

“My problem is reconciling my gross habits with my net income.”

-Errol Flynn

After a Stomach-Churning Debut, the Year Ends With Generous Gains

Whether you crave roller-coaster dips or prefer merry-go-rounds, 2009 provided most investors with a wild ride, like it or not. Early in the year, global financial markets signaled an impending global financial Armageddon as the broad indexes sunk to multi-year lows. But eventually, as governments' massive stimulus efforts averted a global depression and US corporations' cost-cutting and productivity efforts sparked an earnings recovery, the financial markets sighed relief that the worst was over and roared back with an impressive run from the March lows. For those investors who stood firm in their investment approach, some much needed recoup in asset values were enjoyed by year-end.

US stocks of all types and sizes reported big advances. The larger company S&P 500 index ended up 26.4% in 2009 while smaller stocks as measured by the Russell 2000 gained 27.1%.

Domestic fixed-income returns varied widely. Longer dated (10 years plus) US Treasury Bonds, beneficiaries of 2008's "flight to quality," lost 12.9% (Barclays Long Term Treasury Index), while the overall bond market (Barclays Aggregate Bond Index) ended up 5.9%. Corporate bonds reversed course from 2008's tough showing with investment grade bonds (Iboxx Liquid Investment Grade Index)

News Notes

Your Long-term Health Care Plan

As the costs for nursing home and in-home care escalate, it's essential that you address this important issue in your comprehensive financial planning. For 2010, ISG is committed to helping you design a long-term health care plan through a clear understanding of the risks involved and potential solutions. Watch for more information from ISG in the near future on this important topic.

Tax Tidbit: When "Realized losses" Don't Equal Bad News

Soon, all of you will have received ISG's realized gains/losses report which in most cases shows net capital losses for the year. Do understand that these losses while reportable for tax purposes do not always tie in with one's actual economic gain or loss for the year. For example, 2009 was a year where account values for most grew significantly despite capital losses from trading being booked throughout the year. This is a best of both worlds scenario since these losses can be used to offset gains this year from other portfolios or future ISG-generated gains. Make sure you and/or your accountant keeps close tabs on these loss figures.

RMD's...They're back!

FYI, Required Minimum Distributions (RMD) from IRA's have been reinstated for 2010. Please contact your ISG Advisor should you have further questions.

returning 12.7% and lower credit quality issues bouncing back from their depressed levels and beating most stock indexes with a 57.5% return for the year (Merrill Lynch High Yield Master Index).

Abroad, the story was emerging markets for both the stock and bond markets. Emerging market stocks (MSCI Emerging Market Index) gained 74.5% while the broader developed stock markets index, MSCI EAFE, earned 31.7%. For bonds, the pattern was similar with emerging market debt (JP Morgan EMBI Global Index) returning 29.8% versus 2.6% for developed market bonds (Citigroup World Government Bond Index).

For ISG, 2009 was a year when tactical moves, old fashioned diversification, and good manager selection came together to deliver rewarding results. In the first quarter, our diversified portfolios helped soften the blow when the floor fell out from beneath the global stock markets. Tactical moves away from government bonds and into investment grade US corporate and foreign bonds and currencies enhanced results and our play on high yield corporate bonds gave us stock-plus returns with much less volatility.

In addition, our stable of selected managers took full advantage of the gross mispricing throughout the stock and bond markets and almost without exception handily outpaced their benchmarks.

Today's Watchword: Sustainability

To date, unprecedented levels of fiscal and monetary stimuli have resuscitated the global economy. Capital markets are functioning again. Many of the economic metrics have bottomed out and are showing some signs of improvement. Many corporations are now very lean so any incremental pick-up in customer demand can bolster earnings growth numbers. Interest rates remain low which helps support stock valuations as well as drive investors out of cash into higher risk stocks, bonds, and real estate. Since last March, the financial markets have been pricing in a rather normal recovery.

Nevertheless, there are many questions and concerns. Here in the US, growth in Q3 and Q4 was spurred by massive government spending and inventory rebuilding, neither of which is sustainable in our view.

