Portfolio**VISION**

July 2010

Investment Intelligence on the Economy, the Markets and Strategies

After a dramatic rally that lasted nearly fourteen months, the U.S. stock market began correcting in late April. What triggered the correction, how long it is likely to last, and how investors should respond is the subject of this newsletter.

Capital Markets

After a stable first quarter during which stocks continued their rally off the March 2009 lows and corporate bonds remained attractive to investors, the capital markets were thrown for a loop in the second quarter. Sovereign debt worries in several European Union countries combined with a sluggish Chinese stock market spooked investors around the world, and the "flight to quality" that characterized the second half of 2008 and early 2009 took hold of the markets once again. The U.S. Dollar gained even more strength against the Euro as U.S. Treasuries again became the investment of choice. By quarter end, significant levels of capital had fled all major domestic and international markets for the perceived safety of U.S. government paper, pushing yields down and flattening what had become a historically steep yield curve. Unlike the fall of 2008, however, the corporate bond market remained stable, a testament to corporate America's strong balance sheet, which is anchored by historically high levels of cash. Even high-yield bonds, which carry the greatest risk of default, remained relatively stable during the period.

Stocks

Unlike the stability of the bond market, extreme volatility took hold of the stock market in the second quarter. Global concerns combined with worries that our sluggish recovery might be faltering gave investors little reason to continue driving stock prices north, instead causing them to pocket some of the gains earned in the past four and one half quarters. By quarter end, the S&P 500 had declined 11.86% on a cash basis (before dividends). The index of 500 of the largest domestic companies declined 15.69% from its 2010 peak set on April 23rd, after having rallied 79.93% off its March 9th lows of a year ago. Year to date, the index is down 7.75% (cash basis) and 6.65% (total return basis). Likewise, the NASDAQ Composite fell 17.27% from its rally peak, (a 99.44% move off last March's closing lows), finishing down 12.04% for the quarter; the index now stands down 6.62% on the year. One of the only bright spots for domestic stocks year-to-date is the fact that they are outperforming most of their European counter-parts by a comfortable margin.

Asset Classes

As was the case in early 2009, managed short equity, long and intermediate term Treasuries, agency-backed and investment grade mortgage paper led all asset classes in performance in the months of May and June. Other areas of strength so far this year include precious metals stocks and REITS, although these two classes fell in value at quarter end. And although emerging markets have fared better, most foreign stocks have been weak this year, their plight exacerbated by the strength of the U.S. Dollar. Finally, a feared slowdown in global economic activity took its toll on natural resources stocks in May and June as oil prices fell 16% from their 2010 peak of $86/barrel, established the week of April 30.

The Economy

The economic recovery, which appears to have begun in June 2009, has continued along its upward, albeit halting, path. GNP results for the first two quarters of 2010 continued to show positive gains. But this growth to date has been driven principally by fiscal stimulus (i.e., federal spending), business inventory investment, and a modest rebirth in consumer spending. The question looming is: will the private sector finally pick up the slack and become a source of sustained growth in the second half of 2010 and beyond?

Clearly, several headwinds dampen the prospects for growth: residential and commercial real estate sluggishness, the strained balance sheets of state and local governments, and persistently tight credit standards for small and middle market businesses. Companies also appear to be somewhat hesitant to expand in the face of an uncertain and changing regulatory climate. Combine these factors with the perceived negatives of the European debt crisis and the Gulf oil disaster, and the impediments to growth seem all too clear.

But investors must not forget the powerful factors that offset these headwinds, most notably the Federal Reserve's commitment to monetary stimulus (i.e., low interest rates), nary a sign of inflation, continued improvement in consumer sentiment, and the powerful impact of corporate earnings and profitability on our economy. The end result: the probability of a "double-dip" recession is unlikely. In fact, the economy is more likely to move slowly, but steadily forward.

Strategic Thinking

A relatively bullish view of the economy would imply that investors should have a similar perspective on the capital markets. And, generally speaking, that is true - with one important caveat. The return of excessive volatility to the markets in the second quarter must be watched closely. In some respects, the markets now seem

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programmed to react in the extreme. It is almost as if the traders in our capital markets are not content with "middle-of-the-road" results and instead perceive economic news to be either "great" or "terrible". In this climate, volatility and the potential risk of short to intermediate term market instability – including a decline of significance - is a fact of life for investors.

Consequently, investors must rely even more heavily on a fundamentally sound, analytical approach to investing in these choppy markets. Investors know that the stock market is forward-looking and that sentiment can shift swiftly from bullish to bearish and back again. Long-term investors must look through the "ping-pong" nature of short-term price movements by examining the fundamental driver of market value… earnings. And overall, the news on the earnings front has been consistently positive. It is through and by this axiom - that ultimately, earnings will drive market values - that the well-reasoned investor sets his course.

Investor Psychology

When the stock market experiences the kind of swoon that characterized the months of May and June 2010, less savvy investors are tempted once again to climb back on board an emotional roller coaster. The ride begins with a high degree of anxiety at the beginning of a rally (so much so that the initial advances of new bull markets are often missed) and eventually gives way to rally-induced euphoria and complacency (the false sense that the market will advance in a straight line). Then, when the market deals the newly comfortable investor a cold dose of reality, the cycle begins all over again.

And that's where effective portfolio design becomes paramount. A well-designed portfolio can help *reduce the emotional volatility* of the investor by *limiting the actual volatility* of his portfolio.

Intelligent investors accomplish this by designing a portfolio to both capture upside returns and minimize downside losses. Such a portfolio typically experiences far less volatility than the stock market; this is a direct and intentional result of proper portfolio design. As a result, investors may avoid the temptation to climb back aboard that emotional roller coaster, and in the long term, be more successful for it.

Personally Speaking

We all know that summer is a great time to retreat from the realities of work and enjoy some time with family and friends. We encourage everyone who is able to do just that this summer. Soon enough, the days will be noticeably shorter and the nights cooler, and most of us will begin preparing for another long season… a season that *isn't* summer. So be well! Go on a picnic, have some ice cream, walk barefoot in the grass… enjoy the summer and enjoy life!

Databank	2010
Dow Jones Industrial Average (DJIA)	-5.00%
S&P 500	-6.65%
NASDAQ Composite	-6.62%
MSCI EAFE (U.S. Currency)	-12.93%
Dow Jones Select REIT	5.28%
Dow Jones UBS Commodity	-9.60%
Barclay's Capital U.S. Aggregate	5.33%

The DJIA is an index of 30 "blue chip" U.S. stocks, the S&P 500 is a cap-weighted index of 500 leading U.S. stocks and the NASDAQ Composite is an index of mostly smaller company stocks. The MSCI EAFE is a cap-weighted index of developed markets' stocks (Europe, Australiasia, Far East) excluding the U.S. and Canada. The Dow Jones Select REIT is a subset of the Dow Jones Composite Index of all publicly traded U.S. real estate investment trusts. The Dow Jones UBSCI measures the performance of futures contracts on 19 physical commodities traded on U.S. exchanges and the London Metal Exchange. The Barclay's Capital U.S. Aggregate covers U.S. investment grade, fixed rate government, corporate, mortgage pass-through and asset-backed securities. All indices are unmanaged and cannot be invested in directly.

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Upcoming Events!

Update Session: Thursday, October 19th at 2:00 p.m. and 6:00 p.m. at the Courtyard Marriott. This client presentation will provide deeper insights into our thinking and will include a question & answer period.

Holiday Party: Thursday, December 16th from 3:00 to 8:00 p.m. at Shady Hollow Country Club. Don't forget to mark your calendars for our thirteenth annual holiday season get-together!