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Personal Wealth Management

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We continue to be very concerned about the same problems we've written about repeatedly in recent years. Europe seems to be close to either spinning out of policymakers' control, or nearing a trigger point of more comprehensive and effective action. As we go to press there are indications that it might be the latter as Germany agreed to soften their stance on direct capital infusions into Spanish banks, and other measures which suggest movement in the direction of more integration. While the wrong outcome here could be extremely harmful to global equity markets and the global economy, the crisis is beginning to create some opportunities. By early June, the sharp sell-off in the European and emerging-markets stock markets had, in our view, fully priced in a slow-growth scenario that we believe is most likely. These markets are now looking more favorable on a valuation basis relative to the US Stock Market, unless the wrong outcome is where we find ourselves. Not knowing exactly what European policymakers will ultimately agree on, European and emerging markets are not yet a full-fledged fat pitch on an absolute basis and in our more pessimistic scenario, they would likely experience a sharp sell-off. Context is always critical to decision-making, so let us walk you through some of what we think we know, what we don't know, and how this informs our decisions.

What We Know

We know that extremely high debt levels have created a headwind to global growth resulting in a weak economic recovery with risk of another significant economic and market downturn. This risk has been turning into reality in Europe for a number of months and is reflected in an economic recession, which includes extremely high unemployment in the weak peripheral countries, slowing growth in the core countries, and a large decline in European stock prices.

Generally, we know there is no easy solution to the problems of excess debt that almost all of the developed economies are suffering from. It is likely that taxes will need to rise and spending growth will decline over several years, and this will continue to be a drag on economic growth.

Index Returns *Through 6/30/2012*

			Annualized Returns		
Index	**QTD**	**YTD**	**1-Year**	**3-Year**	**5-Year**
S&P 500	-2.75%	9.49%	5.45%	16.40%	0.22%
Russell 2000	-3.47%	8.53%	-2.08%	17.80%	0.54%
MSCI EAFE	-7.13%	2.96%	-13.83%	5.96%	-6.10%
MSCI All Country World Index	-5.56%	5.65%	-6.49%	10.80%	-2.70%
MSCI Emerging Markets Index	-8.89%	3.93%	-15.95%	9.77%	-0.09%
Barclay Capital US Aggregate Bond	2.06%	2.37%	7.47%	6.93%	6.79%
Barclay Capital Municipals	1.88%	3.67%	9.90%	7.62%	5.96%
Dow Jones UBS Commodity	-4.55%	-3.70%	-14.32%	3.49%	-3.65%
HFRI Fund of Funds Composite Index	-2.31%	0.99%	-4.50%	2.17%	-2.04%

We know that conflicting political motivations and economic circumstances across nations in Europe are a huge impediment in dealing with the crisis there. The need for a fiscal union or fiscal integration is central to the problem, but it requires surrendering some control of country budgets, tax policy, etc. Gaining agreement will require heroic efforts on the part of politicians. (Germany's concessions at the June 28 EU summit suggest compromise is possible but very difficult decisions and negotiations lie ahead so uncertainty remains very high.) All of this suggests that a partial breakup of the Eurozone is very possible.

Appropriately, the second quarter of 2012 closed with a spike in volatility, this time on the upside, as news out of Europe sparked hope that fiscal and monetary cooperation in the region could keep the worsening fiscal crisis from spinning out of policymakers' control.

Recent market optimism aside, the debt-related fault lines in the global economy have not stabilized, and are likely to be with us for at least a few more years.

However, our expected equity returns, especially outside of the U.S., are starting to improve.

Our portfolio positioning is driven by a weighing of risk and potential reward and patiently assessing opportunities before investing more aggressively.

In each of the last three years, there have been strong market rallies early in the year followed by market corrections ranging from about 9% to 19%.

