

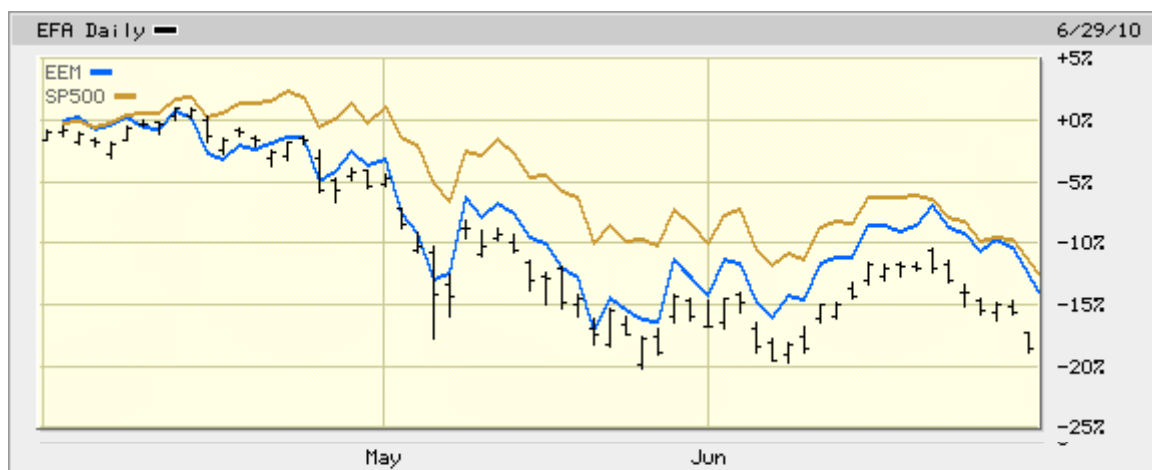
20 July, 2010

Q2 2010 Update

Equity Markets

In the second quarter global stock markets sold off as concerns about the sustainability of economic recovery came to the fore and the European sovereign debt issues continued to weigh. The chart below shows that the S&P 500 fell approximately 13% in the second quarter while non-US developed markets (EFA in the chart) fell about 18% in USD terms - led by losses in European equities.

The third (blue) line in the chart represents an emerging market equity index. It is interesting to note that emerging market equities, which are traditionally more volatile than developed market equities initially fell at about the same rate as the non-US developed market index but recovered more quickly starting at the beginning of June. This trend has continued into July and in fact emerging markets are now slightly ahead of the S&P 500 for the year.



It is worthwhile to consider why emerging markets have done as well or better than developed markets recently. It is a function of two things: First of all, many of the emerging market stock indices haven't performed as poorly as those of developed markets, and secondly many emerging market currencies are either tied to the US Dollar or haven't fallen much vs. the Dollar. The US Dollar has gained vs. the British Pound and especially against the Euro so far this year, which has in turn supported values in emerging markets versus non-US developed markets.

In addition it seems that many emerging economies are actually doing better than developed economies at present; and also becoming less dependant upon developed economies. Emerging nations generally did not suffer as much as developed countries as a result of the financial crisis. Emerging market growth rates are still substantial (China recently announced 11% GDP growth), whereas growth rates in many European countries especially have stagnated.

Recently there has also been a great deal of concern regarding the PIIGS. PIIGS stands for Portugal, Ireland, Italy, Greece, and Spain. This acronym started making the rounds late last year and is intended to denote the opposite of the BRIC countries. The BRIC's (Brazil, Russia, China, India) are considered to be fast-growing countries worthy of investment; whereas the PIIGS are countries to avoid at the moment because of their high sovereign debt levels, exposure to the financial crisis, and stalled economies. Interestingly, all of the PIIGS are considered to be developed markets and all of the BRICS are emerging markets.

I am sometimes asked which countries are considered "emerging" and which "developed", and why. Most investors go by the MSCI indices when placing countries in these categories. The MSCI EAFE index contains 22 countries that are considered "developed" – since this is a non-North America index we need to add the USA and Canada to this group. Here is a list of developed, emerging, and frontier (the wildest of the three), countries as categorized by the MSCI indices:

Developed	Emerging	Frontier
Australia	Brazil	Argentina
Austria	Chile	Bahrain
Belgium	China	Bangladesh
Canada	Colombia	Bulgaria
Denmark	Czech Republic	Croatia
Finland	Egypt	Estonia
France	Hungary	Jordan
Germany	India	Kazakhstan
Greece	Indonesia	Kenya
Hong Kong	Malaysia	Kuwait
Ireland	Mexico	Lebanon
Israel	Morocco	Lithuania
Italy	Peru	Mauritius
Japan	Philippines	Nigeria
Netherlands	Poland	Oman
New Zealand	Russia	Pakistan
Norway	South Africa	Qatar
Portugal	South Korea	Romania
Singapore	Taiwan	Serbia
Spain	Thailand	Slovenia
Sweden	Turkey	Sri Lanka
Switzerland		Tunisia
United Kingdom		Trinidad and Tobago
United States		Ukraine
		United Arab Emirates
		Vietnam

In my opinion, many of the emerging market countries are worthy of investment both in the near term and the long-term. One thing to watch out for, however, is that these countries often do not have well-diversified economies; which may mean that an investment in an emerging market country index is also a bet on a certain economic sector. For example, the Mexican country index is dominated by telecom, and the Taiwan index by technology companies.

Fixed income and Alternatives

Treasury bonds and gold benefitted from the increased economic fears in the second quarter as long-dated US Treasuries rose 15% and gold was up 10%. An especially interesting development has been the recent large purchases by investment managers of long-dated Treasuries. This is the opposite of what the trend has been over the previous few quarters. It seems that many are starting to believe that we are in for a sustained period of tame inflation or even deflation (at least in the US). This is despite the fact that traditionally low interest rates, a large deficit, and loose monetary policy lead to an inflationary environment.

