

See back cover for 2<sup>nd</sup> quarter performance review.

A number of major problems have been weighing on the markets.

A Greek default is a significant concern, particularly the risk of contagion spreading to the other weak EU countries and the broader financial system.

We are increasingly concerned that China could face a “hard landing” for its economy.

At home, the debt/deficit problem is significant and we probably have only a few years before borrowers start demanding higher rates for the risk of lending to a fiscally challenged U.S.

Given the wide range of potential outcomes, which are skewed to the downside, we remain underweighted to equities and overweighted to non-traditional, lower-risk asset classes.

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## Quarterly Investment Commentary

### Quick Take

There are a handful of important points that underlie how we view the world in general and the investment landscape in particular. If this brief summary section is all you choose to read, we hope it gives context for the investment decisions we are making on your behalf. If you want more detail, the subsequent sections provide it.

First, we continue to see potentially serious risks out there that could be damaging to the investment markets. The possibility of a Greek default is in the headlines, but there are other significant risks as well including the chance that China sees a sharp slowdown that affects the global economy, our own debt problems (both at the household and government level), and ongoing weakness in the economy highlighted by persistent weakness in jobs and housing. These issues matter because they have the potential to roil markets and, in a bad-case outcome, cause significant losses. And, even if they don't they still strongly suggest that it will be harder for the economy to grow at a normal pace in the years ahead.

Second, it is especially difficult to predict how these global and domestic issues will unfold in the years ahead because complexity is so high. We are confident, though, that there is more downside in a bad outcome than there is upside in a good outcome.

This brings us to our third takeaway, which is that stocks and other risky assets aren't priced cheaply enough to reward us adequately for the risks we see. Meanwhile, we believe we can get similar or better returns with less volatility and less downside from other investments that we own, like flexible bond and absolute return strategies, which don't depend on tailwinds from rising markets to earn their returns. The net of this is that our portfolios are conservatively positioned at this time and we expect this to continue until we see better return potential from riskier assets.

Finally, in terms of setting expectations markets could continue to climb in the short term. Very low interest rates encourage investors to take risk and, as time passes, can contribute to complacency. But time won't fix the problems such as our federal deficit or Greece's unsustainable debt load. These problems will either come to a head on their own, or actions will be taken to fix the problems—either

course will result in pain. If we do see markets get roiled, we will be prepared to take on more risk at levels that promise better returns. In the meantime we will probably lag in a rising market, which brings up a different kind of risk—the risk of being “wrong” in the short term. To that point, our process is one that demands we make decisions based on analysis of longer-term factors, which we can do with much higher confidence. Predicting the short term is not something we believe anyone can do reliably and consistently. This is why we want to be sure you have the opportunity to fully understand our reasoning and the depth of work we’ve done to arrive at the conclusions we have. For that, please continue reading, and if you have further questions don’t hesitate to contact us.

### **Greek Debt Crisis Fears (Again)**

It appears that the European Union, the European Central Bank, and the International Monetary Fund will once again provide Greece with additional financial assistance (i.e., loans at below-market interest rates) in return for Greek promises of more fiscal austerity. The aim is to buy more time with the hope that Greece will ultimately be able to get its fiscal house in order and pay back the debt. However, we, and most other investors, believe some type of Greek default or “restructuring” or “reprofiling”—in which the debt repayment schedule is extended but the principal value is not marked down—is inevitable given the severity of their situation. As one investment strategist put it, “Everyone knows Greece will default—it’s just a question of whether it’s orderly or disorderly.”

Given the very high likelihood of some form of default, the key question for us as portfolio managers is in regards to the timing and, most importantly, the impact on the global economy and financial and credit markets. Unfortunately, the answers to these questions remain highly uncertain at this point, but potentially quite severe.

By itself, a Greek default is probably manageable for the global financial system without causing a crisis—although even that is not certain given the global financial system inter-linkages. However, the big risk is that a Greek default could spiral into a broader European debt “contagion” spreading to other heavily indebted European countries, such as Ireland and Portugal and possibly even Spain or Italy. Even if these other countries don’t want to default, there could be a “run on the banks” that basically forces default in a self-fulfilling prophecy—the market refuses to lend to these countries, therefore they can’t roll over their debt, therefore they default *unless* the central banks and the IMF can come up with enough financial support to restore confidence and stop the bank run before the financial system is overwhelmed.

