

The Great Recession may be officially over, but we continue to expect that sluggish economic growth may continue for years.

We realize this is a similar story to what we've been writing in the last few quarters, and it's not necessarily encouraging. However, it's not all gloom and doom either. In the scenario we think is most likely, the economy continues to grind ahead slowly as we work through the aftermath of the recent crisis. While we think it will take years to work through all of the housing, debt, and job market issues, at least we are on that track.

However, we think significant risks remain, and at current valuations, we aren't being paid very well for taking on risk.

Though we see few tactical opportunities at the moment, we believe that the longer term environment will be one that favors our tactical asset allocation approach, as periods of fear and volatility create compelling opportunities.

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Quarterly Investment Commentary

The stock market continued its roller coaster ride in the third quarter, with strong September gains bringing returns solidly into the black for the full quarter. The large-cap Vanguard 500 Index (a proxy for the S&P 500) is up 11.3% for the third quarter, yet just 3.8% for the year. Foreign stocks had an even stronger quarter, with Vanguard Total International Stock Index up 17.9%, bringing the year-to-date gain to 3.7%, while Vanguard Emerging Market Stock Index gained 18.7% for the third quarter and is up 10.6% for the year. On the bond side, Vanguard Total Bond Market Index posted a solid 2.4% gain for the quarter and is up nearly 8% for the year to date. Emerging-markets local currency bonds climbed roughly 6% in the quarter and have gained about 16% so far in 2010.

Our portfolios have been underweighted to equities and overweighted to bonds, and this conservative bias helped boost our performance vs. portfolio benchmarks this year. This outperformance was also enhanced by the strong showings of many of our active bond and equity managers, as well as our tactical position in emerging-market local-currency bonds.

Investment Outlook

The National Bureau of Economic Research recently announced that the Great Recession officially ended in June 2009—marking the country's longest and deepest recession since the 1930s—but our big-picture view of the economic environment in the United States remains cautious and is largely unchanged from what we have been describing over the past year. We continue to believe we are in for a sustained (multiyear) period of subpar economic growth as a consequence of the financial crisis of 2008 and its aftermath. Ongoing “structural” headwinds such as consumer deleveraging, high levels of unemployment and underemployment, weak wage and income growth, tight credit availability to households and small businesses, weak housing markets, higher taxes, and cuts in local, state, and federal government spending in response to their financial difficulties all imply that aggregate demand, and ultimately corporate revenues and earnings growth, are likely to be under pressure for a while. In short, this is not your typical post-WWII business cycle.

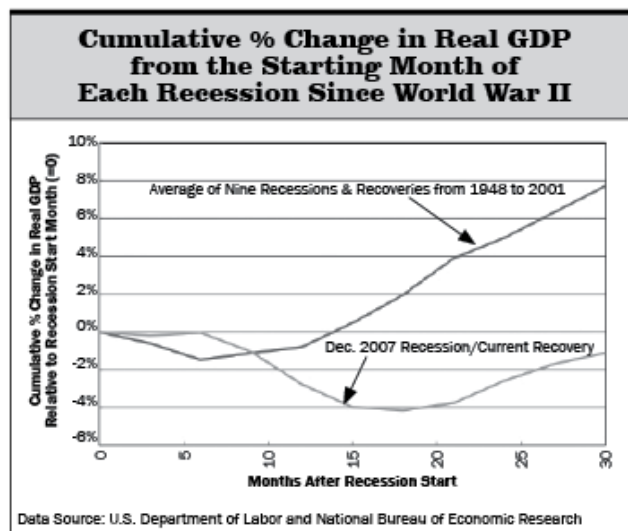
With regard to deleveraging, households have started to make progress reducing debt toward sustainable levels—although they still have a considerable way to go—but federal government debt has ballooned.

