Financial Alternatives

Integrated Wealth Management

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July 2010

Year to Date 2010

The first six months of the year have been a bit of a roller coaster ride for financial markets. They were down through February, then up quickly through April (with the S&P 500 up 7.05% at that point), then experienced another plunge by the end of June.

The S&P 500 index was down -6.65% through June 30th. Foreign equities had an even more difficult six months, with the EAFE International index ending down -13.23%. Bondholders were helped by a flight to safer assets and the US Aggregate Bond Index ended up 5.33% for the same period.

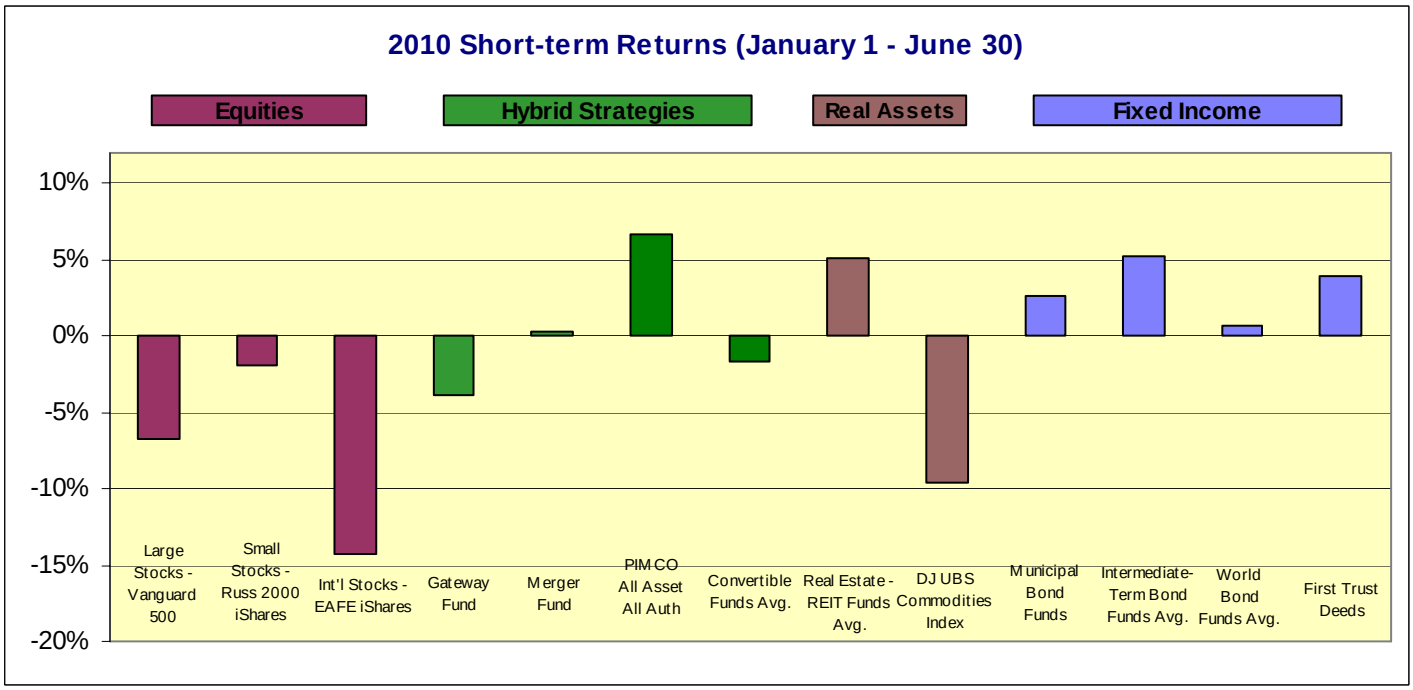
In addition to bonds, other assets classes that provided positive returns helping to offset the decline in stocks were REITs 5.16%, First Trust Deeds 3.96%, and one of our hybrid investments Pimco All Asset All Authority 6.72%. These diverse results illustrate the importance of constructing portfolios of several uncorrelated asset classes -- please refer to the graph below for additional asset returns.

The CBOE Volatility Index (VIX), often referred to as the "fear index", closed June at a high level (34.54 which is above the historic 95th percentile); and we think this reflects the unusually high uncertainty stemming from the economic challenges we face.