Greece remains a rapidly evolving situation. We continue to analyze the potential outcomes in terms of their likelihood and magnitude of impact on the asset classes in which we invest. Should there be a crisis in the near-term related to Greek debt, we’d expect Treasury yields to fall (and therefore Treasury prices to rise) and “risk assets,” such as stocks and emerging-market currencies, to fall. Treasury bonds are still perceived as a “safe haven” asset class—despite the United States’ own debt problems.

### **China Hard Landing**

Another risk that we have highlighted recently and that is growing in importance in our macro assessment is a potential “hard landing” for the Chinese economy (as opposed to a smooth manageable slowdown) and the global ripple effects that would result. Most experts we have talked to agree that there is a bubble in at least some segments of China’s property market. The general consensus is that this bubble is not widespread and can be managed by the Chinese government, as it has been in the past. There is a risk, however, that the bubble may have already grown very big and, if pricked, will result in a sharp contraction for China, which we believe has not been priced into risk assets. A hard landing will be negative for equities, commodities, and also for our allocation to emerging-markets

local-currency bonds. We have talked to and read analysis of both the optimists and the pessimists, and it is hard to really know who is right, partly because of the lack of reliable information from China. However, we find ourselves leaning toward the bearish side because of the following big-picture observation.

For much of the last two decades, China has been building infrastructure—residential and commercial real estate, factories, roads, bridges etc.—that may have made sense for the urbanization rate it experienced then. In large part, this urbanization was driven by much of the developed world spending beyond its means, enabled by excessive borrowing. So, the question is: has China factored the ongoing developed-market deleveraging into its infrastructure plans? This does not seem to be the case. In fact, fixed-investment spending has grown at a faster rate in the past two years than it did before the crisis. It is difficult to imagine that all the excess capacity that has likely resulted from this above-normal investment, at a time when the developed world is deleveraging (and must continue to deleverage), can be soaked up by China's domestic consumption. The numbers don't add up: China has a \$1.5 trillion consumer economy versus \$20 trillion for United States and Europe combined. Further, China is inducing a negative wealth effect among the rich urban Chinese by pricking the housing bubble there—and rural China in our view does not have high enough per-capita incomes to absorb all the excess industrial capacity China likely now has.

### **The U.S. Economy Is Slowing Again**

Recent U.S. economic news has been disappointing, with sluggish GDP growth and continued weakness in employment and housing (which are important drivers of consumer confidence, income, and spending). On the jobs front, the latest employment report for May showed growth in nonfarm payrolls of only 54,000 for the month, a big drop from the 220,000 monthly average increase in the prior three months. We have seen estimates (from various economists) that the economy must create anywhere between 100,000 and 200,000 net, new jobs each month just to absorb the natural flow of new entrants into the labor force and keep the unemployment rate flat. The unemployment rate in May ticked up to 9.1%. Meanwhile, private and government economists have been cutting their growth forecasts for the year to below 2.5%–3% in most cases.

### **What Would Lead Us to Become More Optimistic?**

We are occasionally asked what would lead us to increase our equity exposure or become more optimistic about the macro environment. In terms of increasing our equity exposure, first and foremost would be an improvement in market valuations, which would raise our return expectations for stocks over our five-year analysis horizon. All else equal, a drop in stock prices improves the expected future return.

Alternatively, if our assessment of the economic fundamentals and, in turn, corporate earnings growth materially improves while stock prices remain flat, that could also lead us to increase our exposure to equities based on higher expected returns. We also continue to reassess the positive impact on our earnings-growth estimates from the growing share of U.S. corporate profits coming from emerging-markets demand. Credible and concrete policy actions to control the United States' long-term structural budget deficit and evidence of successful deleveraging among the public and private sectors would be additional fundamental factors that could lead us to shift our scenario assessment to a more positive range of outcomes for riskier assets.