In the second quarter, household debt contracted by \$57 billion (a 2.3% annual rate), marking the ninth consecutive quarterly decline. State and local government debt also declined slightly in the second quarter after five consecutive quarterly increases. However, growth in federal government debt continued to soar, at an annual rate of 24%. Over the medium to longer term, there is a great deal of uncertainty about the ultimate resolution of the growing government debt problem. But even in the near term, there remain serious questions about the sustainability of the current (weak) economic recovery as the short-term boost from business inventory restocking ends and the \$800 billion federal stimulus program winds down. After spiking to a 5% growth rate in the fourth quarter of 2009, real GDP growth dropped to just a 1.6% annualized rate in the second quarter of 2010. The recent economic weakness is not a surprise to us and is consistent with the view we expressed a year ago as the economy finally emerged from its deep downturn when we wrote, “It is the expectation of slow consumer spending growth coupled with increasing regulation and likely reduced risk taking on the part of businesses and investors (relative to much of the past 20 years) that suggests to us that any near-term burst of economic activity is unlikely to be sustained at a robust level.”

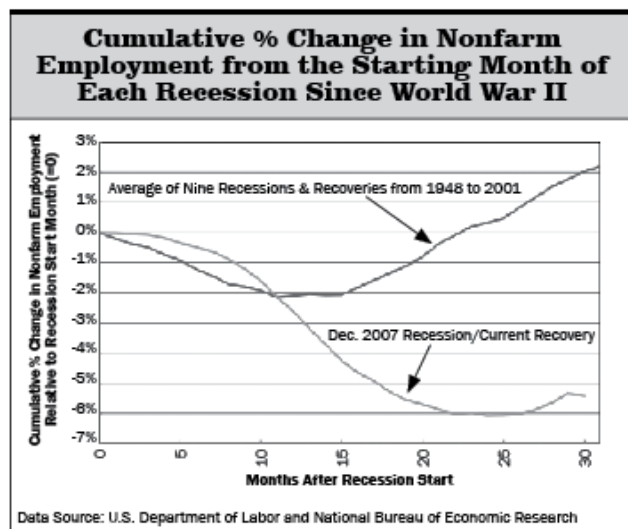
Exacerbating the economic uncertainty is the significant political uncertainty and risk of policy errors. Most pronounced is the tension between those who argue for fiscal austerity now in order to start addressing our deficit and debt problem, and those who

argue that more government stimulus is needed to get the economy out of its current rut. On the one hand, if the creditors who are lending to the U.S. government at the current very low interest rates (2.5% for a 10-year Treasury note) start to lose faith in the credibility and credit-worthiness of the United States and/or the dollar, that could lead to a sharp rise in interest rates, which would not be good for the economy. Fifty percent of Treasuries are held by foreigners, with China and Japan each accounting for 10% of the total. On the other hand, a premature move towards fiscal restraint—before the economy is in a self-sustaining growth mode—could tip the economy back into recession or worse, as economic historians argue was the cause of the second down-leg of the Great Depression in 1937.

We realize this is a similar story to what we’ve been writing in the last few quarters, and it’s not necessarily encouraging. However, it’s not all gloom and doom either. To be balanced, there are some positive economic signs. Industrial production and earnings have rebounded strongly (more strongly than we expected). Profitability is high (due to aggressive cost cutting during the recession) and companies also have very high levels of cash on their balance sheets. (However, it should be noted that corporate debt levels are also very high, as companies have opportunistically issued long-term debt and held much of the proceeds in cash.) The personal-savings rate rose to 6.1% in the second quarter, which, while not



GDP data through June 2010.



Employment data through June 2010.

helpful for near-term economic growth is necessary for the longer-term healing of the economy. Interest rates remain low and relatively stable. (But low rates also reflect the risk of deflation and even the Federal Reserve recently stated that inflation is currently “somewhat below” its target range.) Developing economies continue their high rate of growth (the IMF forecasts they will grow 6.5% next year versus 2.5% for the developed world) and have relatively strong fiscal/debt balances, which should drive growth in emerging-market demand for U.S. exports.

