

## **The Debate Has Been Joined**

During the second quarter of 2010 the S&P 500 lost approximately 11.43% (-6.65% ytd); the Dow Jones Industrial Average lost approximately 9.36% (-5.00% ytd). The Russell 1000 and Wilshire 5000 Indices lost approximately 11.44% (-6.40% ytd) and 11.19% (-5.83% ytd), respectively. The Russell 2000 Small Cap Index and the S&P 400 Mid Cap Index lost approximately 9.92% (-1.94% ytd) and 9.59% (-1.36% ytd), respectively. Approximately forty percent of these quarterly losses occurred in the final three days of the quarter.

Igniting this market volatility was increased visibility into both fundamental economic and governmental policy forces confronting investors. Some economists and forecasters, focusing on near term consequence, have argued that increased fiscal, and continuing monetary, stimulus are essential so as not to derail the modest economic recovery while others have argued that fiscal restraint is required in order to prevent more severe economic consequence in the future. A similar debate has recently been playing out in the international arena among G-20 countries.

We believe this volatility in the equity markets, and the flight to quality (in the bond market), reflect the intensity of this debate and the recognition by investors that high impact risks to financial asset values are present. We will address the positive and negative economic factors (both near term and longer term) that are impacting the financial markets and how we have incorporated our views into an action plan reflected in the portfolio composition of our clients.

### *Fundamental Positives*

By historical measures, the valuation of equity shares seems reasonable at 12.6x earnings for the S&P 500 based on 2010 operating earnings estimates and 10.9x 2011 operating earning estimates. Corporate balance sheets are stronger as corporations have shed debt and retained profits in cash reserves. A low interest rate environment is further supporting corporate profits by allowing larger companies to have access to inexpensive capital. Although much of the earnings outlook has been underwritten by cost cutting and governmental stimulus programs, companies have experienced modest growth in top line revenues. Internationally, China and India are continuing to focus their efforts on infrastructure and a developing middle class that will over time support GDP growth through domestic consumption. Finally, U.S. GDP exposure directly attributable to exports to the troubled Eurozone is limited.

The most significant of the positive fundamentals outlined above is the relative price of equities as compared to other financial assets including bonds whose interest rates approximate 4% for intermediate term investment grade corporate credits as compared to a 2010 earnings yield for the S&P 500 of 8% and 9% for 2011. Of course, we are aware that the bond market's pricing could be read as an indication that the anticipated corporate earnings are not sustainable (see below) and therefore equity valuations are richer than they appear. Our view is that the bond market is more likely pricing by reference to artificially low Treasury interest rates.

### *Fundamental Negatives*

Notwithstanding the increase in corporate profits and GDP growth, unemployment levels remain high. Although hours worked have recently increased and wages earned have similarly increased, job creation is tepid. As the length of unemployment has increased, state and local unemployment benefits have not been extended, further pressuring the economic recovery.

Continued consumer deleveraging and reduced consumer and small business access to private credit is also placing pressure on the economic recovery. Weakness in the housing market and increased mortgage delinquencies and foreclosures present additional significant economic challenges to the recovery.

The economic crisis triggered in Europe as a result of a worldwide economic slowdown coupled with high levels of sovereign debt, reduced tax revenues and declining values in real estate markets has created instability in the Eurozone and pressure on its common currency. The interconnectivity of the risks associated with this can be seen by examining cross border indebtedness among banks within the Eurozone. We also recognize the largest US banks have exposure to the larger European banks. Finally, because the countries comprising the Eurozone are distinct socio-political entities (sovereign nations) with separate economies, those countries with surpluses which are in a better financial state than countries with high debt and current deficits are not required to use their surpluses to ameliorate economic pressures on the deficit countries.

While the negatives above present near term concerns, there are additional negative fundamentals that impact the longer-term outlook. The level of entitlements at the federal level and state and local “unbooked” pension and other employee benefits have risen to unsustainable levels and are continuing to grow. Federal debt levels are projected to increase significantly during the next several years as annual deficits accrue. And while corporations have deleveraged, federal and state governments have increased their debt. If interest rates were to rise, annual deficits reflecting current interest costs could increase significantly and the high levels of governmental debt could crowd out private debt availability in the capital markets.

### *Policy Positives*

The Federal Reserve Bank continues to maintain a historically low short-term interest rate environment and has signaled that it is not anticipating rate increases in the near future. In addition, bank balance sheets have improved as a result of the TARP program and other bridge and liquidity programs designed to allow banks to bolster their profits and re-deploy liquidity challenged assets. Although these policy initiatives have been designed to produce short-term benefits to the economy, concerns regarding budget deficits and increased government debt loom large in the debate. And while fiscal restraint through reduced government spending is widely viewed as a long term imperative, the debate centers on the proper timing of any change in the current highly stimulative fiscal policy.

### *Policy Negatives*

Any near term reduction in government spending could slow the economy or even derail the recovery. Similarly, increasing tax rates as a result of the sunset of the Bush tax cuts coupled with increased taxes to fund healthcare costs, increased state taxes to close budget deficits, and increasing healthcare costs, all bode for reduced consumer spending and could result in economic slowdown in the near term. As to monetary policy, the Federal Reserve has begun to pull back its quantitative easing strategies which may contribute to higher longer-term interest rates and reduced liquidity for certain types of securities. Additionally, although the United States is not suffering the debt levels of some Eurozone countries, there is concern in the financial markets that government policies in Europe favoring fiscal restraint may further slow Eurozone activity and have a contagion effect with respect to its trading partners. There is also a concern that an absence of fiscal restraint on the part of Eurozone countries may lead to further credit problems and pressures on Eurozone sovereign debt which may pressure portfolios and affect pricing of other financial assets. Finally, with respect to longer-term regulatory matters, it appears that “serious financial reform” does not seem so serious at this point. The legislators and regulators continue to focus on regulation of behavior, capital requirements and disclosure and do not in our view adequately address the need to incorporate economic mechanisms to align the interests of bank issuers and securities originators with those of the investor.

### *Portfolio Construction*

Policymakers are faced with a vexing paradox in addressing the near and long term demands of the economy. This will have ongoing implication for investors as individual asset classes will be affected by these decisions.

One of our guiding principles in portfolio construction is the mitigation of high impact risks which can devastate a portfolio. Risk has all too often been analyzed in terms of probability of occurrence rather than the magnitude of the impact if it should in fact occur. Such was the case in the analysis and structuring of mortgage related securities, and such was the case in the risk analysis undertaken by British Petroleum in drilling and managing its deep water well.

As stewards of our clients’ wealth, we continue to devote our energies to the avoidance of high impact risk. To this end we have continued to increase diversification of client portfolios as the nature of risk in the financial markets and the economy has evolved. While each portfolio is managed individually, for most clients we are underweight long equities and have overweighted mid and small capitalization companies within this long equity allocation. We have established an allocation to tactical managers that include tactical fixed income managers, tactical asset allocators and long/short equity managers. We have also diversified our exposure to municipal credits in our municipal bond portfolios, emphasizing high quality revenue bonds and general obligation bonds.

We view the tactical component of the portfolio as essential in responding to the rapidly changing macroeconomic environment as it is impacted by government policies and debt levels. Our goal is to balance the potential rewards against the risks we are willing to accept while limiting the consequence of high impact risk.

As always, client portfolios are managed individually, taking into account individual circumstance as well as broader financial market implications. Please discuss your individual account performance with your KLS account manager.