The normalized price-to-earnings ratio, which we

Executive Summary

- Stock market volatility continued in 2010. The S&P 500 index fell -6.65% and the EAFE International index fell -13.23% through June 30th.
- Bondholders were helped by a flight to safer assets and the US Aggregate Bond Index ended up 5.33% for the same period.
- REITs 5.16%, First Trust Deeds 3.96%, Pimco All Asset All Authority 6.72% and bonds all provided positive returns which partially offset stock declines.
- Emerging economies are generally in better shape than many developed countries due to stronger balance sheets, higher growth rates, younger populations, and the beginnings of a consuming middle-class.
- Near term inflation will likely remain low although we are concerned with longer term inflation.
- Continued market volatility and higher taxes are near certainties.
- We continue to study and prepare for various economic outcomes.
- Income generating investments reduce risk and generate 'portfolio paychecks'.
- We are implementing a state of the art rebalancing program which will be operational later this year.
- Our service and planning capabilities have been strengthened by our recent hiring of Ellen Li, MSBA.



explained extensively in our July 2009 newsletter, ended the quarter at 20.19, which is well above the 16.30 historical median. This higher P/E ratio is perhaps why Jeremy Grantham of GMO, a manager we like to pay attention to, believes the market is somewhat overvalued.

There are several opposing forces in the economy which have left investors uncertain and financial markets hampered. So what is likely to occur in the economy and stock market in the near term? That's easy: Nobody knows. In spite of this, we do study possible scenarios that could play out and design action plans ahead of time for each scenario.

In this newsletter we discuss the economy and the certainty of higher taxes. This is followed by a look at three possible economic scenarios that could unfold and how we'd react to each one. We then briefly review the importance of including income generating and hybrid investments in client portfolios. And finally we discuss the new trading technology we are currently implementing as well as how we have increased our service capabilities.

Economic Tightrope

Most experts agree that we are in a fragile part of a recovery that may or may not be sustainable, and that we may be experiencing a shift to slower growth for the foreseeable future.

Developed nations face challenges because they need to reverse the growth of debt without seriously harming their own economies. This is further complicated by the demographics of an aging population, social safety net spending, and the political will to follow through on spending discipline.

A long list of problems remain in the private sector with consumer debt repayments, potential mortgage defaults, and commercial real estate refinancing concerns among them.

Signals for future US economic growth do not bode well due to a very high debt to GDP ratio, and looming entitlement costs from Social Security and Medicare.

Better News

Many developed world countries look worse than the United States by comparison. They have been plagued by debt problems, currency devaluations, and shifting demographics that have made these nations less competitive.

In contrast, global growth may come from emerging economies that are generally in much better shape because they have stronger balance sheets, higher growth rates, younger populations, and the beginnings of a consuming middle-class.

The current US Federal Reserve (Fed) policy of maintaining extremely low interest rates has not affected inflation rates so far – prices (CPI) are up 1.1% from a year ago. Also, the large amount of deficit spending has not seemed to increase long-term interest rates as might be expected. One reason for this may be that the dollar still remains a reserve currency of choice, helping to maintain a relatively strong demand for US treasuries.

Now, many economists are split on whether inflation or deflation (falling prices) is a bigger worry in the near term. Furthermore, various experts agree that a broad based V-shaped recovery will not occur. All of this points to tame inflation – at least in the near term. Nevertheless, we are concerned that inflation will become a problem in the longer term.

Near Certainties: Further Volatility and Higher Taxes

The implications of the credit crisis and recession are still being felt and will continue for years to come. As government regulatory and policy changes are applied worldwide, there is likely to be volatility that may have more to do with regulation and politics than with the economic impact of the change itself. For now, this headline risk alone can drive significant changes in asset prices and patience will be required to avoid potential pitfalls.

