

## **Year End Review and Outlook**

After losing 6.7% of its value during the first 6 months of 2010, the S&P 500 rose to finish the year at an annual gain of 15.1%. The Russell 2000 Small Cap Index and the S&P Midcap Index (each down less than 2% at June 30<sup>th</sup>) similarly advanced for the year, gaining 26.9% and 26.6%, respectively.

These gains were fueled by low short-term interest rates, a renewed commitment (“QE2”) by the Federal Reserve to hold down intermediate term rates (although the bond market has been less than cooperative), and passage of a fiscal stimulus program aggregating \$800-\$900 billion in the form of payroll tax cuts, extension of unemployment benefits and the extension of lower income tax rates. Recent stock market performance also reflects an optimistic outlook for growth in corporate earnings without pricing in significant multiple (or price-earnings ratio) expansion. We caution, however, that mid-teen PEs are not inexpensive although their relative value is enhanced by low treasury bond yields (i.e., 10 year at 3.3%, which represents a PE equivalent of 30.3x).

The enthusiasm of the equity markets also reflects cyclical gains in the U.S. economy including increases in personal incomes and consumer spending, reduction in consumer debt, revitalized corporate balance sheets, and corporate productivity gains – all without triggering near-term inflation concerns.

Throughout this cyclical recovery, structural uncertainties have continued to persist. As U.S. budget deficits expand, federal debt increases. Unemployment remains stubbornly high, corporate spending on capital items has been restrained, the housing market remains soft, and materials and commodity prices have risen dramatically as a function of currency debasement concerns and increased demand in developing countries. Increased energy cost may adversely impact future corporate profits and slow consumer deleveraging and spending.

Europe continues to struggle with budget deficits, balance of trade, and bank and government debt burdens. Several countries have commenced austerity policies including reduced spending and tax increases that may slow their economies in the near term.

While the United States’ economy and capital markets, still in the midst of stimulative monetary and fiscal policies, may benefit in the near term, the government will eventually need to address its own structural spending and debt issues. These structural problems are not confined to the federal government but also plague the state governments that must reduce spending and increase taxes to balance budgets, manage their debt burdens and maintain access to favorable borrowing rates.

Finally, although developed economies each have their respective local issues, the overlay of globalization presents further structural challenges: (1) competition for resources impacts pricing that may spur inflation, (2) imbalances in standards of living and corresponding lower labor cost drive down wages in developed countries and add to unemployment, and (3) lackluster reciprocal trade impedes economic growth in the developed markets. This trade imbalance effectively causes developed countries to finance trade deficits with debt issuance further exacerbating budget deficits. In order for globalization to self-regulate, currency relationships must be set by free markets. This, however, is unlikely to occur in the near term (notwithstanding China recently loosening some controls in capital flows).

### ***Portfolio Construction***

During 2010 we sought to capitalize upon the opportunities presented by the cyclical economic recovery by establishing a significant allocation to tactical asset managers early in the year with the goal of increasing exposure to risk assets while incorporating in client portfolios the ability to react quickly to a rapidly changing environment replete with a plethora of structural issues. We also increased our allocation to long equities in the second quarter of 2010.

As a result of these changes, most client portfolios meaningfully participated in the gains realized by the equity and debt markets during the year.

We also maintained a significant allocation to municipal bonds that have been broadly diversified by issuer and state of issuance to guard against credit concerns. While there has been much recent negative press regarding municipal securities, we believe that by working with managers that maintain high credit quality standards and emphasize large state issuer general obligation bonds and high quality essential service revenue bonds in broadly diversified portfolios, credit risks are muted. As discussed above, the structural issues remain though they can be addressed in part through diversification of credit risk and individual security selection.

By maintaining an allocation to fixed income and tactical funds, the impact of losses experienced by the equity markets during the first six months of 2010 were greatly reduced in most client portfolios. Correspondingly, during the last six months of 2010 the equity gains reflected in overall portfolio performance was substantial but similarly impacted as a result of the allocation to fixed income and tactical managers. While the cyclical recovery in stock market performance during 2010 has given some investors a heady sense of confidence, we believe that the structural issues discussed above leave the economy and capital markets in an elevated risk position as we enter 2011.

We endeavor to strike the appropriate balance between risk and reward as the economic landscape unfolds. To that end, we have created a portfolio during the past year that is highly diversified by asset class. As we enter 2011 most client portfolios have exposure to diversified domestic equities, long/short equity managers, developed country foreign equities, emerging market equities, foreign currencies, sovereign debt, materials and precious metals, and high quality municipal bonds. Additionally, most client portfolios are partially invested with managers that actively manage fixed income credit, interest rate, and net equity exposures.

### ***Portfolio Rebalancing***

As the domestic and global economies continue to evolve we revisit asset allocations on a regular basis and effect changes based upon our assessment of the risks and rewards represented in the capital markets and economic landscape. In January, we anticipate equalizing allocations among the long only equity managers in client portfolios and reallocating half of our overweight position in the mid-cap index to an all-cap (though principally mid and small cap) manager. This will result in a small increase to most clients' equity allocation and increases flexibility in the long only equity portion of the portfolio by adding another actively managed fund.

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

### ***Developments at KLS***

During the past twenty-two years KLS has served clients principally in the greater New York area, the greater Washington, D.C. area, southern and northern California, London, and other international locations.

We are delighted to announce the opening of our Los Angeles, California office that will serve clients on the West Coast. Kara Boccella, Managing Director, has relocated to Los Angeles where she will head this new office. We are committed to increasing growth of our West Coast client base and view it as critical to our strategic plan.

We appreciate your confidence in KLS and wish you and your family a healthy, happy, and prosperous New Year.

December 31, 2010