



# Tarpley & Underwood

Financial Advisors, LLC

## Quarterly Investment Commentary

Stocks continued their slide in June, ending the first half of 2010 with losses in every segment of the equity market. The large-cap Vanguard 500 Index lost 11.5% for the quarter, and is down 6.7% year to date. The small-cap iShares Russell 2000 and iShares Russell Midcap both lost 10% in the second quarter, though thanks to a strong first-quarter, both benchmarks are down just 2% year to date. Turning abroad, the story was similarly painful. The Vanguard Total International Stock Index dropped 13.3% in the second quarter, bringing its year-to-date loss to 12%. The Vanguard Emerging Market Stock Index lost over 9% for the quarter and nearly 7% year to date.

Most of the positive news for the first six months of the year was in fixed income. The Vanguard Total Bond Market Index Fund, a proxy for high-quality, intermediate-term bonds, gained 3.6% over the second quarter, and is up 5.3% for the year through June. Foreign bonds were mixed. The Citigroup World Government Bond index was flat in the second quarter, but still down 1% year to date, and although the JPMorgan GBI-EM Global Diversified Index lost 2% for the quarter, it returned a positive 3.4% for the year through June.

### Investment Outlook

As noted in the performance review above, the first six months of 2010 have been a bit of a roller coaster—domestic stocks were up early in the year, then down 5% by early February, then up almost 10% for the year by late April, then down nearly 7% for the year by the end of June. This reflects what we see as an economic “tug of war” in the stock market, with improving economic and company fundamentals on the one side, and concerns about debt-related stress points and the longer-term strength of the economic recovery on the other. The tension between these opposing forces has left investors uncertain and the stock markets stuck in a trading range (i.e., bouncing around within a range with no clear trend). We think that unusually high uncertainty could be with us for years to come because the economic challenges we face are serious and will not be resolved quickly.

Though we won't forget the market freefall of 2008, now that there has been a strong stock market rebound from the bottom, it's interesting to compare market levels today to three years ago. Despite the rebound they continue to reflect a level of economic stress:

As long-term investors, our views tend to evolve gradually rather than change suddenly based on new information. That's certainly been true in recent quarters with our assessment of the big picture unchanged.

### The Challenges We Face

It's no secret that there is too much debt in most of the developed world—the United States, Europe, and Japan. We've written about it ad nauseam. That the problem is

Investment	Time Period (6/30/07 - 6/30/10)	Comments
S&P 500 (Vanguard 500 Index Fund)	-26.7%	Earnings hit/investor fear
MSCI Emerging Markets Index (iShares MSCI Emerging Markets ETF)	-8.1%	Damage from global bear mitigated by stronger economies
MSCI US REIT Index (Vanguard REIT Index Fund)	-23.2%	Real estate mega-bear
Gold	91.2%	Currency debasement fear
Yield Change		
10-Year U.S. Treasury yield	-2.1%	Flight to safety
3-Month U.S. Treasury yield	-4.6%	Monetary stimulus

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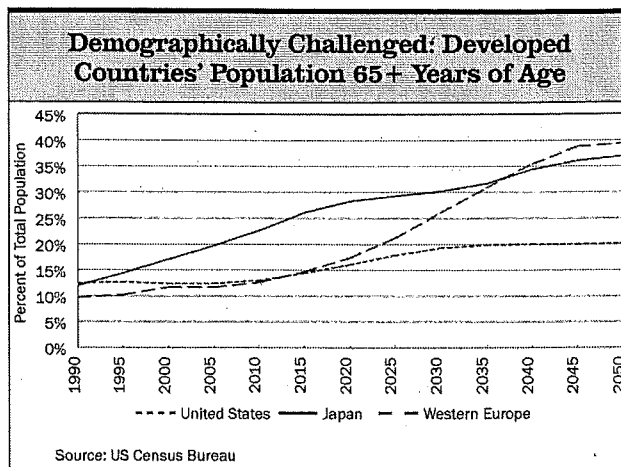
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identified doesn't lessen the challenge. In coming years the developed world must walk a tightrope as it deals with the pressing need to slow and ultimately reverse debt growth without also seriously harming economic growth rates.

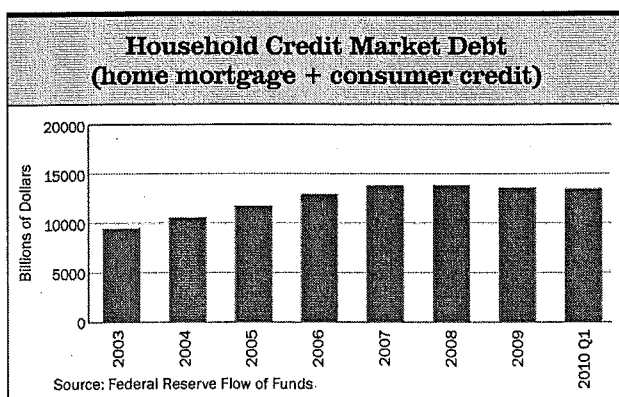
The United States and other countries with excessive household sector debt are in the early stages of what is likely to be a long process of deleveraging. Though it is dropping, household debt relative to income remains excessively high. Most of these countries must also dramatically reduce public sector (government) debt growth and in some cases they will need to reduce the absolute amount of debt. This huge challenge has not yet begun.