While we acknowledge these positives, we continue to view the economic/macro risk as asymmetrical in that a negative shock to the system could tip the fragile economic recovery back into a recession, but it’s hard to imagine a substantial positive shock to economic growth or employment. (A peaceful resolution to the various conflicts in the Middle East would be an example.) In the parlance, we believe the left (negative) tail of the distribution of potential outcomes is fatter than normal. Of course, that doesn’t mean there won’t be positive surprises and developments that are good for societies, economies, and businesses. But given the imbalances currently in place, we view the macro risks as still skewed toward the downside.

We Consider a Range of Outcomes in Making Portfolio Decisions

Meanwhile, investment opportunities are more a function of price than of the overall economic story. As we work through our analysis for each asset class across the various scenarios we think are most likely or plausible, the potential risk versus potential reward for most of them is not attractive. (See table, “Scenario Analysis: Asset Class Return Estimates,” below.) Following is a brief summary of our outlook for some of the key asset classes we closely follow.

U.S. Equities – At current prices, we don’t think stocks are cheap enough to provide a level of return to fully “pay” us for taking on the additional risks that exist. We expect to see average annual returns only in the mid-single-digits in the “muddle-through” or sub-par recovery scenario we consider more likely (and that equities would lose money in our more negative economic scenario). As a result, we continue to underweight equities in our portfolios. With this positioning, it important to remind our clients that if there is a strong upward move in stocks, we would expect to underperform our portfolio benchmarks.

Scenario Analysis: Asset Class Return Estimates

Economic Scenario	Scenario 1: Subpar Recovery	Scenario 2: Stagflation	Scenario 3: Recession Recur/Deflation	Scenario 4: Goldilocks
<i>As of 9/28/10 S&P 500 at 1142, Barclays Aggregate yield at 2.5%, 10-Year Treasury at 2.48%, MSCI EM Index at 1061, Merrill Lynch High-Yield Cash Pay Index at 7.72%.</i>				
Equity Asset Classes	Estimated Average Annual Returns over Next Five Years			
U.S. Equities	4.0%	-0.4%	-2.4%	11.0%
Developed International	<i>Similar to U.S. Equities, but exact ranges still in progress.</i>			
REITs	-0.9%	0.7%	-2.0%	1.6%
Emerging Markets	5.7%	n/a	-2.2%	13.6%
Fixed Income Asset Classes				
Investment-Grade Bonds	0.8%	0.8%	1.7%	0.8%
High-Yield Bonds	2.9%	3.3%	2.6%	3.8%
TIPS	0.3%	4.5%	1.4%	0.3%
Emerging-Markets Local-Currency Bonds	<i>High single-digit returns in Scenarios 1, 2 and 4, and potentially zero to low single-digit returns in Scenario 3</i>			
Alternative Asset Classes				
Arbitrage Strategies	<i>Mid single-digit returns in most scenarios</i>			

Given our overall views, though, we think it is prudent to accept that possible “opportunity cost” while we wait in a more protective position for more compelling opportunities.

While we don’t consider stocks overall as cheap, many of our active equity managers, on the other hand, still report finding good opportunities at the stock-picking level. Our top-down asset-class return expectations are based on the overall market’s valuation and profit characteristics, but we continue to note a wide gap between our top-down return expectations and the very attractive bottom-up, company-specific return opportunities many of our equity managers are identifying, for example, among high-quality U.S. multinationals. While most equity managers have a natural bias towards equities, many of our long-tenured managers are telling us that the expected returns from their portfolios are better than average right now, suggesting that they may be able to generate double-digit returns over the next three to five years from active stock picking.

We have also heard a number of equity fund managers make the point that stocks have never been more attractive *relative to* bonds. They will typically compare the stock market’s earnings yield (the inverse of the price/earnings ratio) relative to current bond yields and note that the gap is very wide relative to historical norms. While this is suggestive, it is only part of the picture in our view. When constructing portfolios we assess not only the potential returns but also the potential risks. And while our return analysis is based on a five-year time horizon, we look at risk on a shorter-term, 12-month horizon. To say that stocks are likely to beat bonds over five years ignores the significantly higher downside risk (at least over a 12-month period) of stocks versus bonds. While we’d agree that the stock market is likely to beat the bond market over the next five years, when we look across our scenarios we don’t think we are being adequately compensated to take on additional equity risk at current valuations. Moreover, we believe our active bond funds are all likely to outperform the bond index over this period, which reduces equities’ relative attractiveness (or put differently, it reduces the opportunity cost of being underweighted to equities).

