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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 was -11.5% for the **quarter**, and is - 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**.

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 I see as an economic "tug of war" in the stock market, with improving economic 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). I 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 I 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

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. 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. A conference call with PIMCO, the leader in bond investing, underlined this point just today.

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 paying down debt. 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.

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.

An aging population presents several challenges. (I am a first year boomer – born in 1946.) 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.

While the private sector gradually pays down debt, and I 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.

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

Capturing Returns and Protecting Capital

Stocks: After a huge stock rebound from the market depths of March 2009, I still feel there is a possibility of slipping into another bear market. Unfortunately, I give that possibility only a 50-50 chance, with the alternative being a slow ride up the DOW ladder with much turbulence and triple digit changes to the DOW – some triple digit up days and some triple digit down days. Even if the latter scenario proves true, I think we are looking at a range of 4% to 7% return potential over the next five years for stocks. On the positive side, I continue to have some optimism that the low-return environment I think is likely may be a good one for highly skilled active managers to add value over their benchmarks. Some of these highly skilled active managers are directing some of the funds in your retirement accounts.

Bonds: Within your 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 I hold are more aggressive and potentially more volatile than a typical investment-grade bond portfolio, as I 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, I find emerging-markets local-currency bonds to be the most compelling from an expected risk/return standpoint, though I don't expect returns to be excitingly high. The fund I use is PIMCO's Emerging Local Bond Fund (PELBX). Potential return comes from the interest income and PIMCO's 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 I expect returns from the emerging market bond asset class to range from the 5% to 10%, possibly even into the low double-digits. Moreover I 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 I don't view it as a defensive asset class—rather, I view it as a hybrid when I assess its impact on our overall portfolio level risk. Right now, I have only a small position for this fund and may increase it in the near-term, particularly for less risk-averse clients.

Although most clients are under-invested in their ultimate allocation of stocks and fully or over-invested in their bond and alternative allocations, I will continue to monitor your allocations and returns on a regular basis. At this writing, I do not expect to reduce any stock holdings, but by the same token, I also don't know if or when I will increase them.

Thank you for your business and your continuing trust.