



Instructions

The content in this newsletter has been edited to be more generic than what we use with our own clients, though it is drawn directly from the same material. You will need to read through and edit the material to make it suitable for your own use.

Key points:

- ❑ The first thing you should do is save a copy of this document to your hard drive by clicking *File* then *Save As* at the top. We suggest you consider creating a folder (off of the My Documents folder, perhaps) for your AdvisorIntelligence documents. You can create a folder by clicking on the folder icon with the asterisk that appears at the top right of the *Save As* window.
- ❑ We have highlighted sections in blue that are most likely to require editing by advisors who employ significantly different strategies and/or funds to implement their strategies than we do. Change them back to black when finished editing by highlighting and clicking on the text color tool on the toolbar at the top on the right (right now it should be a black letter A with an underline). Another way to change text color is to highlight it and then right-click—choose *Font* from the pop-up window then *Font Color*.
- ❑ We suggest that you save this document frequently as you work on it. If you make a mistake and can't figure out how to restore your formatting, for example, you can revert to the saved copy. And gentlemen who are not good with Word should not be reluctant to ask for directions (the Help system)—it is almost always faster in the long run. If you are stuck we are willing to try to help you (you can send a question to us at support@advisorintelligence.com) but we are not Word tech support people and don't wish to be in that business.
- ❑ We have set up this Word document with style sheets. At the top of most versions of Word on the toolbar you will see a style box right next to the font (right now it should say "Normal")—in it you can see how we have defined each piece of text. If you don't see this, you should change your view—click on *View* then *Toolbars* then *Formatting*.
- ❑ If you would like to use two-column format from page 2 on (which we recommend), you need to insert a section break at the top of page 2. The section break will let you divide the newsletter into two sections, where the text above the section break is one column, and below it are two columns. Unfortunately, section breaks are not normally displayed. But the standard toolbar at the top has a paragraph symbol  which toggles "hidden" codes on and off. These codes show paragraph breaks and section breaks. To see your section breaks, click on the  symbol (they actually say "section break"). You can insert section breaks by choosing the *Insert* menu at the top and selecting *Breaks*. To set the number of columns, choose *Columns* from the *Format* menu at the top.

[[IMPORTANT NOTES: While we recommend using two-column formatting starting on page 2, we have turned off the two-column formatting to make editing the newsletter easy for users who are not Word experts (leaving it on can create very confusing formatting shifts as you edit). If you want two-column formatting starting on page 2, instructions are provided below (note that the following page is not in two-column format; the summary text on the left is a separate text box).

The following instructions apply to versions of Word prior to the Office 2007 edition. First, complete your editing in one-column mode, and then SAVE A COPY. Next, place your cursor at the very start of page 2 (in front of the first letter of text). Insert a section break, by clicking on Word's *Insert* menu at the top, and choose the first item, *Break ...* and then select *Continuous* under *Section Break Types* (it is the second choice in the second group of options). Then while still on page 2, click on Word's *Format* menu and choose *Columns* and then select two-column. The text from page 2 through the end of the newsletter should now be in two-column format. WARNING: if you subsequently make further edits your formatting could become distorted. If this happens, we suggest going back to your saved copy, making the additional edits while still in one-column mode, and then repeating the steps above to use two-column formatting. For more on section breaks, see our instruction page preceding this page. **For users of Word 2007** – life has gotten much better. Simply highlight the text that you want to change to two-column format (starting at the top of page 2 until the end) and then choose *Page Layout* from the ribbon at the top and then select *Columns*, and *Two*. As always, we have highlighted in blue those sections which may require customization by advisors before using with their clients.]]

Your Firm's Investment Letter

Your Firm Name

Second Quarter 2010

The first six months of 2010 have been a bit of a roller coaster—domestic stocks were up early in the year, then down 5% by early February, then up almost 10% for the year by late April, then down nearly 7% for the year by the end of June. [All of our portfolios have outperformed their benchmarks by several percentage points for the year through June 30 as a result of both our tactical positions and of the value added by our active managers.](#)

Our commentary examines the economic “tug of war” being reflected in the stock market, with improving economic and company fundamentals on the one side, and concerns about debt-related stress points and the longer-term strength of the economic recovery on the other.

Our view of the big-picture environment we face in the next few years remains unchanged. The recovery continues but it is not inspiring, and we see above-average risk in spite of being early in a recovery cycle.