My opinion is that we are likely to see commodity inflation as a result of greater and greater commodity demand from emerging markets and a firming of demand in developed economies. I believe these inflationary pressures may be offset in the near-term by high unemployment and a stagnant housing market in many developed countries – but in emerging markets we may well see inflationary pressures become more important as wage growth accelerates and housing prices continue to rise.

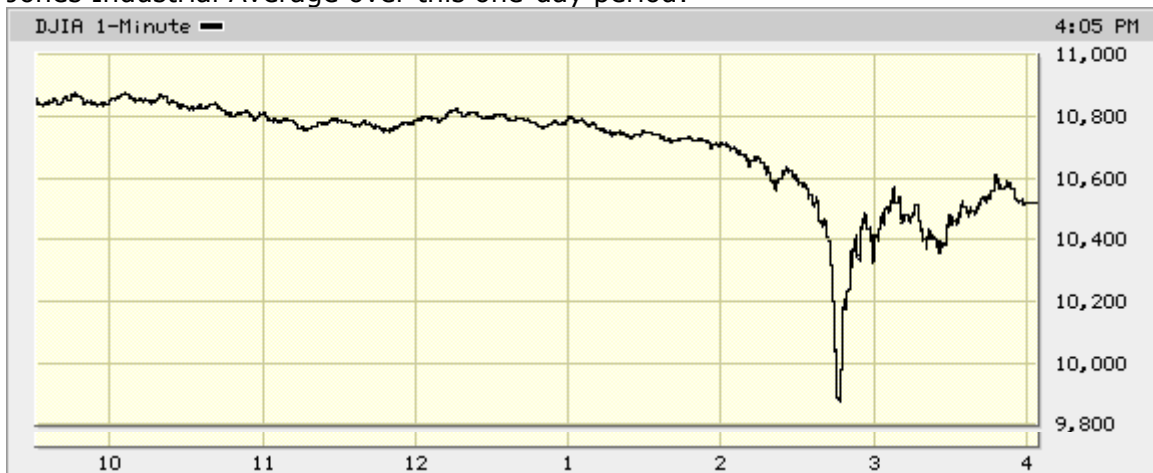
Commodity prices as a group generally tracked the S&P500 in the second quarter and have underperformed the S&P500 year-to-date – but this is largely as a result of a 20% decline in oil prices in the month of May.

Gold has provided a good hedge to the equity markets over the last quarter and seems to have become the place to hide in times of uncertainty. It will be interesting to see whether gold prices are supported in view of the recent trend towards investments that would be expected to outperform in a benign inflationary environment – gold usually does well during inflationary periods.

The US Real Estate index also did better than the S&P500 this past quarter, falling only 5%. The non-US index was down a bit more than the S&P500, most likely as a result of negative currency impact and worries about overheating in Hong Kong.

One other thing

An interesting event happened in US stock markets on May 6. Here is a chart of the Dow Jones Industrial Average over this one-day period:



Notice that the market went down steadily from just over 10,800 to about 10,600 and then around 2:30 PM it simply started to plummet; falling 800 points in a matter of minutes and then recovering almost as quickly. I happened to be watching both the market and the investment news channel (CNBC) at this time and it was truly amazing to see. Nobody had

a good explanation for what was happening and even now I haven't heard anyone fully explain the incident.

While the drop in the DJIA was, of itself, stunning, what was even more amazing was that shares of many large companies were at one point trading hands for pennies. Accenture fell by 90% at one point and even Proctor and Gamble, one of the most heavily traded stocks in the Dow, was down 35%. These losses lasted only seconds, and were subsequently explained as a sudden lack of liquidity on some of the smaller electronic exchanges – basically no buyers on the exchange and therefore no floor to prices.

There isn't really much to say about this other than you just never know what can happen these days in investment markets and it is always important to not panic in the face of the unusual. The stock exchanges are currently experimenting with "circuit breakers" for individual stocks that will automatically stop trading in the company should the price experience unusual volatility.

Where to invest now

In my opinion not much has fundamentally changed over the last quarter – what has changed to some extent are perceptions. For example, the realization has sunk in that certain European countries may have serious debt repayment problems and that this might be a drag on the whole of the EU. The perception with respect to inflation has also changed recently as outlined above.

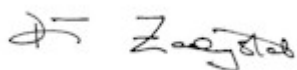
In my opinion, none of this warrants a change in our investment philosophy at this time. We have been holding some extra cash over this last quarter in most accounts and I foresee hanging onto this perhaps until the end of the traditional slow summer investment period.

I believe it is still wise to be diversified internationally and to have an allocation to commodities as well as dividend-paying stocks and other income producing investments. I would still underweight Treasuries and other fixed income investments in anticipation of the day interest rates must inevitably rise.

We are now entering the second quarter earnings season and, as usual, I have been listening to earnings calls in an attempt to gauge how companies and industries are doing. So far it seems that by-and-large growth is continuing albeit at a slower pace than in the past few quarters. In addition, US financial companies are reporting lower credit losses on both their mortgage and credit portfolios. At the same time, the picture amongst retailers is mixed and suggests that, while consumers are spending, they are spending carefully and avoiding excess debt. The real estate market in the US appears to be stagnant at best – at least in terms of new homes. The picture is also increasingly mixed at technology companies – Apple just reported an excellent quarter but others haven't done as well as expected.

In general, I see no reason to be overly defensive but neither do I expect huge investment gains in the near future. With this in mind, it seems that dividends will continue to be an important part of our returns and that we must rely on investment selection instead of investing in broad indices.

Until Next Quarter,



Tom Zachystal