

We saw decent economic growth in 2010 but a number of significant stresses remain.

Household debt and unemployment are slowly improving but remain high, and the housing market appears to be weakening again. The huge government debt will pose a major challenge in the years ahead that is made tougher by exploding growth in federal entitlements. State and local governments are stressed as well.

Despite our conservative bias, our portfolios have performed well over the past two years thanks to our tactical calls and strong performance by some of our active equity and fixed-income managers.

With overall risk elevated and return potential for riskier asset classes muted, we are satisfied that our current allocations can provide competitive returns at less risk over our multiyear horizon. We also expect periods of fear to create compelling opportunities, and that our discipline and patience will allow us to take advantage of them when they do occur.

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Quarterly Investment Commentary

A strong fourth quarter rally, punctuated by a December sprint, turned an okay year for stocks into a very good one. The large-cap Vanguard 500 Index gained nearly 11% for the quarter, and ended 2010 up 15%. The small-cap iShares Russell 2000 and iShares Russell Midcap both returned in the mid teens in the fourth quarter, and gained 25% and 27% for the year, respectively. Looking abroad, the story was similarly positive for emerging markets, with the Vanguard Emerging Stock Index climbing 7.5% in the quarter and 19% for the year. Developed-market foreign stocks also had a good year, but returns for the benchmark Vanguard Total International Stock Index were restrained by concerns over Greece's fiscal problems earlier in the year and Ireland's later in the year, which drove the euro (and therefore returns to U.S. investors) lower. The Vanguard Total International Stock Index nevertheless gained a healthy 7% in the fourth quarter and 11% for the year.

Turning to fixed income, the Vanguard Total Bond Market Index Fund, a proxy for high-quality intermediate-term bonds, saw most of its 1.4% fourth-quarter loss come in December. Still, its strong performance earlier in the year left it with a full-year gain of just over 6%. Foreign bonds also struggled through the fourth quarter, with the Citigroup World Government Bond Index falling 1.8% and the emerging-markets JPMorgan GBI-EM Global Diversified Index down 0.4%. Each index was in the black for the year, with emerging market debt returning a notable 16%.

Macro Thoughts

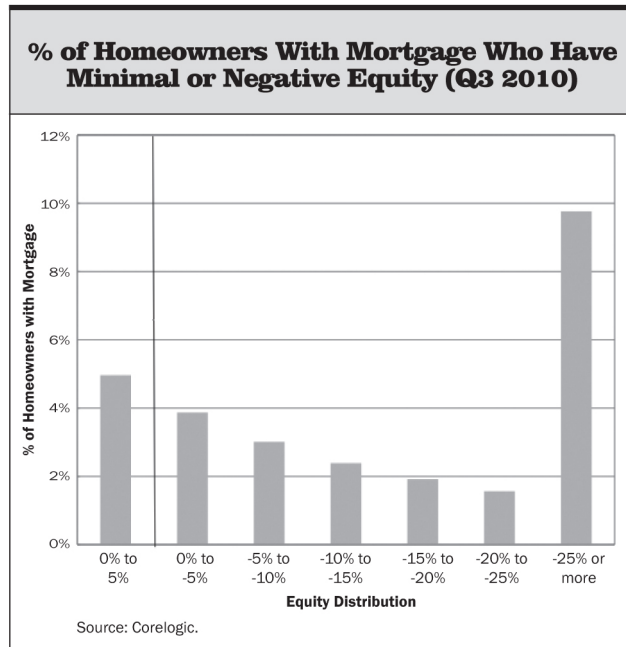
The recent strength in the stock market along with a gradual improvement in the economy should not lull us into a state of complacency. Though the economy is improving at the margin and could exhibit stronger growth in 2011, structural risks remain. In fact, the story is not very different from the one we've been telling for the past year.

Household Debt Levels: The trend in household debt levels is down and that's good. On an absolute basis and relative to income, household debt has declined at the fastest rate on record. However, much of the decline is due to defaults. And despite a meaningful reduction, the overall level of household debt remains excessive relative to disposable income. The income comparison is important because it indicates the long-term ability of households to pay down their liabilities. (Compared to assets, debt levels have improved but still remain very high relative to long-term history. Overall, house-

hold wealth is still 17% below its 2007 peak.)