The reality is that consumer spending remains constrained as households face income and employment challenges and continue to deleverage and repair balance sheets. Banks remain stingy with their lending which further restricts consumer spending and inhibits small businesses from growing and playing their traditional role of creating jobs. Housing markets are still soft and face rising delinquencies and foreclosure rates while stresses throughout the commercial real estate markets continue to mount.

Given these headwinds to a "normal" recovery, our forecast for 2010 might sound something like "cloudy with a chance of relapse." Yes, governments worldwide have stepped in and successfully met their first goal of restoring some stability to the financial system but it's much less clear whether the broader goal of attaining sustainable economic growth will be met. Government stimulus can only act as a temporary offset to the collapse in the private sector. At some point, new sources

Tough Decision for the Fed

2010 will likely lead the Fed to an important decision cross-road. Do they stop purchasing government bonds, thereby risking higher long-term interest rates, dampening the housing market and potentially endangering the recovery? Or do they extend their "quantitative easing" efforts and continue funding these purchases by printing more dollars which could undermine our dollar and raise inflation expectations?

We believe Bernanke & CO view the primary risk as withdrawing stimulus too quickly rather than applying too much. With government stimulus spending expected to peak by mid-2010, they will not risk derailing the economic recovery and with consumers in debt pay-down mode, slack labor markets, excess capacity, and banks mostly hoarding their Fed-provided liquidity, inflation concerns remain a problem for another day.

Extending these "reflationary" policies will likely support financial markets which is why most investors should keep a toe in the stock market. Stay tuned.

of stability and global growth will be needed to help supplement a subdued US consumer. Financial markets in 2010 will likely be quite sensitive to how smoothly this public back to private "hand-off" transpires. ISG, too will be watching this transition closely.

Meanwhile, some of the issues and "themes" shaping our investment policies for 2010 are as follows:

- **Last year's green light for US stocks and bonds is now flashing yellow.**

On the equity side, valuations today fall within a "fair value" range but should earnings growth estimates fall short - a distinct possibility - stock prices, in general, would become stretched. It's also possible, that lackluster private sector activity would force an extension of government support programs. This might sustain higher GDP and corporate earnings growth, thus appeasing investors and driving the market higher. Either way, the easy money has been made off of last March's lows and going forward, astute stock selection and fundamental analysis will factor more heavily into getting satisfactory returns

in 2010. It's a time to be cautious and for now, we are somewhat underweight in US stocks relative to traditional asset allocation guidelines.

On the fixed income side, the stellar returns earned on our bond investments are now history and a more conservative approach is warranted for 2010. We've taken profits on our high yield bond position (although we maintain some exposure through broader mandate funds like [Loomis Sayles Bond](#)) and throughout the first half of the year we are looking to transition into bond strategies that can more effectively respond to rising interest rates whenever that might occur (see box, "Tough Decision for the Fed"). We'll bet on managers who are light on treasuries, agencies, and mortgage-backs and are selective on their corporate bond purchases.

- **The long-term growth story remains in developed Asia and the emerging markets.**

Ten years ago, the US contributed nearly 60% of the global growth. According to the IMF, that share of growth declined to less than 5% in 2008.

This global redistribution of economic activities and global wealth away from the US points towards the fast-growing countries in the emerging world as fertile investment grounds. Valuations in these regions are not nearly as attractive after last year's run-up but GDP growth estimates of 9% for China and 4%-6% for Hong Kong, Indonesia, Singapore, Malaysia, and a few Latin American countries cannot be ignored. We are overweighted in Asia and numerous emerging markets and light on developed Europe which suffers from similar economic stagnation issues as the US.

