Lassus Wherley ...a view from the top
Building Better Futures
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Off and Running: For Now!!!

Food for Thought

Happy end of first quarter! I have no complaints about what has occurred in the financial markets over the past 12 months including the 1st quarter of 2010. In fact, I am thrilled that we have seen a pretty consistent move up in many of the asset classes. There are many open questions floating around right now, like "How long will this upward trend continue?" Another question is when this market takes a breather, and we know it will, is it going to be simple profit-taking or will it really be another "leg-down." The idea of another "leg-down" is what has people worried. We don't believe we will see a really steep drop anytime soon, but we still remain somewhat defensive and have kept a higher percentage investment in our hedge strategies funds for our "just-in-case" scenario. That means we are willing to give up some returns as the market goes up quickly in order to lose less when the market goes down.

Review of the Quarter

by
Anne L. Kehl, Investment Officer

The US stock market returned 6.0% in March 2010, adding to February's 2.85% return. At this point, the S&P 500 has returned 5.39% for the first quarter with January's 3.70% loss having been erased. European stock and bond markets have been quite volatile this year due to the debt crisis in Greece. The Euro has declined vs. the US Dollar. Fears that Greece could default on its sovereign debt spilled over to some of the other southern European countries such as Portugal, Italy, and Spain. Greece's budget deficit is about 12.7% of GDP which is roughly four times the ceiling set by EU budget rules.

Greece was able to sell some bonds in March after announcing austerity measures designed to reduce their budget deficit. The issue is that investors are requiring yields over 6% on Greek 10-year debt or twice the rate paid by Germany. Towards month end, the leaders of the EU agreed on a plan under which the EU and the International Monetary Fund would jointly bail Greece out if the country is not able to sell debt to cover its borrowing needs. At month end, Greece announced that it intends to sell $5 - $10 billion in US Dollar denominated bonds in the US and Asia in order to try to tap markets outside of Europe. Greece's finances remain tenuous as the country needs to refinance about $27 billion in debt in April and May.

We expect that this issue will not be easily resolved and will continue to be in the news for several months. The US Dollar should trade stronger versus the Euro based on concerns about the impact of the Greece debt. These concerns should support demand for US Treasuries in the short-term.

The rally in US stock markets this year has been fueled by investors' increasing confidence in the economic recovery. Not surprisingly, European stocks have declined 1.95% in the

first quarter, while Asia-Pacific stocks are up 3.87%. Japan is having a banner year, with good performances by large exporters leading to a 7.32% gain in the quarter. Emerging stock markets are taking a break after last year's torrid run, with a year-to-date gain of just over 2%.

According to Morningstar, the highest returns on Domestic Stock funds this year have been registered by the most cyclical categories. Topping the leaders have been Industrials, Consumer Discretionary, Small Value and Real Estate funds. Equity Energy and Utilities funds have been bringing up the rear among Domestic Stock funds. Performance in Fixed Income funds has been led by the 4.6% return on Emerging Markets Bond funds, an area we have added to in our portfolios as part of the International Bond Asset Class. Returns on the Long Government category are 0.87% for the quarter, as investors trimmed positions in long-dated US Treasuries in advance of any moves by the Fed to raise interest rates, and as concerns grew that the recently passed health care reform legislation might have the potential to widen the US budget deficit.

We find that both US and International Large Cap remain particularly attractive asset classes and we continue to rebalance funds into them. We invest in the International Large Cap asset class through DFA Large Cap International fund (DFALX). This fund invests in developed markets outside the US, including countries in Europe, Asia and North America.

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What's Next

The global economy is recovering and there are enough forces in place to eventually turn this recovery into an expansion. In the US, we continue to have pent-up demand among the four most cyclical areas of the economy – autos, housing, capital spending and inventories, and much of the $780 billion fiscal stimulus that was passed just over a year ago is still sitting there waiting to be spent.

Fed Chairman Bernanke's position continues to be that with inflation low, or even negative, the Fed intends to keep rates low for an "extended period." While at some point the Fed will move to raise rates, we don't see that happening until much later in the year. The actual timeframe for moving the fed funds target up depends on how the economy fares over the summer months. There is still a deflationary pressure in the global economy.

