



June 5, 2010

Dear Valued Client,

If complacency crept into the psyche of investors during the month of April, then it was quickly replaced with anxiety during the month of May as contagion fears from sovereign debt troubles in Greece caused investors to reassess the prospects of our economic recovery. As of the date of this writing, the S&P is down 12.57% from its closing high for the year set on April 23, 2010. Year to date, the S&P, NASDAQ, & Dow are down 3.69%, 2.20%, & 3.59%, respectively. No matter what the cause for the market's correction, 10-15% declines after an 80% gain off the market low is normal, historically speaking. For those with cash sitting on the sidelines, such retracements should be viewed in a positive light because it allows us, alongside our recommended mutual fund managers to allocate capital at more advantageous prices. Instead of our usual letter, we've decided to put this month's update into more of a question and answer format so we can answer directly some of the questions that are probably on your mind.

- **Question: *What happened on May 6th that caused the market to go down so much in such a short period of time?***

Answer: Some of the craziest trading occurred during about a 30 minute span on May 6, 2010, which caused the Dow at one point to drop nearly 1,000 points. Coming into the day, investors were worried about the Euro making new lows against the dollar, along with general contagion fears, but those were not the primary reasons why such a large drop occurred in the market within a short time span. The decline was reminiscent of the sharp drop that occurred in 1987, when the market dropped 508 points or 22%. Similar in some ways to 1987, the reason for the decline was the effect of program trading occurring within an illiquid market, where trades were cleared at somewhat ridiculous prices due to the lack of liquidity provided that would normally make for a fluid market. This quirky trading day was a reminder of how much trading is done electronically via computers that are pre-programmed by traders to fire off trades at certain price points. Fortunately, the only people who were hurt on May 6th were the investors who saw this volatility, panicked, and sold. The fund managers we've selected for your portfolios tend to react in the opposite direction of the crowd, so they try to exploit the short-comings of traders who think in terms of hours, days, and months when investing. This will continue to serve us well.

- **Question: *How do the events occurring in Europe affect us here in the United States?***

Answer: There are many issues at play, but we'll just highlight two. The most direct effect comes in the form of currency adjustment. The debt trouble in Greece has caused the Euro to drop to a 4-year low against the dollar, so that dynamic has negatively affected the



value of domestic-based companies selling goods and services in Europe. For some companies, this currency adjustment has a marginal effect on profits, while at other companies, the impact is more significant. Needless to say, growth assumptions may need to be lowered for US multi-nationals amidst this European belt tightening that is being demanded by investors who worry about the increasing risk of owning sovereign debt.

The second direct way debt issues in Europe affect us here in the United States relates to how debt yields move in response to changes in risk perception, which have a direct impact on our economy. Specifically, global debt investors who are nervous about the value of European debt or the stability of our global economy shift money into what are perceived to be safer assets, like treasuries. This movement is known as a “flight to quality”. As a result of these shifts, prices on safe assets move up in value amidst higher investor demand for safety, while prices on riskier debt moves lower as investors demand more return to compensate for increased risk. Gold is also considered a safe alternative to the devaluation perceived in paper-based currencies, which explains why its price is up 11.07% year-to-date. The impact of these changes in investor sentiment on the broad US economy can be seen through the changes in interest rates. On the positive side, demand for treasury securities help to keep long term interest rates low, which is a positive factor helping to stabilize the banks and the housing market. On the negative side, increased risk assumption within European banks has caused the London Interbank Offered Rate, called LIBOR, to move higher. LIBOR is a short-term interest rate banks charge to lend to & from each other, which is what banks use to set short-term loans like adjustable rate mortgages, consumer loans, & business loans. As short-term rates move higher, it affects the cost and the volume of money, which are critical to our financial system.

- ***Question: What are the differences and similarities between the sovereign debt issues in Greece and the mortgage debt issues we are dealing with here in the United States?***

The differences between the two primarily relate to: 1) Size—The size of the troubled credit within US mortgages & mortgage backed securities is much larger than the size of the sovereign debt troubles in Greece. 2) Distribution of Ownership—US mortgage debt was packaged into debt securities and sold to investors around the world, while Greek debt is mostly held by European banks; & 3) Resolution complexities—Although our authorities did stall once, they did a fairly good job of coordinating a resolution effort for the banks through TARP and the other multitude of programs enacted by the Federal Reserve. It’s much tougher to enact a resolution effort among 16 different countries, which share a common currency, but don’t exactly share the same priorities or challenges in each of their respective economies, which makes control over monetary policy difficult.

The similarities between the two crises relate to leverage & contagion. Generally speaking, European banks are leveraged heavily just like our banks were during the mortgage crisis, so given the fact the most of the troubled Greek debt is owned by European banks, it expands the risk of contagion to other debt-laden countries in Europe that are on a somewhat firmer



footing than Greece, which in principle, is very similar to how contagion spread from subprime to prime borrowers here in the United States.

We hope the discussion of these questions help facilitate some perspective and insight into the issues at hand in the market today. As always, we thank you for your trust and assure you we're doing our best to keep it. If you have any further questions or concerns, please feel free to call us.

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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