• **“Tactical” Strategies Will Be Essential to Adding Value**

With a normal recovery and bull stock market in question, investors may need to remain nimble and opportunistic in order to carve out respectable returns. Presently, ISG sees opportunities in some non-traditional fare such as foreign bonds and currencies held in funds like Templeton Global Bond and Loomis Sayles Bond. There's a sound longer-term story for commodities and we're participating through our allocations to emerging countries, many of which are tied closely to the commodities industries. We've also seen increased weightings in commodity-linked businesses in some of our domestic stock funds as well. Finally, several of our recent fund additions like Ivy Asset Strategy and newcomer, Leuthold Asset Allocation maintain nimble, “go-anywhere” strategies which seek out the best risk/return opportunities among the global asset classes and are quick to change when conditions warrant. The Ivy fund, for example, has approximately 15% in gold while the Leuthold investment has 7% in Brazilian bonds. Hong Kong real estate companies make for a big stake in existing holding, Third Avenue Value, as well.

In sum, the 2010 investment environment looks to be a challenging one for investors that may require working harder for less. Maintaining a flexible opportunistic approach, outside-the-box thinking, and risk management will all play essential roles to success. We look forward to these challenges and are confident that we can step up to meet the task at hand.

All Eyes on the Chinese Consumer: A Key to Rebalancing the Global Economy?

For years, the economies of the US and China have been mirror images of one another. The US has imported, over-consumed and under-saved. China has under-consumed, over-saved and relied on exports. Both are in need of moving towards a more balanced middle ground. Will this happen?

Skeptics argue that Chinese consumers are too poor or their savings culture is too ingrained to supplant the US consumer in the global economy. On the other hand, according to advisory group Riverfront Investment Group, a return of Chinese consumption to pre-meltdown levels would generate approximately \$400 billion in increased consumer spending, double the \$200 billion decline in US spending since the beginning of the recession. A 25% rise in the Chinese currency would increase that figure to \$500 billion from a dollar perspective and, no doubt, this would spur increased consumption across the region as other Asian economies have restrained their buying power by maintaining undervalued currencies as a competitive response to an undervalued Yuan.

This giant powder keg of global buying power in the East will be watched by investors and company CEO's closely. It may be the key factor behind the fortunes of the global economy and what sustains earnings growth for many companies across the US.

Portfolio Revisions & Comments

1. We're using more funds with broader investment charters like Ivy Asset Strategy and Leuthold Asset Allocation which tactically alter their multi-asset strategies as conditions change.
2. We're transitioning out of sector bond funds Pimco Mortgage Backed Securities and Vanguard Intermediate Investment Grade Bond to more flexibly managed Pimco Unconstrained and JP Morgan Strategic Income.

Dear Valued Client:

In lieu of our “state of the company” letter at year-end, we’ve opted this year to address an important financial planning topic which has received lots of press and airtime lately: The IRA to Roth IRA conversion. Starting 2010, taxpayers with adjusted gross incomes of \$100,000 or greater will be able to convert a traditional IRA to a Roth IRA (others have always been able to convert). The amount converted is considered ordinary income and taxed accordingly. In 2010 only, the conversion income can either be included in 2010 income or spread over 2011 and 2012 and taxed at income tax rates for those years.

The benefits of converting include the elimination or reduction of the required minimum distributions associated with traditional IRAs, the availability of tax free withdrawals during retirement and the diversification of the tax treatment of your retirement assets. As mentioned, the cost of conversion is the upfront tax hit. For example, if \$200,000 is converted the tax bill would be \$74,000- assuming a 33% Federal and 4% State tax rate.

Converting could make sense if the expectation is that all of your traditional IRA assets will not be needed in retirement and there is a desire to pre-pay taxes for your heirs. Another situation when a conversion may be considered is if you are years away from retirement and have the time to allow the Roth to grow to overcome the tax hit. In any case you should have non IRA money to pay the taxes.

It is probably prudent to keep your traditional IRA if you are in or close to retirement and expect that you will spend your IRA assets; in this situation there may not be time for the account to grow enough to recover from the tax payment.

If you feel that an IRA conversion may add value, we encourage you to contact your advisor and we can discuss the type of analysis required to provide more definitive guidance.

As always, thank you for the privilege of allowing us to serve your investing and financial planning needs and our very best to you and yours in 2010!

Sincerely

Investment Security Group, Inc.