The timing and aggressiveness with which public sector debt and deficits are attacked will be extremely tricky to get right given current economic headwinds. On the one hand, too much austerity coming from very tight fiscal policy can be counterproductive because it risks smothering already weak growth, which reduces tax revenues, increases social safety net spending, and could weaken the political will that is needed to follow through on spending discipline.

But waiting too long to tackle rising debt levels digs a deeper hole and risks a lenders' strike, which could result in government borrowers (and all others too) being forced to pay a much higher interest rate to finance their debt. At the extreme, as we are seeing with Greece, debt levels become unmanageable as borrowing costs become untenable, resulting in a crippling crisis for the country and a ripple effect that in a global economy has reached far beyond Greece's borders. A critical unknown is whether enough countries, including the United States, can thread the economic needle so that the recovery has time to gain steam while maintaining lender confidence that the deficit/debt problems will be addressed over time. Slowing and ultimately reversing the growth of debt is further complicated by aging populations—a reality that most of the developing world faces to different degrees.



A large portion of Japan's population is over 65 and the percentage will move sharply higher in coming decades. Europe's demographics are not too bad at present but are set to get sharply worse over the next 30 years. The U.S. population is also aging and though the 65+ age group will be a much larger percentage of the total population in 25 years, we will be much better off than Japan.



Credit is contracting but it's been a drop in the bucket in terms of total debt outstanding (shown here) and also relative to household income (not shown).

An aging population presents several challenges. It means that savings rates will face downward pressure as more of the population moves from working and saving to retiring and depleting savings, and paying fewer taxes given lower income. More retirees also mean more government retirement and health care expenses (Social Security and Medicare in the United States). This is fine if pensions and health care are fully funded. But that is not the case.

While the private sector gradually de-levers, and we wait for the public sector to later do the same, at least



the United States is experiencing an economic recovery, albeit a tepid one. There has been clear improvement from the depths of the recession. The economic cycle is, for now, a plus, but the big problems have not been resolved.

Three variables critical to improvement in private-sector consumption and a normal recovery—the labor markets, credit growth, and housing—remain weak. We are still down about eight million jobs from the peak and in the private sector job growth is barely positive – though that is an improvement from last year. Credit market debt is contracting as it has been for about two years, which removes an important driver of consumer spending. And the housing outlook, which is critical to household financial strength and the banking sector, remains cloudy and appears to be slipping backward with an expiration of the homebuyer tax credit.

The rest of the developed world looks worse. Europe is experiencing very slow growth, southern Europe is uncompetitive and has many countries in various stages of sovereign debt crisis, and economic policy is a challenge given a single monetary policy in the eurozone, but no political union and differing economic situations.

Fortunately, key parts of the developing world are in much better shape with stronger balance sheets, higher growth rates, younger populations, and slowly emerging consumer sectors. Their strength is an important source of support for the global recovery. And there are other positives that help to mitigate the negatives. The continued impact of massive federal stimulus (though this will wane later this year in the United States), healthy corporate balance sheets and cash flow (after huge cuts to expenses), and a natural rebound in economic activity after a huge decline are also sources of strength in the U.S. and global economy.

Thus, our view of the big-picture environment we face in the next few years remains unchanged. The recovery continues but is not inspiring, and we see above-average risk in spite of being early in a recovery cycle.

### **Portfolio Positioning**

**Stocks:** After a huge stock rebound from the market depths of March 2009, equity scenario analysis continues to suggest that developed stock markets offer below historical return potential over the next five years. On the positive side, we continue to have the opinion that these equity returns while lower than we are used to historically will be in the upward direction.

**Bonds:** Within our bond allocation, while high quality investment-grade bonds only offer minimal return potential over our five-year horizon, they do offer a defensive investment that could perform well if the economy is very weak or falls back into recession. Additionally, the fixed-income vehicles we hold are more opportunistic and potentially more volatile than a typical investment-grade bond portfolio, as we believe these fixed-income positions will capture materially higher returns and provide much better protection against unexpected inflation and in a rising rate environment. We are controlling risk in the fixed income allocations by keeping overall durations low and credit quality high. Additionally, we have more diversification on the fixed income side than we have had in several years. We believe this positioning is appropriate given the near and long term uncertainty in the fixed income markets given the risks we highlighted earlier.



Among the fixed-income asset classes, we still find emerging-markets local-currency bonds (ELB) to be the most compelling from an expected risk/return standpoint, though we don't expect returns to be excitingly high. Potential ELB return comes from the interest income and our expectation that the economic fundamentals (less debt and more growth) in many key developing economies are very likely to lead to currency appreciation (versus the dollar) over a multiyear time frame. Moreover we view this asset class as significantly less risky than equities. However, it is much more volatile over the short run than investment-grade bonds and we don't view it as a defensive asset class—rather, we view it as a hybrid when we assess its impact on our overall portfolio level risk.

Though we recognize a positive investment scenario is possible, as is a temporary period of strong market performance that could be driven by improving economic news and impatience with the near zero return offered by the money markets, we are clearly not placing a high probability on a bullish environment. For some time now, our view of the opportunities and risks for investors hasn't been very encouraging. And while the story is what it is, it is also important to remember it won't last forever—there will be better opportunities at some point. We hope that some of those opportunities will come soon and allow us to perform better than what the broader markets give us. But we're prepared to be patient. In the meantime we are working hard to ensure that when opportunities do present themselves we are in a position to recognize and take advantage of them, while also being highly attuned to the potential risks in this uncertain environment.

