

Celebrating Our Second Decade of Providing Unbiased Financial Advice

“The rearview mirror is always clearer than the windshield.”

Warren Buffet

So Far, So Good

The view from our windshields over the recent past has caused considerable anxiety for investors as we experienced the greatest destruction in wealth and the deepest recession since the 1930’s. Last year at this time we were questioning if the rally that had started on March 10 was for real or just another stop on our way down. To date, our rearview mirror has confirmed that an economic recovery has taken hold and that the stock market’s impressive advance is justified.

The rally has continued through the first quarter 2010 with all domestic equity asset classes well into positive territory.

For the quarter, the large-cap S&P 500 Index was up 5.45%, while the IShares Russell Midcap benchmark gained 8.6% and the small-cap IShares Russell 2000 gained 8.8%. After posting strong gains in March, foreign stocks are now in the black for the year, with developed international stocks up 1.5% for the quarter and emerging market stocks up 2.5% for the same period.

Returns for fixed income are mixed. The domestic intermediate-term, investment-grade Total Bond Market Index posted a 1.7% return year-to-date but developed foreign bonds fell 1.3% for the quarter. Emerging-markets bonds gained an impressive 5.4% thru March and high-yield bonds ended the quarter up 4.8%.

Our clients’ portfolios continue to benefit from many of the tactical moves we have made over the past 18 months. Moving away from domestic index funds to active managers that do well in distressed periods provided significant value. Concerns over

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European debt issues have been confirmed as that story continues to unfold and emerging markets like Brazil, India, China, and Mexico are creating long term opportunity for investors. We focused last quarter on taking profits from investment grade U.S. bonds and mortgage backed securities and placing these funds into more flexible strategies that should fare better in the uncertain interest rate and credit environments forthcoming. Caution continues to be the driver going forward as the global economy shows modest signs of sustained recovery. We continue to be slightly underweight domestic equities in our models and have placed increased emphasis on funds that seek out the best risk/return opportunities among global classes. These same funds are also quick to move to defensive positions as conditions warrant.

LTC Seminars

Just a reminder, we are hosting 3 long term care seminars to provide information to you on the financial risks of needing care and the options to mitigate the risk. Tammey Sullivan, a long term care specialist, will be our guest speaker. The seminars will be held at our building and will begin at 6:30 with light snacks and desserts with a presentation beginning at 7:00. We have two of the dates scheduled including Thursday, May 13 and Thursday, June 3rd with a third date pending. We have had several clients respond but have space to accommodate more of you. Please call the office if you have interest.

The Long Road Ahead

Headwinds

The path forward is still filled with uncertainty. Historically, following a deep recession, the U.S. economy grows

for several quarters at an annualized rate of 6-7%. There are many factors that lead us to believe that growth for the next couple years is likely to be around half that level.

One of the most important contributors to a strong and sustainable economic rebound is job creation. The labor market appears on the verge of a turnaround, but there is little sign of strong job growth. The monthly survey from the National Federation of Independent Business continues to show reluctance to hire. To exceed the growth rate of the working-age population, employment probably needs to rise by more than 150,000 a month. According to Ned Davis Research, if job growth averages 150,000 a month over the next 10 years, unemployment won't fall below 6% until 2019. A strong temporary snapback in job creation at some point would not be surprising. With over eight million jobs lost, there was probably some overreaction on the part of businesses that will be reversed. However, it is likely that many businesses are adjusting to a smaller workforce in the face of continued concern about future economic growth. The weight of the evidence suggests that, even with a strong temporary snapback, we shouldn't be optimistic about the return to a strong labor market for several years.

In normal cycles, the consumer is the key to sustained growth. Economies are driven by the demand for goods and services and consumption drives about 70% of U.S. GDP. Below are the four primary factors driving consumption and the associated recent status of each.

1. Consumer income: Real personal income has declined over the past two years, primarily driven by high unemployment.
2. Consumer wealth: Overall household net worth is down close to 20%.
3. Consumers' ability to borrow: Asset levels are down. Capacity to take on more debt has hit a wall and lending standards have tightened.
4. Consumers' spending desire: Frugality is the mindset of consumers. No longer is there a willingness to support spending.

Before the decades-long trend of leveraged consumption, the consumers' contribution to GDP was in the low 60% range. It is possible that we may revert back to comparable levels in the future.

Other areas of continuing concern are weakness in the growth of bank lending, commercial real estate debt,

housing market strains, and the potential for future high inflation as a result of deficit spending.

Tailwinds

Domestically, the health of the corporate sector is strengthening. Indexes for both manufacturing and service oriented companies indicate that both are in strong expansion mode. In fact, the manufacturing index is at its highest level since 2004 and the service sector is growing at the fastest pace since May 2006. Durable goods orders are up and industries such as manufacturing, construction, and mining added 41,000 jobs last month. As we write this newsletter, earnings are becoming public and analysts are expecting a 37% rise in first quarter profits. Much of the corporate sector is generating cash flows sufficient enough to pay down debt and self-fund future growth. Significant cash amounts on balance sheets provide ample ammunition for future mergers and acquisitions and capital expenditures. The resilience of emerging market growth continues to provide opportunities for those companies generating revenues through international sales. An environment of moderate economic growth, low inflation, and extreme policy stimulus has been very supportive to "risk asset" prices like stocks and non-government bonds.

Globally, manufacturing levels have risen to their highest levels in nearly six years. Much of the emerging world is not saddled with high debt levels, and many countries should benefit from a rising middle class. Many of these countries have commodity-driven economies that benefit from emerging world growth. Others are highly competitive in a number of export industries.

The Investment Outlook

Massive policy stimulus has broken the downward spiral in asset values and economic activity but we have yet to see a strong self sustaining recovery in confidence and spending. Deleveraging remains a major headwind and we don't yet know if the economy will be strong enough to stand on its own as government supports are withdrawn. Our approach remains cautious with a slight underweight in equities. The potential for active managers to outperform still exists as opportunities to find bargain valuations arise. We have positioned portfolios for an environment of rising interest rates and potentially higher inflation. Investments in global equities and bonds are in areas of strong growth with minimal exposure to the deficit problems seen here and in Europe. We are constantly challenging our assumptions and seeking out those inefficiencies in the markets that provide opportunities to add value.