, which is based on a much longer history.

Emerging-Markets Local-Currency Bonds: Among other asset classes, emerging-markets local-currency bonds remain a compelling opportunity from a relative-return perspective versus the other major asset classes we track. We think it can generate mid- to high-single-digit returns in our most likely five-year scenarios—admittedly not spectacular returns but better than any other asset class. The returns are driven by the underlying bond yields plus an expectation of at least mild currency appreciation we expect given the stronger fiscal conditions in much of the developing world.

High-Yield Bonds: High-yield has continued to do well in 2010, though the returns have been much more moderate. As high-yield has rallied, we have reduced our exposure. We no longer view the asset class as clearly superior to equities (both have low expected returns in most scenarios). High-yield could continue to generate decent returns in the short to intermediate term if the economy continues to gradually improve and interest rates remain low. But the huge increase in prices of high-yield bonds (now at or approaching par for most of the high-yield universe) means that our expectations for returns over our five-year investment horizon have fallen.

Core Fixed-Income Strategies: We have begun a process of actively reducing the interest rate risk in these holdings by a combination of strategies. In some cases where we can target specific cash



flow needs, we are purchasing government backed securities to hold to maturity. By holding to maturity, we avoid the need to worry about the potential upward fluctuation in interest rates which can negatively affect bond prices. In situations where we don't have targeted cash flow needs, we are changing the nature of our mutual funds and exchange traded funds from those with longer aggregate maturities and greater holdings in treasury like securities to those that have shorter maturities and more flexible investment grade holdings. We believe these funds will be better situated to address the future interest rate environment.

Overall we believe our fixed-income exposure will be subject to materially less inflation/rising interest rate risk than the overall bond market and has higher return potential (except in a period of extended deflation or near-zero inflation). It also gives us some defensive ballast, though less in the double-dip recession scenario than the overall bond market. That is the compromise, but we make up for that in other ways at the portfolio level.

The Value of Our Research is in the Decisions We Make

Investment decisions involve determining if you are being adequately compensated for risk. We think risk assets like stocks are not priced attractively enough to fully compensate investors for the risks we see. But periodic declines in the years ahead could give us opportunities to improve returns by adding risk when we expect to be paid better for taking it on—this requires patience.

The possibility that it may take years to complete the process of deleveraging is not uplifting. Skewing towards a positive view when the environment doesn't support it may feel better, but is not a path to generating better returns, so we are committed to working hard to understand the reality we live in and make decisions accordingly. A positive note is that the kind of volatile, challenging environment that we think is probable actually plays to our strengths of planning and taking a holistic view of wealth. By being aware of the risks and challenges that come not just from the markets but from the changing tax and planning environment that we live in, we believe that our client's overall wealth management outcomes can be improved. That is why we approach our advice around money in a manner which is specific for each client because everyone's circumstance is different. We will continue to apply that approach as we move forward into the year.

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