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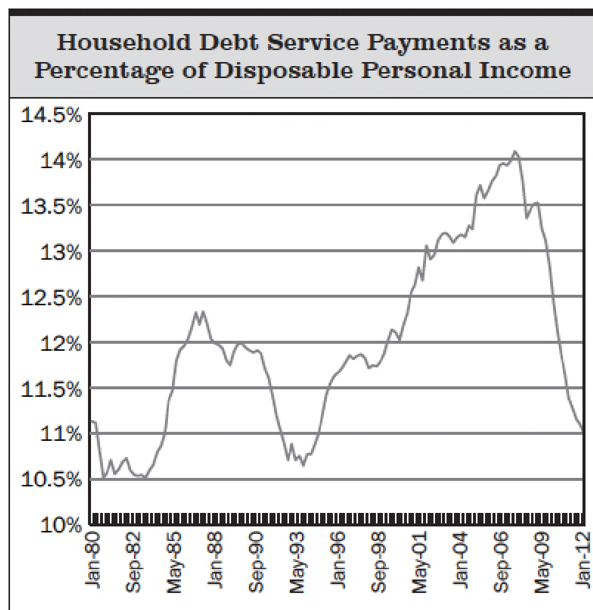
If that happens, the hope is that it will be well planned so as not to unnerve the markets, thus avoiding a possible credit freeze and increased capital flight, which would exacerbate the risk to the entire Eurozone and trigger a major economic downturn. This scenario is a major worry and has been rapidly intensifying.

We know that Japan also has a huge debt problem (relative to GDP their debt is actually greater than in the United States or Europe), though to date there has been no market focus on Japan. We know that the United States has its own debt and political dysfunction over both the short and long-term. Near term there is the potential "fiscal cliff" of large spending cuts and tax increases which, depending on how it plays out, is estimated to reduce GDP in 2013 by 1% to 4.5%—a sizable amount. (The wide range of GDP impact is due to accounting for the probability that all measures might not be implemented.)

We know that in the United States, recovery continues and there has been improvement in some areas. Housing is showing signs of a possible bottom. The labor market has improved a little, though more recent data has been less encouraging. The economy remains weak overall based on employment, consumer spending, disposable income, residential fixed-investment, household net worth, and overall GDP. This weakness makes the United States vulnerable to economic shocks.

We know deleveraging in the U.S. private sector is progressing (16 consecutive quarters of debt reduction), but mostly through debt defaults. We also know the financial sector has been deleveraging on a quarter-by-quarter basis. This progress is important, but we also know that this process is by no means complete. Overall debt levels in the private sector are still high, though debt service is low compared to incomes because of low interest rates—and this is a big help. And in the public sector, debt has been building—so deleveraging there has not yet begun but it will have to.



Household debt service compared to income has plummeted to low levels and is a positive factor for consumers. However, much of the decline is due to very low interest rates and the high number of defaults. Overall debt levels are still high and at some point interest rates will rise.
Data as of January 1, 2012. Source: Board of Governors of the Federal Reserve System.

We believe that Europe and the emerging markets seem to be pricing in the subpar growth world that we anticipate. As mentioned above, their recent decline in value make their stock markets more favorably valued vs. the US. However, the US stock market is not fully pricing in this subpar growth scenario, as valuations seem more fairly valued.

We know that traditional investment-grade bond yields are so miniscule that very low returns are assured over the next five years. This being said, there are opportunities in certain fixed-income sectors and we have taken advantage of those sectors by adding more flexible fixed income managers and direct investments in high-yield, floating rate, and convertible bonds.

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What We Don't Know
The bottom line is that while we believe the subpar growth scenario is most likely, we are not highly confident in making this prediction. However, it is very helpful in our decision making to be able to be honest about our uncertainty and to instead define and understand the range of potential outcomes.

One of the most important unknowns is that policymakers have the potential to take actions that could have various outcomes, positive or negative, for the global economy and the markets—including actions that could trigger positive market surges. While we think it is more likely than not that their choices will be a net positive (because the consequences of bad choices could be truly awful), we are not confident which choices they will make, especially given the politics involved.