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Quarterly Investment Commentary

Stocks continued their slide in June, ending the first half of 2010 with losses in every segment of the equity market. The large-cap Vanguard 500 Index lost 11.5% for the quarter, and is down 6.7% year to date. The small-cap iShares Russell 2000 and iShares Russell Midcap both lost 10% in the second quarter, though thanks to a strong first-quarter, both benchmarks are down just 2% year to date. Turning abroad, the story was similarly painful. The Vanguard Total International Stock Index dropped 13.3% in the second quarter, bringing its year-to-date loss to 12%. The Vanguard Emerging Market Stock Index lost over 9% for the quarter and nearly 7% year to date.

Most of the positive news for the first six months of the year was in fixed income. The Vanguard Total Bond Market Index Fund, a proxy for high-quality, intermediate-term bonds, gained 3.6% over the second quarter, and is up 5.3% for the year through June. Foreign bonds were mixed. The Citigroup World Government Bond index was flat in the second quarter, but still down 1% year to date, and although the JPMorgan GBI-EM Global Diversified Index lost 2% for the quarter, it returned a positive 3.4% for the year through June.

[All of our portfolios have outperformed their benchmarks by several percentage points for the year through June 30 as a result of both our tactical positions and of the value added by our active managers. In our balanced portfolios, the largest contributor to performance was our tactical allocation to emerging-markets local-currency bonds \(ELB\). Other tactical positions, such as our new investments in arbitrage strategies and our overweight to investment-grade bonds versus U.S. equities, also helped performance.](#) We talk more about our current views and future performance expectations in the commentary below:

Investment Outlook

As noted in the performance review above, the first six months of 2010 have been a bit of a roller coaster—domestic stocks were up early in the year, then down 5% by early February, then up almost 10% for the year by late April, then down nearly 7% for the year by the end of June. This reflects what we see as an economic “tug of war” in the stock market, with improving economic and company fundamentals on the one side, and concerns about debt-related stress points and the longer-term strength of the economic recovery on the other. The tension between these opposing forces has left investors uncertain and the stock markets stuck in a trading range (i.e., bouncing around within a range with no

clear trend). We think that unusually high uncertainty could be with us for years to come because the economic challenges we face are serious and will not be resolved quickly.

Though we won't forget the market freefall of 2008, now that there has been a strong stock market rebound from the bottom, it's interesting to compare market levels today to three years ago. Despite the rebound they continue to reflect a level of economic stress:

As long-term investors, our views tend to evolve gradually rather than change suddenly based on new information (the fall of 2008 being a notable exception). That's certainly been true in recent quarters with our assessment of the big picture unchanged.

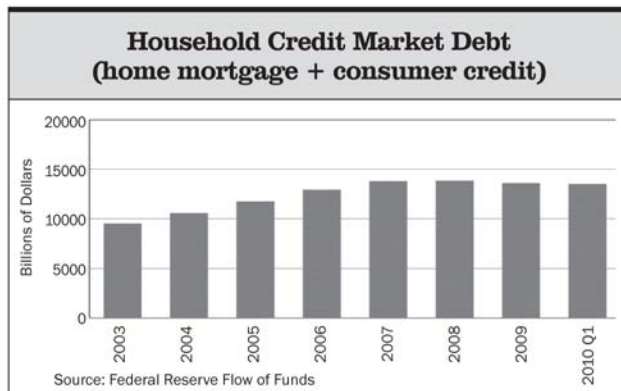
The Challenges We Face

It's no secret that there is too much debt in most of the developed world—the United States, Europe, and Japan. We've written about it ad nauseam. That the problem is identified doesn't lessen the challenge. In coming years the developed world must walk a tightrope as it deals with the pressing need to slow and ultimately reverse debt growth without also seriously harming economic growth rates.

Investment	Time Period (6/30/07 – 6/30/10)		Comments
	Total Return		
S&P 500 (Vanguard 500 Index Fund)	-26.7%		Earnings hit/investor fear
MSCI Emerging Markets Index (iShares MSCI Emerging Markets ETF)	-8.1%		Damage from global bear mitigated by stronger economies
MSCI US REIT Index (Vanguard REIT Index Fund)	-23.2%		Real estate mega-bear
Gold	91.2%		Currency debasement fear
Yield Change			
10-Year U.S. Treasury yield	-2.1%		Flight to safety
3-Month U.S. Treasury yield	-4.6%		Monetary stimulus

The United States and other countries with excessive household sector debt are in the early stages of what is likely to be a long process of deleveraging. Though it is dropping, household debt relative to income remains excessively high. Most of these countries must also dramatically reduce public sector (government) debt growth and in some cases they will need to reduce the absolute amount of debt. This huge challenge has not yet begun.