The Weak Labor Market: In short, the labor market is recovering but it's a wimpy recovery compared to past expansions and in light of the number of jobs lost. It will get better. There are multiple indicators that suggest the job market should strengthen, but we have a long way to go to bring employment back up to acceptable levels. It will take years and the improvement will help growth but it is unlikely to be robust enough to support a strong or quick recovery in income, the housing market, or domestic consumption.

The Housing Market: After showing some strength in late 2009 and early 2010 largely due to the homebuyer tax credit, the market is, as we feared, weakening again. In recent months home prices have slid backwards again and the declines are spreading to more markets. Looking ahead, despite hugely improved affordability, there are several reasons to expect some further declines in home prices.



In total, over 20% of homeowners with mortgages have negative equity and almost half of those have negative equity of at least 25%.

First, according to industry data provider CoreLogic, as of the end of September, 23% of all homes with mortgages had negative equity—in other words they owed more than the house was worth. This amounts to 10.8 million homes. Of these, more than 40% (over four million) had negative equity of at least 25%. Another 2.4 million homeowners had equity of 5% or less (meaning a 5% price drop would put them in a negative equity position). Negative equity correlates strongly with defaults and foreclosures so this data suggests that foreclosures will remain high for some time.

On the supply side the number of homes for sale compared to average monthly sales has spiked up again and is near peak levels. The actual number varies depending on the data source at between 12 and 13 months. That is about twice the normal level. Unfortunately the story is actually much worse than that because of the millions of houses that are either in foreclosure or likely to be foreclosed. Based on CoreLogic's numbers the total inventory-to-sales measures, including "shadow" inventory, is at an alarming 23 months. These numbers suggest that house prices have further to fall.

Consumer Spending Headwinds: Each of the above factors is a problem for consumer spending. Generally, we've made the case that consumption, which remains at around 70% of the economy, is likely to grow at a subpar level given the need to reduce debt. In the past, debt growth fueled spending but now deleveraging is a headwind. Moreover, there is an adverse feedback loop as weak spending is a drag on the overall economy, which impacts the labor market, which is a driver of income growth, which in turn is a key driver of consumption growth, completing the loop. Over the last year (through 9/30) consumer spending has rebounded and is up 2%. However, this is not an exciting level of growth, and in total, quarterly spending has barely regained the level of three years ago. We continue to believe spending growth over the next few years is likely to be below average, consistent with a subpar recovery.

Real Personal Consumption (Year-Over-Year Change)



Source: Bureau of Economic Analysis.

Improving but still not consistent with a normal recovery.

The U.S. Government Debt Explosion: Government debt levels remain very high. Gross federal debt is pushing 100% of GDP and state and local debt is another 20% (some research suggests that GDP growth rates drop meaningfully when gross government debt exceeds 90% of GDP). Many developed countries face similar problems. And the absolute level of debt is only part of the problem. The impact of aging baby boomers will exacerbate the problem as Social Security trust fund expenditures increase along with increasing demands on Medicare and Medicaid. We're all aware of these problems and the economic risks that accompany them. This is likely to be a very important issue during our five-year decision horizon that could have a material impact on the economy and financial markets.

State and Municipal Governments: This sector of the economy continues to be highly stressed. State tax collections have risen but remain 7% below 2008 levels accord-

ing to the Nelson A. Rockefeller Institute of Government. At a local level, property tax collections are dropping and there is more to come as housing values have not been fully reflected in property tax assessments. Overall, state and local governments are not expected to contribute to any improvement in the labor markets in 2011 and will continue to face long-term structural problems from past spending decisions including underfunded pensions and post-retirement obligations. It seems probable that we will see an increase in local government debt defaults though it does not appear likely that these will be widespread. They will generate headlines though, and that may trigger temporary sell-offs in the municipal bond market.

