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REVIEW & OUTLOOK: SECOND QUARTER 2012

REVIEW

The rebound on the last trading day in the quarter cut the S&P's loss by half. For the quarter, the S&P 500 Index returned -2.75%. The S&P 500 is still up for the year and has a return of 9.48% year to date (These figures are for total returns, which include dividends).

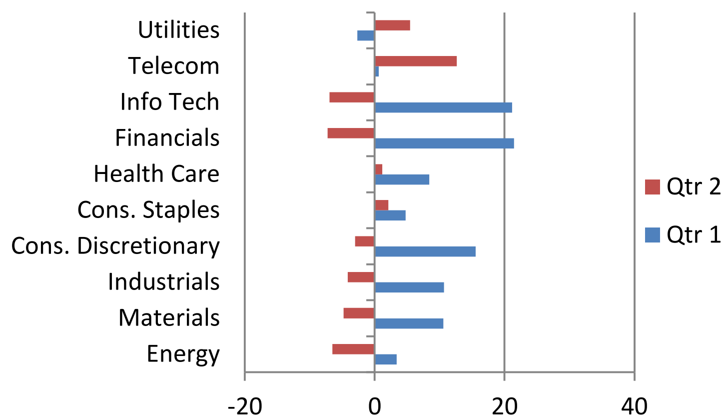
Following a solid first quarter, dark headlines about Greece, Spain, and Italy renewed fears of economic turmoil in Europe, with many people imagining a slowdown in the US economy as a result. Investors moved from riskier to less volatile assets, particularly US bonds, driving their yields to historic lows. In mid-June the U.S. Treasury auctioned 30 year bonds with a yield of 2.72%. Ten year treasuries are below 2%; less than the rate of inflation!

The pending 'fiscal cliff' at the end of 2012 and lack of Congressional action on making Medicare/Medicaid and Social Security more sustainable has also reduced investor confidence. We note that while the news headlines tend to focus on Europe and other countries, some of the most important financial issues are domestic.

S&P 500 PERFORMANCE BY ECONOMIC SECTOR

Figure 1 shows the performance by economic sector of the S&P 500 in the first and second quarters of this year. The figure illustrates the extreme volatility of performance of the sectors in the first half. Stocks in sectors such as energy and materials did very well in the first quarter, only to do very poorly in the second quarter. Stocks in less economically sensitive sectors (including consumer staples) held up better in the second quarter.

Figure 1. S&P 500 Index Performance by Sector



Source: Standard and Poor's Financial Services LLC Web Site

The figure reminds us how important it is to keep portfolios sufficiently diversified.

OUTLOOK

The Federal Reserve took steps recently to stimulate growth and Ben Bernanke, Fed. Reserve Chairman, said the Fed is ready to do more. Still, the Fed has not changed its forecast for economic growth. They continue to predict growth in the 2-3% range for the remainder of this year and next. However, they now highlight assumptions implying that prediction may not hold. For example, they note that their forecast assumes Congress will limit tax increases and spending cuts (the "fiscal cliff" of across-the-board tax increases and large spending cuts scheduled to take place January 1, 2013). They also assume European leaders will find acceptable solutions to their debt problems this summer or early fall. The Congressional Budget Office notes that GDP growth would fall below 1% in 2013 if Congress allows the scheduled tax increases and spending cuts to take effect. Growth would be even slower (possibly negative) if problems in Europe worsen. It's no wonder financial markets are struggling.

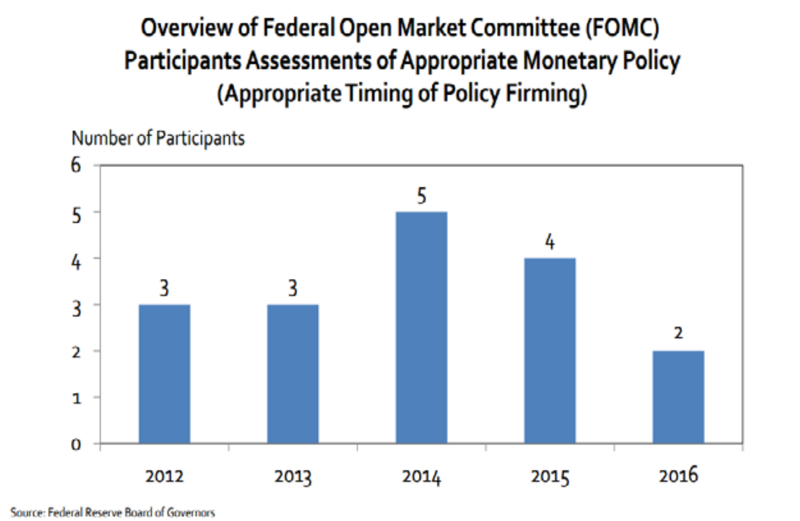
Investors are dealing with extraordinary uncertainty given all the news about Europe and other regions of the world. The headlines certainly get our attention, and probably add to volatility in the market. We think it is important to look past the immediate uncertainty. We see chronic problems with debt and slow growth as the most important issues to consider when thinking about investing.

With this view, we are structuring portfolios to take into account the probability of slower growth and continued volatility. In particular, we believe a strict emphasis on diversification will be critical in the near future. Our analysis shows that diversification between economic sectors combined with diversification within sectors helps returns. Figure 1 illustrates the extent of sector volatility quarter to quarter. While the importance of diversification across sectors seems rather obvious, diversification within sectors can get overlooked. However, a lack of diversification within any given sector can accentuate volatility.

We will continue to take advantage of opportunities in equities as they appear, while trying to avoid the worst impacts of volatility with our selections. We will also continue to work hard to find the best balance across equities, bonds, mutual funds, put options, etc.

With respect to bonds, a key question is when interest rates might increase. Figure 2 shows when FOMC members think rates will begin to increase.

Figure 2.



At current interest rates, high quality bonds still help to limit portfolio volatility. However, very low bond yields will reduce the potential return of balanced portfolios. Yields will increase again. But until then, we will be using a variety of measures to balance volatility and return in portfolios.