The timing and aggressiveness with which public sector debt and deficits are attacked will be extremely tricky to get right given current economic headwinds. On the one hand, too much austerity coming from very tight fiscal policy can be counterproductive because it risks smothering already weak growth, which reduces tax revenues, increases social safety net spending, and could weaken the political will that is needed to follow through on spending discipline.

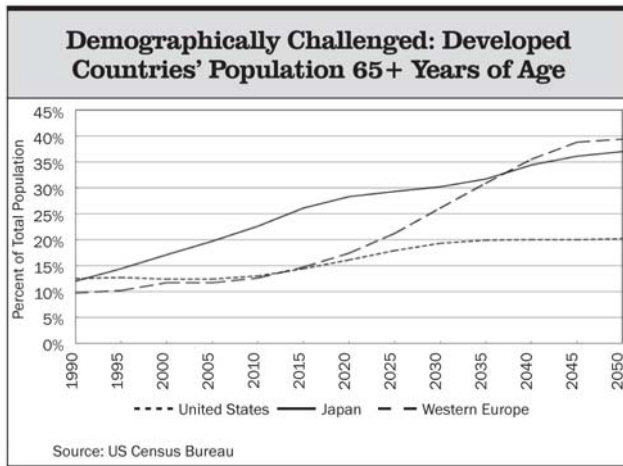


Credit is contracting but it's been a drop in the bucket in terms of total debt outstanding (shown here) and also relative to household income (not shown).

But waiting too long to tackle rising debt levels digs a deeper hole and risks a lenders' strike, which could result in government borrowers (and all others too) being forced to pay a much higher interest rate to finance their debt. At the extreme, as we are seeing with Greece, debt levels become unmanageable as borrowing costs become untenable, resulting in a crippling crisis for the country and a ripple effect that in a global economy has reached far beyond Greece's borders. A critical unknown is whether enough countries, including the United States,

can thread the economic needle so that the recovery has time to gain steam while maintaining lender confidence that the deficit/debt problems will be addressed over time. Slowing and ultimately reversing the growth of debt is further complicated by aging populations—a reality that most of the developing world faces to different degrees.

An aging population presents several challenges. It means that savings rates will face downward pressure as more of the population moves from working and saving to retiring and depleting savings, and paying fewer taxes given lower income. More retirees also mean more government retirement and health care expenses (Social Security and Medicare in the United States). This is fine if pensions and health care are fully funded. But that is not the case.



A large portion of Japan's population is over 65 and the percentage will move sharply higher in coming decades. Europe's demographics are not too bad at present but are set to get sharply worse over the next 30 years. The U.S. population is also aging and though the 65+ age group will be a much larger percentage of the total population in 25 years, we will be much better off than Japan.

While the private sector gradually de-levers, and we wait for the public sector to later do the same, at least the United States is experiencing an economic recovery, albeit a tepid one. There has been clear improvement from the depths of the recession. The economic cycle is, for now, a plus, but the big problems have not been resolved.

Three variables critical to improvement in private-sector consumption and a normal recovery—the labor markets, credit growth, and housing—remain weak. We are still down about eight million jobs from the peak and in the private sector job growth is barely positive – though that is an improvement from last year. Credit market debt is contracting as it has

been for about two years, which removes an important driver of consumer spending. And the housing outlook, which is critical to household financial strength and the banking sector, remains cloudy and appears to be slipping backward with an expiration of the homebuyer tax credit.

The rest of the developed world looks worse. Europe is experiencing very slow growth, southern Europe is uncompetitive and has many countries in various stages of sovereign debt crisis, and economic policy is a challenge given a single monetary policy in the eurozone, but no political union and differing economic situations.