European Sovereign Debt Crisis: The weakness in Europe's periphery continues to create enormous uncertainty. Short of exiting the euro zone (a possibility), countries like Greece, Ireland, and Portugal don't have the option to devalue their currencies to increase their global competitiveness. Because of high debt levels they have had to accept fiscal austerity to reduce deficit growth. That will be a drag on economic growth and if the drag is large enough it could actually undermine efforts to reduce deficits.

While it's possible Europe will muddle through, it is the region that seems most at risk for falling back into recession. And although the risk of a destabilizing breakup of the euro is now on the radar, it remains unlikely in the foreseeable future because the benefit of any breakup relative to the costs is questionable. The negative scenarios for Europe would impact the global economy and are therefore a key risk factor.

Emerging Markets: A new worry is the economic strength in many emerging markets. The problem is not that the economies are strong, but rather that in a number of cases, policies to prevent their currencies from appreciating (and hurting their export competitiveness) necessitate low interest rates that can ignite inflation and asset bubbles. Inflation in China is the most visible problem and it is already driving a tightening of monetary policy and fears that this will cause growth to slow too much.

Looking Ahead

All that said, we aren't meaning to paint a depressing picture that suggests the need to hunker down. Things *are* better, and we are more optimistic than we were a year ago. Consumer spending is edging up, employment is less bad, and we are seeing companies around the globe benefitting from demand

in the stronger emerging market economies. We expect that stocks will deliver low to mid-single-digit returns in our more likely five-year scenarios, and we think our active managers could do better than that.

The negatives are important to consider as context for the conservative bias in our portfolios – just because people feel better at the moment doesn't mean the problems have gone away. Our assessment has led us to skew our portfolios conservatively because we don't believe most risky assets, like stocks, are priced cheaply enough to deliver returns we consider adequate to pay us for the risks we see. Further, we don't see a lot of "opportunity cost" to investing a bit more conservatively than we would in a more normal environment. So while we might lag in the shorter term if stocks continue to earn strong gains, we think longer term we can earn competitive returns at less risk through alternative opportunities that exist.

We use several fixed-income strategies that can be more aggressive than the traditional core fixed-income positions from which they are funded, but we like them because they have wide flexibility to take advantage of fixed-income opportunities, and can provide a cushion if we see interest rates begin to rise. These include Osterweis Strategic Income, PIMCO Unconstrained, and Loomis Sayles Bond. We also own two arbitrage funds that are funded from a reduction in stocks. We consider these funds to be "absolute-return oriented" in that their returns aren't heavily dependent on what stocks or bonds do more broadly. We think these strategies will earn returns that are at least competitive with stocks but with much lower downside risk.

Finally, we have tactical positions in local-currency emerging-markets bonds, which are also funded from a reduction in stocks. These provide an attractive yield and will continue to benefit if the underlying currencies appreciate further against the dollar, as we expect in the years ahead. We don't own a tactical position in emerging-market equities in our balanced strategies, despite the better emerging-market fundamentals, because in our view they are not cheap enough to compensate for their added downside risk. However, we do get exposure via our stock pickers, who own emerging market stocks directly as well as stocks of developed market companies that have significant sales in emerging market countries.

As we look ahead to next year, we continue to believe the range of possible outcomes is wide. We are not confident that we can precisely predict what next year will bring, but our investment approach does not require us to have an answer for the next year. As always we fall back on our scenario analysis to understand the possible range of outcomes over longer periods (which can be assessed more reliably) so we can gauge risk and reward. Our analysis covers time frames that are likely to reward us for getting the fundamentals mostly right; understanding that our clients have investment needs that last far beyond one year. With that guidance we remain cautious as we do not view equities, broadly speaking, as offering potential returns commensurate with the risks as we assess them. As we said last year, if risk-taking takes hold for a while, our balanced portfolios could well underperform. However, we continue to be confident in our positioning over our multiyear time frame, and ready to take advantage of tactical opportunities to add to our risk exposures should fear reassert itself in the markets. – *Cox Financial Services, LLC Research Team (1/11/2011)*