

Second Quarter Review

The second quarter of 2011 challenged investors with the many structural issues plaguing the global economy: the Greek debt crisis and its realities of austerity, exposure of European banks to Greek debt, and the potential cascading effect throughout the European banking community. The further slowing of European economies as a result of fiscal policies targeting reductions in government spending and debt, and the difficulty of the European Monetary Union members agreeing on a course of action to address the seemingly disparate interests of the members has created heightened anxiety for investors. Throughout, the European Central Bank has expressed concern about the perceived threat of inflation that has not yet manifested other than in food and energy costs.

As the quarter drew to a close the protests and violence in Greece escalated, and equity markets rallied recovering the losses sustained earlier in the period. An austerity plan was passed (in concept – details to follow) by the Greek parliament fulfilling the requirement of the EU for additional bailout funds. The commentary and rhetoric has also escalated – “kick the can down the road”, “extend and pretend” and “moan and postpone” are now well ensconced in the economic lexicon. The tension that exists between forestalling private sector losses (with the goal of slowly letting them out over time) and resolving the public finances of a country that is not likely to be in a position to repay its debts even with a protracted extension of time seems evident. The concern ultimately focuses on the solvency of the banks holding sovereign and related debt and the impact on bank equity holders, bondholders and perhaps depositors.

In the United States, unemployment remains high as a result of slow private sector job creation and payroll reductions by state and local governments. The housing market data has similarly not been encouraging with recent data underscoring the absence of a recovery in housing prices (notwithstanding a modest and preliminary increase in housing prices in April) – likely a result of a delay and extension course of action that has forestalled the “clearing” of the housing market that would allow prices to reset at a base level that would support growth. The federal government continues to wrestle with stimulus vs. deficit reduction, the debt ceiling, and tax policy. The deep ideological divide between Democrats and Republicans presents a substantial impediment in the near term to arriving at a “grand bargain” that in the best case will avoid overreaction that could lead to further problems and unintended consequences. Finally, the ratings agencies have expressed their great concern and lack of confidence in management, i.e., the Executive and Legislative branches of our government.

Meanwhile, the Fed advises that the economy is growing at a slower pace than anticipated after completion of both Quantitative Easing I & II, and urges Congress and the President to seriously address deficit and debt issues. The Fed apparently does not believe that structural core inflation is a near term concern given slow growth in GDP and the absence of wage inflation. As compared to the developing world and Europe, increasing food prices have less of an impact on US consumers. High gasoline and other energy costs, however, “tax” the consumer and slow GDP growth.

Throughout the quarter, concern has grown over the continuing direct leverage and the masked leverage (attributable to derivative securities) present in the worldwide financial system. This culminated in the recognition that the stress tests for European banks must contemplate impairment of value for sovereign debt holdings, implicitly recognizing the need for increased capital. The recent Basel accords have also raised capital requirements for the largest financial institutions. Finally, spurring concern that central banks and policymakers are low on ammunition to address stubborn structural economic issues, the coordinated release of strategic petroleum reserves by worldwide governments rattled markets toward the close of the quarter.

With the euro zone under fiscal pressure and facing possible further economic slowdown, and the United States in slow growth/high unemployment mode, investors are cautious and continue to look to emerging markets – in particular, China, as the economic engine for corporate earnings growth. At the same time, inflation in housing prices, food, energy and certain raw materials has drawn the attention of the Chinese government. The policies employed by the government, including increased capital requirements for banks, control of capital flows, and currency exchange policies aim to prevent overheating of the economy, while promoting internal consumption and addressing infrastructure needs. Debate continues over the efficacy of these policies, but investors are cognizant that the performance of emerging market economies remains critical to the earnings growth of multinational corporations. Recently, it also became clear that notwithstanding the efforts of the Chinese government, a nascent shadow banking system in China may fuel future problems, and accounting and auditing standards by certain Chinese companies have proved opaque and misleading (if not fraudulent).

The fundamental thesis for equity investing in the midst of all of these uncertainties is two-fold: (1) share valuations provide substantial “cushion”, with the S&P 500 trading at approximately 13.5x estimated 2011 earnings and (2) the expectation that the Fed will continue strongly accommodative policies. Even if the Fed does not proceed with QE III it likely will maintain liquidity and yield curve support by reinvesting interest and principal of its government debt holdings as they are received, thus preserving its balance sheet, and not become a net seller of government debt. Nevertheless, on the last day of the quarter, in active bond market trading, bond prices declined and interest rates rose.

It is likely that it will take some time for the domestic economy to gain momentum as consumer deleveraging continues, high unemployment persists, the housing market struggles to find a bottom, and major fiscal policy issues remain unresolved. We believe that emerging middle class consumption in the emerging markets is a critical support for worldwide economic GDP growth and bridge for corporate earnings growth. Although there are challenges in every economic cycle, the longer term demographics support this trend.

Portfolio Construction

Given the continuing structural concerns, we more than ever stress diversification in client investment portfolios with a substantial allocation to tactical managers who consider and address macroeconomic policies and events in managing their investment portfolios. These managers endeavor to identify the risks and capitalize on the opportunities presented by the rapidly changing environment.

Changes in the yield curve, credit outlook for governments and corporate issuers, foreign exchange relationships, as well as business environment and competitive outlook for sectors and companies are addressed in attempting to strike the appropriate risk-reward balance.

High quality municipal bonds continue to provide competitive yield and support for most client portfolios, and diversified developed market equity funds provide further participation in equity gains. We continue to over-weight mid-cap stocks in the equity fund portion of most client portfolios while maintaining strong sector and issuer diversification.

Our approach to portfolio construction will mitigate, though not eliminate, the volatility experienced in the equity markets, while meaningfully participating in market gains.

Market Performance

During the second quarter, the equity markets gave up much of the gains realized in the first quarter of the year and then dramatically rallied back to recover those second quarter losses. For the three months ended June 30, 2011 the Dow Jones Industrial Average increased 1.42% (+8.58% ytd); the S&P 500 and Russell 1000 indices gained .1% (+6.02% ytd) and .12% (+6.37% ytd), respectively while the Wilshire 5000 lost .08% (+6.09 % ytd). The Russell 2000 Small Cap Index and the S&P 400 Mid Cap Index lost 1.61% (+6.21% ytd) and .73% (+8.56% ytd), respectively. The MSCI EAFE index gained 1.56% (+4.98% ytd). Finally, the MSCI EM index lost 1.15% (+.88% ytd).

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