Fortunately, key parts of the developing world are in much better shape with stronger balance sheets, higher growth rates, younger populations, and slowly emerging consumer sectors. Their strength is an important source of support for the global recovery. And there are other positives that help to mitigate the negatives. The continued impact of massive federal stimulus (though this will wane later this year in the United States), healthy corporate balance sheets and cash flow (after huge cuts to expenses), and a natural rebound in economic activity after a huge decline are also sources of strength in the U.S. and global economy.

Thus, our view of the big-picture environment we face in the next few years remains unchanged. The recovery continues but is not inspiring, and we see above-average risk in spite of being early in a recovery cycle.

Capturing Returns and Protecting Capital—Our Investment Posture

In assessing potential returns, our scenario analysis approach has been invaluable, and we believe, a superior approach to traditional valuation analysis. This approach allows us to be forward-looking so that we can factor in a number of possibilities that impact potential returns over our decision horizon, and it gives us the advantage of considering a range of outcomes when we make investment decisions, rather than requiring us to correctly identify one specific forecast.

Stocks: After a huge stock rebound from the market depths of March 2009, our equity scenario analysis continues to suggest that developed stock markets [offer only low to mid-single-digit return potential over the next five years](#). On the positive side, we continue to have some optimism that the low-return environment we think is likely may be a good one for highly skilled active managers to add value over their benchmarks.

Bonds: Within our bond allocation, while high quality investment-grade bonds only [offer minimal return potential over our five-year horizon](#), they do offer a defensive investment that could perform well if the economy is very weak or falls back into recession. [Additionally, the fixed-income vehicles we hold are more aggressive and potentially more volatile than a typical investment-grade bond portfolio, as we believe these fixed-income positions will capture materially higher returns and provide much better protection against unexpected inflation and in a rising rate environment.](#)

Among the fixed-income asset classes, we still find emerging-markets local-currency bonds to be the most compelling from an expected risk/return standpoint, though we don't expect returns to be excitingly high. Potential ELB return comes from the interest income and our expectation that the economic fundamentals (less debt and more growth) in many key developing economies are very likely to lead to currency appreciation (versus the dollar) over a multiyear time frame. [In all but our most pessimistic scenario](#) we expect returns from the ELB asset class to range from the [mid- to high single-digits, possibly even into the low double-digits](#). Moreover we view this asset class as significantly less risky than equities. However, it is much more volatile over the short run than investment-grade bonds and we don't view it as a defensive asset class—rather, we view it as a hybrid when we assess its impact on our overall portfolio level risk.

Alternative Investments: [After a concerted research effort, we recently added two alternatives strategies—AQR Diversified Arbitrage and the Arbitrage Fund—to our balanced portfolios because we believe they can provide some downside cushion through their relatively low correlation to stocks and bonds. These are the first true alternative investments we've implemented across our entire balanced-portfolio client base. The Arbitrage Fund focuses exclusively on merger arbitrage, and the AQR fund pursues several arbitrage strategies, including merger arbitrage, convertible arbitrage, and event-driven arbitrage. Additionally, the AQR team seeks to add value through its tactical allocation decisions across the strategies \(tactically overweighting strategies that have more attractive return potential\). The investments were funded by selling all of our remaining high-yield bond positions—effectively closing out the last of a tactical asset-class move that was one of the most successful in our 23-year history.](#)

Assessing five-year return expectations is a critical step in our investment process; however, so is our portfolio-level risk analysis. This step involves assessing how each portfolio is likely to perform in various one-year risk scenarios, then using this information to further calibrate the exposure to various asset classes. This process, along with our individual asset class analysis, has resulted in our portfolios being materially underweight to equities and therefore somewhat conservatively postured. We believe we are positioned to perform better than benchmarks in a bear market or a low-return market. However, if stocks have a strong upward move, our portfolios are almost certain to lag their benchmark returns.

Though we recognize a positive investment scenario is possible, as is a temporary period of strong market performance that could be driven by improving economic news and impatience with the near zero return offered by the money markets, we are clearly not placing a high probability on a bullish environment. For some time now, our view of the opportunities and risks for investors hasn't been very encouraging. And while the story is what it is, it is also important to remember it won't last forever—there will be better opportunities at some point. We hope that some of those opportunities will come soon and allow us to perform better than what the broader markets give us. But we're prepared to be patient. In the meantime we are working hard to ensure that when opportunities do present themselves we are in a position to recognize and take advantage of

them, while also being highly attuned to the potential risks in this uncertain environment. – *Your Firm Research Team (7/12/2010)*