Investment-Grade Bonds – Returns across the broad intermediate term, high-quality bond universe are similarly unexciting. We think this overall asset class is unlikely to generate more than low single-digit returns in the next five years. That said, we believe the bond market is generating good investment opportunities within certain bond sectors. As on the equity side, by identifying and investing with highly skilled, opportunistic bond managers – such as Osterweis Strategic Income and PIMCO Unconstrained Bond – we believe we can earn competitive returns at very acceptable risk levels. While part of our fixed-income allocation is dedicated to these non-traditional strategies, core positions in high-quality bonds (as we have through PIMCO Total Return) also play an important role in diversification in the event we see a major downturn in the economy and stocks, which is something we can’t rule out.

Emerging-Markets Local-Currency Bonds – We are especially enthusiastic about the opportunity we still see in emerging-markets bonds, denominated in local currencies. This is an asset class that has attracted more attention recently, with many others coming to recognize the characteristics that attracted us to take our tactical positions over a year ago. Current yields in these bonds are well above what we can earn in developed market bonds (including the U.S.), and their prices would further benefit if the dollar declines in the years ahead as we expect. Further, many of these emerging market economies are in far better shape than the developed countries’, with trade surpluses, strong government balance sheets, and an emerging consumer class.

Arbitrage Strategies – Late in the second quarter of this year we added two absolute-return-oriented arbitrage funds in our balanced portfolios. We view these as relatively low-risk strategies – having more downside than a core investment-grade bond fund but much lower risk than equities – that we expect will generate at least mid-single digit annualized returns over the next several years. We also expect

them to have low correlations to the stock and bond markets, providing additional diversification to our balanced portfolios. These lower-risk/lower-return strategies are particularly attractive right now given our muted return expectations for stocks and bonds.

Concluding Thoughts

We'd like to reiterate several important points that define the environment we're in and how we're positioned.

First, this is not a typical business cycle; it is the aftermath of a financial crisis the likes of which the United States has not experienced since the 1930s. Therefore, one should not rely on the cycles of the past few decades as a road map for what the next five years are likely to entail.

This is an environment that requires an intensive and disciplined analytical approach that is also flexible and open-minded in assessing the risks and investment opportunities. One must be aware that the four most expensive words in investing are *It's Different This Time*, while also understanding that this period is different from the rest of the post-WWII U.S. economic and financial experience, and understanding the investment ramifications of these differences.

The range of potential economic outcomes is unusually wide, with some severe bad outcomes probably more likely than historical experience would suggest, i.e., the "left tail" risk is larger. Based on our analysis and assessment we remain underweighted to risk assets (equities) in our balanced portfolios. While this means our portfolios should hold up relatively well in a subpar or more negative scenario, they will likely lag if a bullish scenario plays out in the near term.

The multi-decade tailwind of declining interest rates for bonds is likely over, so returns from traditional bond indexes will be low. Equity index prospective returns also look subpar relative to their long-term historical averages. With lower returns likely, it is a good time for investors to revisit their financial independence or retirement plan and make adjustments accordingly. Lower returns compounded over the next five to 10 years might push back retirement dates or require adjustments to spending levels. Investors should also reevaluate and be honest about their true risk tolerance and make sure their overall portfolio allocation is consistent with it. The experience of 2008 through 2009 provided everyone a real-world test of their ability to handle extreme risk and volatility.

In light of the above, we believe this is an environment that favors Litman/Gregory's tactical asset allocation approach and opportunistic investments in asset classes and strategies outside of the standard stock and bond indexes. Our role will be to continue focusing our research efforts on assessing risks across a variety of scenarios, identifying compelling asset class opportunities when they occur, and owning active managers/strategies that we are confident can outperform. – *Cox Financial Services, LLC Research Team (10/11/2010)*