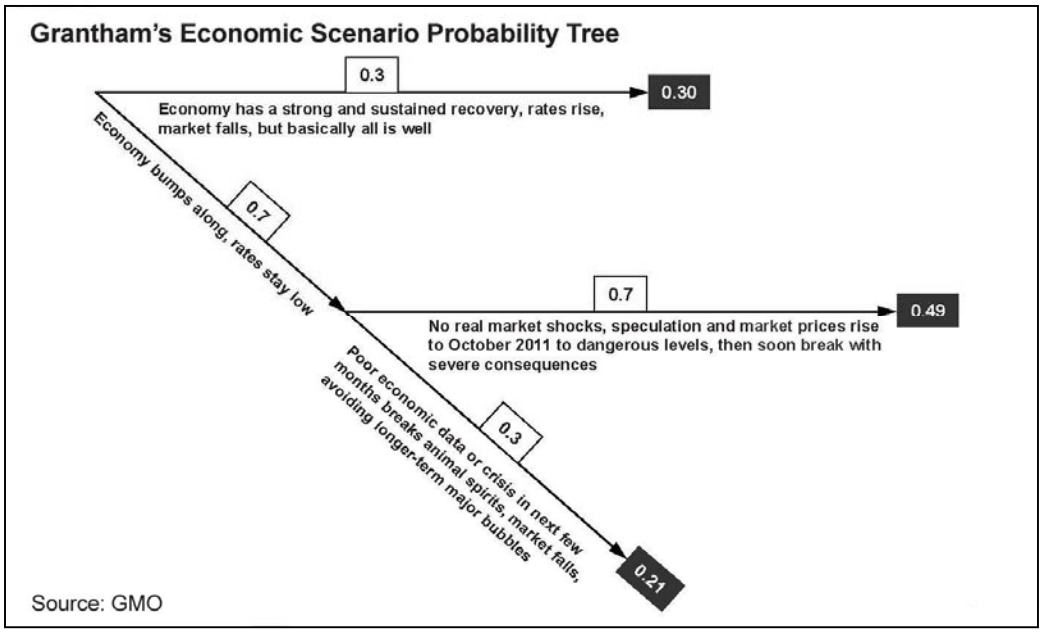
The year is more than half over and Congress has a great many tax issues to deal with. If they don't act soon, the broad income tax cuts enacted in 2001 and 2003 will expire at the end of the year. This means that tax rates on dividend income, capital gains income, as well as gross taxable income will increase.

It's impossible to predict future legislation; taxes on many types of income and estates will undoubtedly increase over the next few years, but there are still questions as to how much they will increase and whom will be affected.

That said, there will be one tax change that you can count on next year. As a result of the bank bailout (Emergency Economic Stabilization Act of 2008), the IRS will begin tracking the purchase, transfer, and sale of securities in your brokerage accounts beginning in January 2011. This program will be phased in over a three year period, and custodians such as Fidelity and Schwab will be responsible for tracking and reporting the cost basis of your assets to the IRS.

Although this may be the first time you've heard about this change, we have been diligently working with custodians and software providers on it for over a year.

As custodians finalize their procedures for the new standards, we'll provide you with further information on this cost basis matter. In the meantime, feel free to contact us if you have any immediate questions or concerns regarding this issue.



He thinks the rally is also likely because we enter the third year of a presidential cycle this October. Since 1932, there has never been a serious market decline in year three of the presidential cycle.

He feels the market has the potential to move back to the old highs, say, 1,500 to 1,600 on the S&P over the next 18 months, followed once again by a very dangerous speculative bubble in markets.

Grantham expresses that he is very concerned that the Fed not only lacks the willingness, but now the ability to deflate a new bubble. The Fed will also be unable to employ rate reductions to stimulate or jump-start the economy – as it has in the last decade.

If this scenario were to unfold, we would take profits in more volatile growth-oriented investments as the market climbed, while adding to fixed income and hybrid investments.

Possible Economic Scenarios

Longtime newsletter readers are familiar with Jeremy Grantham who offers cautious, yet well-reasoned insight into the economy and the markets. In Grantham's April quarterly letter he discusses three short-term economic scenarios that may unfold. Grantham's probability tree above shows the projected odds of each scenario.

I. First Scenario

In the first scenario at the top of the probability tree (30% probability), the economy will experience a strong and sustained recovery, interest rates will rise, the stock market will fall and basically all will be well. How can all be well if the stock market falls? Grantham's fear is that the market is already overpriced but not terribly overpriced (he feels fair value for the S&P 500 is near 875 and we are currently around 1,096 as of 7/15/10) and if the market does not fall in the shorter term it could become severely overpriced and precipitate a market crash.

If this occurred, we would opportunistically increase select equity positions as valuations became more attractive.

II. Second Scenario

In the second scenario in the middle of the probability tree (49% probability), the economy will bump along in fits and starts, and the Fed will keep interest rates low in an effort to both reduce unemployment and increase economic growth.

He is very concerned that the near 0% interest rates are forcing otherwise conservative investors into more risky assets – simply because treasuries and CDs are not providing needed income. This further bolsters the already moderately high valuations.

III. Third Scenario

In the last scenario listed at the bottom of the probability tree (21% probability), the economy bumps along, rates stay low, but some poor economic data or crisis breaks the speculation that has pushed stocks higher over the past year, sending the market lower, and avoiding a longer-term major bubble. He sees this as a positive outcome as it would restore us to a more balanced economic foundation from which the stock market could grow in a more sustainable fashion.