In fact, the easy monetary policy which major central banks in the developed world have conducted since the financial crisis began is possible because inflation remains largely absent. The global recession and very high levels of unemployment have created a lot of slack in the system and no upward pressure on wages.

Stocks have tended to do well in most periods when the federal funds target is low and in particular in the year or so leading up to the first rate increase. We believe that the current "neither too hot nor too cold" (Goldilocks) economy is one that should allow for respectable returns on both our equity and fixed income investments over the course of the year 2010.

There are many positives that could continue to fuel growth in this market including the fact that so many individual investors are still sitting on the sidelines. They are too afraid to move dollars back to equity investments so they either keep their money in cash where they aren't earning anything or they are moving into bonds and bond funds. At some

point, they will become worried that they are missing the boat and will move back to equity funds.

Corporate balance sheets are certainly looking better, which is good news for the future. Corporate profits have improved and the amount of cash held by non-financial companies in the S&P-500 has risen to over $830 billion. We also recognize that more and more people believe the economy is moving in the right direction.

Have all the negatives disappeared? No. We still have concerns around the impact of health care reform and tax increases but the positives outweigh the negatives at this stage of the cycle. A potential wild card includes rising interest rates in emerging markets. The economies of Brazil, India and China have continued to grow, putting pressure on their governments to push up interest rates to slow things down.

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Thank you, as always, for the great questions you send our way. You keep us on our toes and we appreciate the opportunity to respond and share the answers with other readers. Here are some of the questions with our responses:

Question: *What do you think about inflation at this point?* **Answer:** We think that inflation is unlikely to pose a problem in the near term due to the slack in the system and the lack of wage pressure. The fact that banks are keeping high levels of reserves, rather than creating new loans, is also serving to keep inflation low. For these reasons, there is low risk of inflation over the near term. We think that core CPI is likely to return to positive territory but still stay low this year as the global economy recovers.

Question: *What do you think about inflation further down the road?* **Answer:** At some point the fiscal and monetary stimulus that was implemented in order to stabilize economies in the financial crisis will need to be unwound to reduce inflationary conditions. In the U.S., for example, the Federal Reserve has been following a very easy monetary policy in order to stimulate demand and give a boost to the housing market. In addition to maintaining a targeted federal funds rate of 0.0% to 0.25%, the Fed has also dramatically expanded the size of its balance sheet through the purchase of US Treasuries and agency debt.

There were solid reasons for taking these actions both on the fiscal (government spending) and monetary side (Fed's easy money policy). At some point, the stimulus will need to be taken away and the Fed will need to execute on its "exit strategy". The Fed can now continue to pay interest on reserves and is likely to continue to do so as a way to influence banks' behavior. If they are paid interest on reserve balances, banks will remain willing to keep cash in excess reserves rather than use it to create credit and expand the money supply. This will help to contain growth in the money supply and inflation.

Those who argue that inflation will get out of control are in many cases assuming that the Fed will delay too long in starting to raise rates and that the fiscal deficit will become too large to be financed. Inflation could also come about as a result of the industrialization of developing economies such as China and India. While the current deficit is indeed large by historical standards, there remains significant interest in owning the debt of the US in spite of the size of our deficit. Recent events in Europe and concerns around the viability of the Euro have reinforced our belief that the US Dollar and US Treasuries

will remain in demand for the foreseeable future.

The US Federal deficit has in fact been higher as a % of GDP than it is now. In FY 1943, the deficit was over 28% compared to the 10.6% in FY 2010, according to www.usgovernmentspending.com. This earlier deficit was reduced as a share of GDP by the growth in the economy in the post-war years. As long as the deficit does not become entrenched or as long as the debt is not financed through the creation of new money, it does not have to become inflationary.

On the monetary policy side, it is possible that the Fed will succeed in managing its exit strategy. We think that the Fed is in good hands under Chairman Bernanke and that the central bank has a good chance of being successful in facing the monetary policy challenges. While that is the case, we have been adding Treasury Inflation Protected Securities (TIPS) to portfolios since last August as a form of insurance, in the event that inflation becomes more of an issue than we expect in later years.