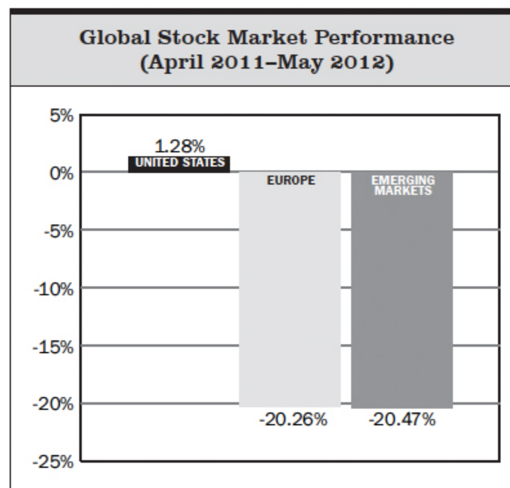
We continue to worry about the possibility of a hard landing in China impacting the global economy. Developments in the Middle East (e.g., war with Iran, etc.) could also significantly impact oil prices. As always, there are unknowable risks and developments that could blindside us either positively or negatively.

Portfolio Positioning
This all nets out to an investment environment that is likely to be volatile, as was the case in 2010, 2011, and so far this year, with periods of strong market performance followed by sell-offs. Given this context, we will continue to refrain from trying too hard to capture uncertain returns in a choppy, potentially very high-risk environment. But, we do seek to add value where we can while we wait for better opportunities. While we are not excessively defensive, we are conservative enough that we risk underperforming if the stars align: the Eurozone pushes the right buttons, U.S. and global growth accelerates, and China avoids a hard landing.

More specifically our focus is now on the following:

Structure all accounts so that risk is somewhat below average: This will provide some protection in down markets and importantly, will leave us with some dry powder that we can re-deploy if stocks get cheaper.

Maintain some exposure to risky assets but skew toward equity markets that offer a better risk/reward relationship: The declines in emerging-markets stocks and European stocks created decent value so that returns even in a subpar growth world are looking more attractive. In short we may now get paid to take some risk.



Europe and emerging-markets stock markets have hugely underperformed the U.S. stock market over the past year resulting in much improved relative value.

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We will continue to watch these markets closely before increasing our investment in developed foreign market and emerging market stocks. We remain somewhat cautious because there is still much tension between short-term risk and long-term opportunity. We also believe there is a good chance that given the debt-related risks (especially from Europe), stocks may get even cheaper, perhaps substantially so.

Focus our fixed-income exposure on the best value that also allows us to capture more yield: The more flexible fixed-income funds we hold in our portfolios will probably not help us as much in a market downturn as Treasuries, but we are very confident that they will be a source of major value added over the longer term horizon and even over much shorter periods (but not necessarily measured over a few months), as the higher yields we capture more than compensate us for the ground we would temporarily lose in a market scare that drove investors into Treasuries.

Maintain our liquid alternative investments: These investments have the potential to provide somewhat more return than fixed-income investments (and potentially competitive with equity markets) over coming years at a level of risk that is likely to be quite a bit lower than the stock market.

Wanting to Feel Better, But Not There Yet

The fault lines in the global economy, mostly debt-related, have not stabilized and are likely to be with us for at least a few more years. There are no easy solutions and we are all tired of it. We are also tired of the risk-on/risk-off related volatility. It is confusing for clients to see the markets roar for a month or more, only to be followed by a surge in scary headlines and sharp sell-offs. A disciplined, unemotional approach is absolutely necessary in order to resist the emotional pull of these ups and downs so that decision making is not impaired. For long-term investors, the silver lining we expect is that the price declines that could come with these risks should generate good buying opportunities. As always our motivation is to stay clearly focused on our goals of long-term performance, risk management, clear communication, and a high level of service.

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