

Celebrating Our Second Decade of Providing Unbiased Financial Advice

“If all the economists were laid end to end, they’d never reach a conclusion.”

-George Bernard Shaw

Angst & Uncertainty Rules!

The first six months of 2010 have been a roller coaster ride with stocks up early in the year, then down in February, back up in late April, then down again by the end of June. The S&P 500 ended the second quarter down 6.65% for the year. Smaller US stocks, as tracked by the Russell 2000 index, lost 1.95%. Foreign stocks followed a similar pattern, losing 13.23% (EAFE index).

On the brighter side, most bond strategies made money. US bonds, as measured by the Barclays Aggregate Bond Index, earned 5.33% for the six month period and more aggressive global and lower credit quality strategies used by Loomis Sayles Bond and Templeton Global Bond returned 4% and 3.67% respectively through June 30.

The increased volatility and see-saw market action of the last six months are indicative of skittish investors who are seeing (or hoping for?) some improvement in the economic metrics on the one side yet immersed with the structural concerns about public and private debt levels, government leadership and policies, and the sustainability of the economic recovery on the other. This tension has left investors uncertain and led to the large

day-to-day swings in the market as investors react to the latest news which spins the arguments one way or the other.

We said going into the year that 2010 wasn’t going to be easy. After a robust recovery in the market in 2009, the US economy is now coming off its “sugar high” (i.e. government support programs) and handing off the job of generating long-term economic growth back to the private sector. This transition almost never goes smoothly and with high unemployment, uncertain housing markets, and debt-related stress points, the road to recovery will likely be a long and drawn out affair for the US and Europe with the possibility of increased risks along the way.

Fortunately, key parts of the developing world are in much better shape with higher growth rates, better finances, younger populations, and emerging consumer sectors. Their strength is an important source for the global recovery. Other positives include continued loose monetary policy throughout the developed world and healthy corporate balance sheets and cash flow along with impressive productivity and earnings growth. Taken together, this nets out to a global economy, that while improving, is still very fragile.

News Notes

Settlement Paperwork

For those of you receiving settlement paperwork for Schwab Yield Plus or Strong Funds, no response is needed. For other settlements, please call us. Thank you!

Research-on-the-Go

ISG partners are looking beyond state borders for the latest in portfolio strategies. Mitch Powers recently returned from a national conference held in Miami on alternative investments. Rich Rust will be meeting with portfolio managers in San Francisco later this summer to size up emerging investment opportunities and trends in Asia. This fall, Mike Dibala will be interfacing with portfolio managers and other strategists at Charles Schwab’s annual advisor symposium in Boston.

Notes From Our Committee Meetings

Given the high levels of uncertainty among our clients, we thought it would be helpful to share with you some of our current views and investment “themes” driving our investing decisions. What follows is an “insider’s view” from some of our recent weekly investment meetings.

1) **Sub par recovery and stock return outlook for the US and Europe.**

Serious headwinds constrain growth over the next several years (at least). No double dip recession. Overall markets not compellingly cheap...which they need to be in order to get us to historical return levels in the slower growth environment (most “experts” expect 6% - 8%/yr from these markets in the next five years). Higher-than-historical risk exists given fragile public finances and uncertainties about future policies. Tread carefully.

“Wild cards” which could improve the return outlook:

a) Better than expected corporate earnings growth attributable to continued productivity enhancements/high profit margins as US/European companies tap into surging consumer demand from the developing economies.

b) Skilled stock pickers thrive in the volatile, range bound environment and deliver better-than-market results. This happened over the last decade. We need more data to support this thesis and will monitor future results closely.

For now, remain underweight in these asset classes versus traditional “textbook” allocation guidelines.

2) Higher growth and stock return prospects from the developing economies.

A global transformation is underway shifting some of the economic prowess and wealth from the US/Europe to the developing economies. Better fiscal finances, younger demographics, and early growth stage economies create return tailwind for stocks. Be careful. Smaller financial markets still susceptible to in/out money flows. Stock prices today are no screaming bargain. Increase our exposure here opportunistically.

3) Developing market currencies should do well.

Higher yields plus appreciation potential versus US dollar make total return prospects attractive versus other asset classes. This is a complex investing strategy. We should rely on specialists like Michael Hastenstab at Templeton Global Bond or the emerging markets fixed income team at PIMCO. Review current model portfolio exposures to see if increased weightings are warranted.

4) Continue with meaningful allocations to conventional higher quality bonds.

Maintaining defensive “ballest” during these uncertain times is a top priority for most. No changes here.

5) Commodities.

Still too early to assume a dedicated allocation although we get exposure through various stock funds, particularly those in the developing markets.

Risk Management

Given the fragile nature of the markets (and investor psyches), much of our weekly investment discussions have centered around how we can better manage volatility and other risks in this challenging investment environment.

We’ve taken a number of actions thus far. First, we’ve gone back and reviewed our valuation work on all the major asset classes (US and foreign stocks/bonds, REITS, etc). This is important work for us given our belief that, regardless of how good or bad the macro outlook, investment results (including risk levels) are determined by price levels relative to estimated growth and income benefits.

Next, we’ve incorporated some nimble, equity-oriented strategies which should be able to adjust more effectively to steep market declines due to their more flexible investment charters which allow for greater movement into defensive assets when necessary. These new allocations have watered down our overall equity exposure with hopefully minimal sacrifice in investment return. We’ve adopted similar strategies for our fixed income holdings in trying to be proactive about the negative effects of rising interest rates on bond performance.

We are also reviewing alternative investments and strategies which we believe can add value to our portfolios and do not necessarily move lock-step with our conventional holdings. This might be a hedge fund type product specializing in “merger arbitrage” or a stock strategy that “hedges” against a down market using options or short-selling. It could also simply be an income oriented strategy like unleveraged real estate or high yielding stocks or ETF’s.

In short, we’re not jumping on the next product du jour, but hopefully, these efforts will enable us to better navigate the murky investment climate ahead of us.

6) Misc.

Keep reviewing alternative investments in real estate, stock “hedging” strategies, higher dividend-paying portfolios. Keep worrying about higher interest rates and inflation but most likely a problem for another day.

In sum, we remain defensive in this uncertain environment and are focused as much on managing risks (see box, “Risk Management”) as we are on identifying return-enhancing maneuvers. Longer-term, we continue to transition away from a US-centric portfolio approach to one that is more global and nimble. As always, we encourage you to contact your individual advisor should you be interested in more details.