The 10-year breakeven inflation rate of 2.23% is in line with its long-term average. This indicates that, over the next ten years, the market is only expecting inflation of around 2.23%. The very existence of TIPS is a helpful and relatively recent tool which gives both policymakers and investors a real-time gauge of inflation expectations on a day-to-day basis.

So, while we remain optimistic that inflation will not get out of hand, we will continue to monitor closely the inflation expectations reflected in TIPS prices and will increase our exposure here as well as to commodities if we see any significant move up.

Question: *Are you planning on adding any new funds to my portfolio?* **Answer:** Yes, we have begun to initiate positions in the PIMCO Emerging Markets Bond fund, symbol PEBIX. We will be splitting the allocation in International Bonds between DFA Selectively Hedged Global Fixed Income (DFSHX) and the PIMCO Emerging Markets Bond (PEBIX) in many portfolios. The objective of both of these funds is to maximize total returns. You should expect to receive both income and growth from your investment in these funds over time.

DFSHX invests in US and foreign short term debt, primarily of developed market countries. The fund selectively hedges its foreign currency exposure depending on where rates are in the various markets in which it invests. Rates on short term debt in developed countries have come down dramatically as central banks have kept their target rates low.

We have chosen to invest in PEBIX in order to increase the diversification of our portfolios and to capture some of the higher yields that are available in emerging markets debt. We expect to benefit in this way from both the higher economic growth being experienced in emerging markets and from their improving credit conditions. The fiscal deficits of emerging market countries such as Brazil, Mexico and Turkey are much lower as a percent of GDP than the deficits of developed countries such as Japan, the UK or even the US. The fiscal health of the emerging markets has greatly improved over the past decade while that of developed markets has been negatively impacted by the housing crisis and the economic woes it brought about.

We have chosen to invest in emerging market debt through the PIMCO fund given that it emphasizes preservation of capital as well as total return. This fund is a more conservative

way to invest in this asset class. PEBIX invests in those countries in the emerging markets with the best outlook on specific factors such as interest and inflation rates, monetary and fiscal policies and trade and current account balances. The portfolio of PEBIX is overweight in the higher quality countries among the emerging markets. The credit quality of the fund is higher than its benchmark, with an average quality rating of BAA-.

We like the fact that the team at PIMCO that manages PEBIX has been together for more than 10 years. Emerging market debt funds are more volatile than traditional US fixed income funds but we believe that the addition of PEBIX will add to returns in our portfolios over the long term given improving credit quality in emerging markets and their yield advantage.

Question: *What is an inter-class exchange?*
Answer: An inter-class exchange means moving from one share class of a mutual fund to another. We have done four of these transactions this year. They were described in different ways on your statements, depending upon where your account is held. They were described as buys and sells at Schwab, as share class conversions at Fidelity and as exchanges at National Advisors Trust. In each case, we moved from a share class with a higher expense ratio into a share class with a lower expense ratio, typically an institutional share class.

We are always trying to keep our costs as low as possible. The expense ratios are actually very low for both the Vanguard Investor and Admiral Share classes. (Bond funds have lower expense ratios than stock funds and Vanguard's are among the lowest.) There is a $100,000 account minimum for holding the Admiral Share class of any Vanguard fund. If the position held in either VFIJX (Admiral Share class of Vanguard GNMA) or VFSUX (Admiral Share class of Vanguard Short Term Investment Grade) dips below this minimum, your shares will revert back to the Investor Share class in that fund. Either way, you will be paying among the lowest fees for expert bond management.

Not all families of mutual funds have institutional classes of their mutual funds but many are adding them. There is no transaction cost to you for these inter-class exchanges and there is no tax impact. So if you see an exchange in the same fund family it may very well be to an identical fund that has lower expenses.

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Looking Forward

Keep those questions coming in. If you are wondering about something, the odds are pretty good someone else may also be thinking about the same topic. When you ask—we get the chance to share our thoughts on the topic with others.

Please let us know if you have any questions or concerns. We are definitely looking forward to a continued recovery in the markets and the economy. Enjoy a wonderful Spring!

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