### **A Concluding Reminder About Downside Risk**

Having said what could turn us more positive, we will conclude with a reminder about the potentially severe downside, e.g., in the event of a European debt contagion, China hard landing, or some unexpected systemic shock. In that event, we'd expect riskier assets to depreciate. When we stress-test

our Balanced portfolio for this type of scenario—a severe downturn, though not as bad as 2008—we estimate that we would violate the Balanced portfolio’s 10% 12-month loss threshold by a couple of percentage points (but we would also outperform the benchmark). While that would be a tough loss to swallow, we feel the likelihood of that type of scenario is sufficiently low and better outcomes are much more likely, so we would be comfortable with that level of risk exposure. As we’ve said, we don’t manage our portfolios to a worst-case scenario because the opportunity cost from foregone returns in the event less-dire scenarios play out can be significant. However, it is certainly possible that the downside for equities is more severe than we assume in our stress test, for example causing losses in the mid- to upper teens for the Balanced portfolio over the short term. Clients in this model should be able to withstand that type of 12-month loss without panicking. If they can’t maintain their risk tolerance and longer-term return focus if the worst case plays out, then moving to a lower-risk portfolio model probably makes more sense than hoping the bad outcome doesn’t come to pass.

The good news for clients who are in the appropriate model for their risk tolerance is that in the event of a severe market downturn, our relatively defensive positioning should enable us to redeploy capital from lower-risk investments into equities or other higher-risk assets with (at that point) much better return potential. As we’ve written in our past commentaries, if there is one thing we can be almost certain of, it is that there will be market shocks over the next few years and they will create investment opportunities for us to take advantage of. There may also be events that magnify risks that we will want to further protect against. In either case, we will continue to invest based on where our research and analysis leads us, not based on what the investment herds are doing, “common industry practice,” or anything else of that nature. In the long run, investing based on our research conviction has paid off for our clients, and we are confident it will continue to do so.

— *Research Team (7/2011)*

## Performance Review

Momentum that carried stocks higher through the first four months of the year fizzled in May as investors became increasingly concerned about a slowing economy (exacerbated by supply chain interruptions stemming from the Japan earthquake) and fears that a Greek default would spread contagion to other weak EU members and rattle the European and even global financial systems. Those concerns, particularly relating to Greece, intensified as the second quarter progressed, and a modest retreat in May worsened in June before we saw a late-month rebound as it became increasingly likely that the EU and IMF would manage to kick Greece’s debt can down the road at least one more time.

When the dust settled, stocks wound up roughly flat for the quarter. Large-cap U.S. stocks were barely positive while smaller-cap stocks lost 1.6%. Growth did better than value. Domestic high-quality, intermediate-term bonds gained 2.2% for the quarter.

Looking abroad, developed-market foreign stocks gained 1.1%, while emerging-markets equities fell 1%. Local-currency emerging-markets bonds had a strong quarter, gaining 4%.

<b>June Benchmark Returns (Preliminary)</b>			
	<b>Jun</b>	<b>2Q</b>	<b>YTD</b>
<b>Large-Cap Benchmarks</b>			
Vanguard 500 Index	-1.7%	0.1%	6.0%
Russell 1000 (iShares)	-1.7%	0.1%	6.3%
Russell 1000 Growth (iShares)	-1.4%	0.7%	6.7%
Russell 1000 Value (iShares)	-2.1%	-0.5%	5.8%
<b>Mid-Cap Benchmarks</b>			
Russell Midcap (iShares)	-2.1%	0.4%	8.0%
Russell Midcap Growth (iShares)	-1.6%	1.6%	9.5%
Russell Midcap Value (iShares)	-2.6%	-0.7%	6.6%
<b>Small-Cap Benchmarks</b>			
Russell 2000 (iShares)	-2.3%	-1.6%	6.2%
Russell 2000 Growth (iShares)	-2.1%	-0.6%	8.6%
Russell 2000 Value (iShares)	-2.5%	-2.7%	3.7%
<b>Other Benchmarks</b>			
Vanguard Total Int’l Stock Index	-1.5%	0.7%	3.7%
MSCI World ex USA Index	-1.4%	1.1%	5.1%
Vanguard Emerging Mkt Stock Index	-1.5%	-1.0%	0.8%
Vanguard REIT Index	-3.4%	3.5%	10.2%
Vanguard Total Bond Mkt Index	-0.4%	2.2%	2.5%
Merrill U.S. High Yield Cash Pay	-1.0%	1.0%	4.9%
Barclays 7 Yr Muni Bond Index	0.1%	3.3%	4.0%
S&P/LSTA Leverage Loan Index	-0.4%	0.2%	2.6%
Citigroup World Govt. Bond Index	0.2%	3.3%	4.0%
JPMorgan GBI-EM Global Div. Index	0.5%	4.0%	6.9%
DJ-UBSCI (Commodity Futures)	-5.0%	-6.7%	-2.6%