If this scenario unfolded, we would once again follow a similar strategy as described in Grantham's first scenario and strategically add to equities as they become cheaper.

It's interesting to note that his article was written before the most recent stock market correction. With the benefit of hindsight it appears that we are currently closest to the last scenario, but time will tell which scenario or combination of scenarios ultimately unfolds. Regardless of which scenario is realized, we'll be ready to react in a prudent and well thought out manner.

No summary of Grantham's April letter would be complete without including his 7 year return forecast which he states as follows, "A mix of global stocks, tilted to U.S. high quality, has a 7-year asset class forecast of about 5% excluding inflation."

We think this is a reasonable 7 year forecast but the returns are highly unlikely to come evenly over the next 7 years.

One Part of a Diverse Portfolio: Hybrid Strategies

We believe that alternative types of investments have a place alongside traditional equities and fixed income – particularly in the current volatile environment. In the past we called this asset class "Reduced Risk Growth", but recently renamed it "Hybrid Strategies" to reflect the variety of investments we employ in this area. We further segregate the Hybrid Strategies class into two categories: 1) Hedged/Macro Strategies and 2) Value/Event Driven Strategies, mostly for our internal purposes.

Each fund we employ in the hybrid strategy asset class may use different investing techniques, but their unifying theme is a non-traditional approach intended to mitigate losses in a down market, while effectively participating in up markets.

Several of the funds in the class have provided the non-correlated returns we seek in this class. The Pimco All Asset All Authority fund has the ability to short equity positions, so clients can earn a positive return in a falling stock market – it returned 6.72% through June 30th.

Not all funds in this category performed as well so far this year, the Gateway fund is down -3.91% through June 30th; and the Merger fund is up just 0.26%. Still these uncorrelated results are helpful, and together the funds reduce risk which can enhance the portfolio. You may recall that the Merger fund provided excellent downside protection during the 2008 crisis – at -2.26%, compared to an S&P 500 loss of -37.00% for the year.

These investments often provide attractive downside risk/volatility and should add to relative performance if stocks fall or are stagnant. We continue to seek out investments that not only provide a downside cushion, but also perform well in a rising interest rate environment. As you may be aware, bonds provide a downside buffer in a falling stock market, but their returns are impaired as interest rates increase.

Benefits of Income Generating Assets

Current income from investments in the form of dividends, gain distributions and interest can be a large component of overall returns. This income return is one of the criteria we consider when evaluating new and existing investments.

Whether markets gyrate wildly or remain flat, you can have some peace of mind knowing that many of the investments we recommend provide substantial current income. This income acts as a steady "paycheck" providing peace of mind for those who draw cash from their portfolios.

First trust deeds in particular have provided a considerable cash yield to eligible clients over the past several years. Through June 30th they had an average annualized yield of 7.93%. REIT investments also provide significant income, showing a yield of 4.16% as illustrated in the graph on page 5. The Loomis Sayles bond fund is also presently yielding over 5%.

In addition to providing portfolio paychecks, income investments provide another benefit by reducing the overall volatility of a portfolio. By combining fixed income investments, hybrid strategy investments, real assets and equity investments we attempt to balance our clients' competing needs for income, growth, and protection of capital.

Rebalancing your account can also be done effectively using cash distributions. Instead of having to sell down an asset and realize a taxable gain, existing cash can be readily deployed to undervalued investments. This may be particularly important for those who are in a high tax bracket or in an accumulation phase.

