



PRIVATE WEALTH MANAGEMENT GROUP

Investment Strategy

July 2010

Our midyear review is intended both to look back at the first half of 2010 as well as to refine our investment outlook for the remainder of the year.

In January we anticipated a few noteworthy reversals in the trends that had propelled most investment categories higher in 2009. The overriding theme was that the markets would see more volatility than they had in the previous year and that this would create a flight to quality as investors dialed back their appetite for riskier investments.

Going into 2010 we had adjusted our investment strategy with the belief that the US dollar would begin to strengthen versus other currencies and that this would lead at least temporarily to a period of outperformance for dollar-denominated assets. Fueled by the European debt crisis, the dollar did in fact rise against the euro, pound, and yen, as money flowed back into safety. At the halfway point of 2010, dollar-denominated investments have generally benefited from that trend.

Stock prices reflect both the reversal in currencies and also the fragile nature of the global economic recovery. The markets have given back some of the considerable gains made in 2009. In the first half of 2010, the S&P 500 (SPY) lost around 10%, but that compares favorably to foreign stock indices (EFA), which lost nearly 20% over the same period.



Meanwhile, most bond categories have produced positive returns over the first half of the year. US Treasuries rallied during the crisis as assets moved toward the -- relatively, and perhaps temporarily -- safer haven of Treasury bonds and the US dollar. After getting punished by the debt crisis, foreign bonds have recovered somewhat, though default risk in selected countries remains a major concern.

While maintaining adherence to customer goals and to the investment policies governing each of their accounts, we are once again rebalancing and repositioning client accounts for the financial and economic landscape that is ahead of us. That forecast begins with an economic outlook both here and abroad and extends into an analysis of the likely interest rate environment that our bond portfolios will be facing. These themes are instrumental in formulating our investment recommendations in response to those challenges.

Economic Outlook

With the artificial boost from stimulus spending largely behind us, investors now look ahead to whether the global economy can stand on its own two feet. The results to date are still uncertain, as the uneven and subpar recovery that we earlier forecasted continues. Below we highlight some of the issues and developments that that we are closely monitoring.

- **Slower GDP Growth:**

US GDP was revised downward to 2.7% in Q1 and is expected to have slowed to around that rate or less for 2010, meaning that the Federal Reserve is now unlikely to begin raising short-term interest rates until 2011. Faced with stubbornly high unemployment hovering around 10%, the consumer has chosen to largely stay on the sidelines to this point in the recovery. Despite the low interest rate environment, consumer spending remains sluggish.

- **Housing Woes:**

Despite historically low mortgage rates, housing resumed its struggles in May once the homebuyer tax credit expired. Foreclosures accounted for nearly a third of all home sales in Q1, and they are likely to continue to exert downward pressure on real estate prices in the second half.

- **Deficit Reduction Measures:**

The public debt crisis is likely to be addressed through a combination of 1) higher taxes (expiration of the Bush tax cuts, plus some new ones), and 2) less aggressive fiscal stimulus. Each factor would constitute a drag on economic growth going forward.

A potential boost to the markets is the early indication from the Administration that taxes on dividends and capital gains will be capped at 20% starting next year. While higher than the current rates, it would still be considerably lower than most marginal tax brackets and should be treated favorably by the investment community.

- **Reprieve from Political Intrigue:**

With national elections looming in the fall, the remaining items on the Administration's agenda may be temporarily curtailed for the year, giving the private sector an opportunity to reassess their prospects and plans for the future. Whether or not this will translate to new hiring will be critical to the unemployment picture and to the strength of the economic recovery.

- **Default risk:**

In January we were focused on the potential for bond defaults by sovereign governments. While some at-risk countries retain a tenuous grasp on solvency, the spotlight now shifts to state and local governments here in the US as their own budget deficits mount and default risks climb.

Investment Themes

High quality stocks & bonds

We continue to be defensively positioned and to emphasize quality in our stock and bond portfolios, and this strategy has been rewarded by the flow of investment capital out of riskier assets and back into safer havens.

Investor psychology and market valuation are currently at odds, and that conflict will be somehow be reconciled in the second half. Profit growth for US companies is strong (expected to be up 34% in 2010 for the S&P 500), while investors remain skittish about the prospects for a double dip recession and what they may be willing to pay for those strong earnings. At the present time, stock prices remain under pressure, as the major market indices are mired in a difficult trend. That trend has placed the S&P 500 within range of strong technical support, which could set the stage for a rebound in stock prices later this year, possibly placing stocks in positive territory once again when the smoke clears and the books are closed on 2010. Volatility (i.e. risk) will likely remain elevated throughout the summer and fall, reinforcing a preference for the stocks of larger, higher quality companies. Those companies also tend to have more generous dividend policies, and dividend yields could be a significant part of stock total returns over the coming year.

On the bond side, our emphasis on higher quality issues led us toward a larger allocation to intermediate-term Treasuries (IEF), while de-emphasizing emerging market and high yield debt (JNK). International bonds continue to be attractive due to higher yields, but we will proceed cautiously with them due to concerns about credit quality and currency translation.



Inflation-protected Treasuries

TIPS still enjoy a healthy allocation in many of our clients' bond portfolios, due to lingering concerns about rising interest rates (and inflation) at some point in the future. Government deficits and the non-stop printing of paper currency will eventually lead to inflationary pressures, which will reduce the value of fixed-rate bonds. 10-year TIPS currently price in inflation expectations of only 2% over ten years. We feel that there is more potential for upside adjustments to those expectations than there is for any downside revisions to inflationary concerns, especially over the next ten years.

Tax-free bonds

The near certainty of higher taxes in 2010 and beyond continues to make tax-free municipal bonds attractive to our high net worth clients. State and local budget issues, however, force us to gravitate toward higher quality issuers -- insured wherever possible -- so as to minimize our clients' exposure to domestic default risk. (See California, Illinois, and a growing list of nearly insolvent states and cities.)

Hard assets

In January, we predicted that a more stable US dollar would curtail some of the outsized gains in metals and other commodities that we saw in 2009. While that has largely occurred, the performance of gold has been an outlier.

Gold prices (GLD) have outpaced those of a broad basket of other commodities (GCC) in the first half. Gold's success may be attributable more to its safe haven status than to any inflationary concerns on the part of investors. If that is the case, we would expect to see continued strength in the price of gold if the markets remain volatile in the second half, though we do not anticipate adding substantially to our gold allocations at this time.



Real estate is another hard asset that is potentially attractive for the reasons given above, but we feel that the real estate market has many challenges remaining. With foreclosures and unemployment still unacceptably high, we will be monitoring the health of the housing market for an indication that US (IYR) and international (RWX) real estate prices have finally reached a trough from which we can grow.



In summary, hard assets remain attractive as inflationary and currency hedges and as providers of additional diversification. Against the backdrop of a temporarily stronger dollar, however, we do not foresee an overweighting of that asset category at this time.

These adjustments are all a part of our commitment to proactively manage our client assets and to add value to their investments. We will continue to use the collective wisdom and experience within our group to proudly deliver high-quality financial advice and service to our customers.