



July 8, 2011

Dear Valued Client,

Markets experienced a nice recovery in June as participants were temporarily relieved of contagion fears as European leaders agreed to release another tranche of financial support for Greece in light of agreed upon reforms and cuts in spending. Austerity measures amidst a populace that is already struggling with an unemployment rate of 16.2% will not be popular, but that is the price to be paid in order to temporarily avoid debt restructuring (default). It's interesting to note how so many measures have been taken to avoid debt restructuring. If the debt ownership structure of Greece were different, the process of restructuring could be easier. But a good portion of the debt is owned by financial institutions, which themselves are highly levered, so small markdowns in value have amplified effects on capital when leverage is taken into account. This is why European leaders are wary of debt restructuring and decided to "kick the can down the road" once again.

Since the second quarter ended June 30th, earnings season will begin in earnest in the coming weeks. Second quarter earnings for S&P 500 member companies are estimated to be up about 13.3% over last year, according to S&P. It's always important for clients to understand that corporate earnings and the valuations of those earnings are the primary drivers of stock prices, not the un-employment rate and not the housing market as some in the news media would lead you to believe. In spite of an economic recovery that has been slow, corporations are operating as profitably and efficiently as they've ever been, with corporate profits comprising roughly 8.4% of GDP versus a 50-year average of 6.1% (Source: JP Morgan Asset Management). Corporate balance sheets are also in good shape with about 27% of current assets in cash (Source: JP Morgan Asset Management). Combine cash and low interest rates with somewhat constrained organic growth and you have solid underpinnings for increased mergers & acquisitions, higher dividends, and higher share repurchases. All three of these have been themes in 2011 and will likely continue to be as we move into the second half of the year.

One of the debates occurring now is to what degree current profitability levels are sustainable and how we should interpret that in context with overall market valuations. Jeremy Siegel is a professor at The Wharton School of Business at the University of Pennsylvania and he measures market valuation in context to current & projected earnings levels, which produces a modest valuation level for the market around 13.5 times earnings, based upon S&P earnings estimates. On the other hand, Robert Shiller from Yale University believes stocks should be more appropriately valued based upon 10-year inflation adjusted earnings, which dampens the effect of cyclical peaks and troughs. According to his cyclically-adjusted measure of earnings, the current value is 23.64 times earnings, which suggests overvaluation and a low rate of return moving forward. Although it's important to understand the cyclical nature inside certain sectors and industries in the market, it's probably fair to say that most firms don't take two steps forward and then two steps back. In other words, on an aggregate basis, earnings generated today are likely to be a better definition of "normal" versus



earnings averaged over the previous 10 years because most companies today have greater resources in operating assets that can be used to generate higher levels of earnings than they did 3 to 5 years ago or longer. Some exceptions apply, of course.

We don't know how the market will perform during the second half of 2011, but we are definitely off to a good start with the S&P 500's first half gains of 6.02%. Continue to expect volatility. For clients willing to cope with some of the volatility and maintain a multi-year perspective, we continue to believe that real returns on invested assets are going to be found by investing primarily in equities, both domestic & overseas. Taking the current inflation rate of 2.5% into account, CDs, money markets, and short-term domestic bonds are all now producing negative real returns. As Bill Gross said in one of his recent investment letters, the pockets of savers are being picked! Unfortunate, but true.

We hope this discussion has been helpful. Thank you for your continued trust and confidence you've placed in our firm.

Sincerely,

A handwritten signature in black ink that reads "Scott Smith". The signature is written in a cursive style and is positioned above the typed name.

Scott Smith, Investment Analyst



The S&P 500 consists of 500 stocks chosen for market size, liquidity and industry group representation. Each stocks weight in the index is proportionate to its market value. The S&P 500 is one of the most widely used benchmarks of US equity performance.

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Diversification can be thought of as spreading your investment dollars into various asset classes to add balance to your portfolio. Although it doesn't guarantee a profit, it may be able to reduce the volatility of your portfolio.