Investing in Technology & Service

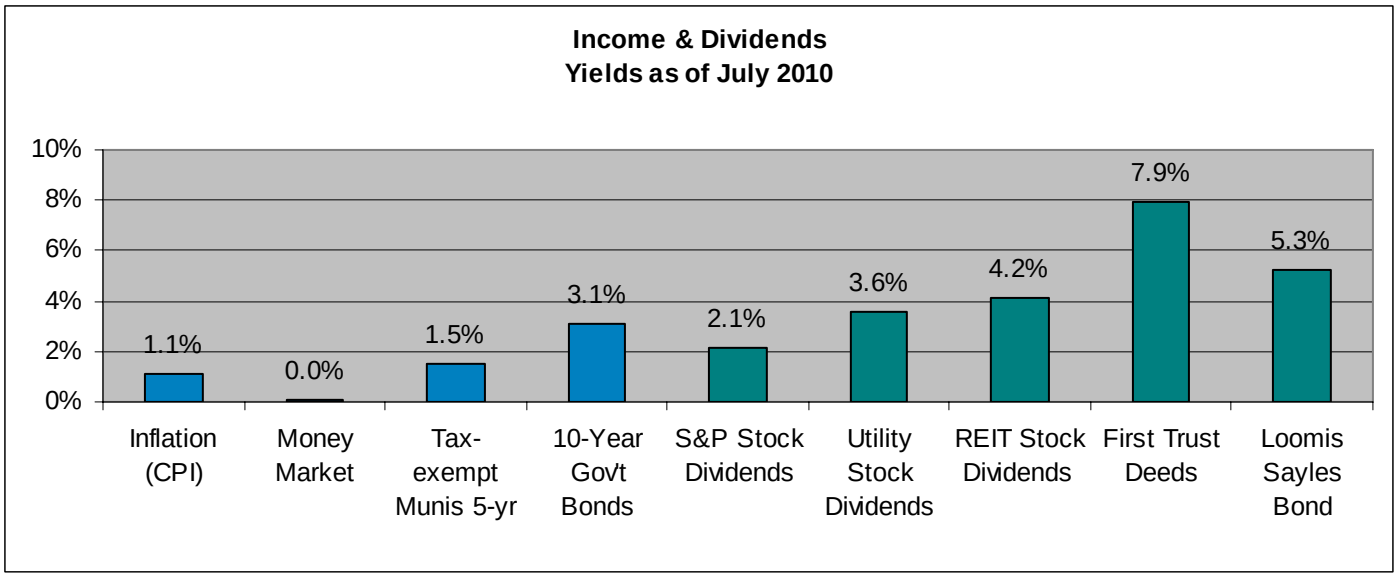
We believe an environment could unfold where it would be advantageous to rebalance or tactically alter your portfolio composition more frequently than we have in the past.

Because of this, we decided to invest in a state of the art trading program that will enable us to make shifts in clients' portfolio allocations at least five to ten times faster than before. The program has sophisticated capabilities to help us manage the trading of your portfolio while minimizing taxes and transactions costs.

We expect to begin rolling this software out by the end of the year. As a result, you may notice us rebalancing to move less tax efficient assets to tax-exempt accounts (particularly if new tax legislation passes), to manage taxable gains/losses, or to consolidate investments into fewer accounts in the second half of 2010.

In addition to this investment in technology, we recently increased our service and planning capabilities by hiring a new financial advisor Ellen Li, MSBA. Ellen is a graduate of San Diego State University where she completed two masters' degrees, one in international business and the other in financial and tax planning. She passed the Certified Financial Planner ™ exam in 2009 and will meet the experience requirement to use the CFP® mark later this year. Ellen is a member of the Financial Planning Association (FPA). In addition she is currently working toward becoming a CPA.

Upon graduation, Ellen worked as an intern at



Financial Alternatives, Inc. She then worked for another fee-only advisory firm in San Diego for two years before returning to us.

Ellen will be involved in both the financial planning and investment management divisions of the firm and we are happy to have her back.

Summary

Stock market volatility is unlikely to subside in the near term. Countries and markets around the world face multiple economic challenges that will take time to work through. We would not be surprised if returns are below average over the next three to five year period.

In spite of facing a cloudy economic and financial market picture, we continue to review various economic scenarios and make strategic plans for how we will react to each one.

By combining income investments, hybrid strategy investments, real assets, and equity investments we attempt to balance our clients competing needs for income, growth, and protection of capital. These strategies also reduce risk and volatility while at the same time providing important portfolio paychecks for clients who depend on income from their investments.

We continue to invest in technology and staff in an effort to provide the highest quality service to our clients. In the past two years we have remodeled our office, upgraded our computer systems, invested in a state of the art trading program, and hired another planner – all in an effort to further enhance the service we provide our clients.

We want to thank you for the confidence you have placed in us and also for the referrals you continue to send our way. Even if your referrals do not fit our current client profile, we promise to help them find a qualified fee-only advisor.

As always, please call if you have further questions or need to update us regarding any changes in your life that affect your finances. We hope you have a pleasant summer.

Past performance is no guarantee of future results. All content in this newsletter is intended as general information, not specific advice. Performance data listed is for illustrative purposes only. Portfolios are personalized and often consider many variables, including investment objectives, age, time horizon, risk tolerance, and tax variables. Information contained herein has been obtained from sources believed reliable, but not guaranteed.

Financial Alternatives, Inc. is an independent Registered Investment Advisor offering investment management and integrated wealth management services.

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