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Dear Client,

We hope you are enjoying your summer! Enclosed, please find your Second quarter performance report.

Market performance in the first half

Developed markets registered solid gains in the first quarter, despite the setback from March's earthquake and tsunami in Japan. However, the events of the second quarter seemed to provide a case of "Déjà vu" as many of the same headlines we saw last year at this time repeated themselves in some fashion, most notably the revival of sovereign debt worries in Europe. Concerns arising from growing inflation threats in emerging markets and a downgrading of growth forecasts for the global economy added to these concerns. However, amidst all this news, markets ended the quarter with a rally that left the broad US Market down only .10% for the quarter and up for the year at 5.90%. World Markets (ex-USA) ended the second quarter up .86%, returning 4.72% for the six months ending 6-30 (source: MSCI).

Is it Different this time?

Last quarter we talked about learning to expect the un-expected. In this letter we provide you with a positive example of what this means. For the twelve month period ending 6-30, among forty-five developed and emerging country stock markets tracked by MSCI, all but five had double digit returns (in US dollar terms), and twenty had returns of 30% or more. Basically, if we had known this was going to be the case, we probably would have assumed that trends in housing, employment and the issues relating to financial distress would have taken turns for the better, and we know they did nothing of the kind! Yet, somehow in spite of the continued repetitive, dreary financial news, equity prices continued to move higher, proving once again that "Investors should be skeptical of their ability to predict future events and even more skeptical of their ability to predict how other investors will react to them" (source: DFA).

So, will current Global financial concerns throw a "wet blanket" on stock performance? Stocks are overvalued at this point and may well see a temporary set-back in the near future (if only for the fact that Congress won't pass a vote to get the debt ceiling raised!). However, despite less than "palatable" forward looking return prospects, all things considered, equity investments represent the best opportunity relative to other investment asset classes going forward. This sentiment is also shared by other prominent figures in the investment field whose opinions are shared below.

Buffett, Fink, Gross and Siegel – opportunities in today's markets

Warren Buffett has been consistent in his positive outlook for the U.S. economy, looking past short-term events to focus on American ingenuity and resolve and its ability to attract the best and the brightest from around the world. He offered this statement is his annual letter to shareholder this past February: "*Money will always flow toward opportunity and there is an abundance of that in America. Commentators often talk of "great uncertainty. Throughout my lifetime, politicians and pundits have constantly moaned about terrifying problems facing America. Yet our citizens now live an astonishing six times better than when I was born. The prophets of doom have overlooked the all-important factor that is certain: Human potential is far from exhausted, and the American system for unleashing that potential – a system that has worked wonders for over two centuries despite frequent interruptions for recessions and even a Civil War – remains alive and effective.*"

Larry Fink, CEO of Blackrock, and Bill Gross, co-CFO of PIMCO and manger of the PIMCO Total Return Fund, are both experts in the bond or fixed income investing arena. In subsequent interviews with CNBC this past June, both expressed similar views that stocks may present better opportunities than bonds at this point. Mr. Fink stated that, "*Corporations worldwide are bigger than ever … their cash holdings are gigantic right now…We are telling our investors if you're worried about sovereign credits, if you're worried about US Treasuries, there may be greater safety in equities, especially high-dividend stocks and there may be greater safety in very high-quality corporate bonds worldwide."*

Mr. Gross, who has recently turned negative on US government bonds, recommending high quality corporate bonds and Canadian and Australian bonds instead of US Treasury bonds, also discussed the appeal of brand-name stocks that pay dividends, stating that, "*In terms of the stock market, there are amazing opportunities in real interest space. I mean, a Procter, a Johnson & Johnson, a utility company, Southern, Duke, as a whole they yield 3 1/2 to 4 percent in terms of their dividend yield compared to a negative .5 percent in Treasury space on that five-year."*

Wharton's Jeremy Siegel, stock market historian and author of what is considered to be one of the most influential investment texts of all time, *Stocks for the Long Run,* explained in a June 28 interview on Business News Network why he's bullish on US stocks: *"We've almost never seen valuations (on the US stock market) this low when interest rates are as low as they are today ... relative to bonds today, I've almost never seen such compelling values."* And here's why he, like Bill Gross, likes dividend-paying stocks: "*History shows that dividend-paying stocks beat inflation and are good investments for income, especially in the early stages of a financial recovery such as we see today … The top 100 dividend-yielding stocks of the S & P 500 over the last half century beat the index by two and a half percent and did so with lower risk.".* As a comment here, he is referring to value stocks.

What this means to investors

In today's low interest rate environment, it's hard to make a compelling case for cash except as a portfolio diversifier and a source of liquidity. As for bonds, our recent move to short term high quality corporate echoes the sentiment shared by Larry Fink and Bill Gross in that risk in bonds is rising, as economies recover and interest rates start to rise…..this leaves stocks. Whether you adopt the "least of evils" view of stocks compared to bonds, as Fink and Gross advocate, or join Warren Buffett and Jeremy Siegel in embracing stocks more enthusiastically, there are valid reasons to favor stocks based on our current economic environment. For the past few years, we've tilted the equity component of client portfolios towards both value and small cap stocks, both of which have shown the propensity to outperform coming out of recessionary periods. We know these two equity asset classes won't always outperform Growth and Large Company stocks – we experienced this in 2008 and early 2009. However, we do know this to be the case over long time periods, the only thing that matters. We will continue to slightly overweight stocks (specifically these two asset classes) in all portfolios as we move forward.

If we have not already touched base with you, we will be in touch to discuss how your portfolio is positioned. Should you have any questions in the meantime on your portfolio, the contents of this note or any other issue, please give us a call – we'd be happy to answer your questions on the phone or at our next meeting.

As always, thank you for the opportunity to work together.

Best regards,

Doug Babcock   Bob Frey