

## **Balancing**

During the first quarter of 2010 corporate profits continued to improve supported by last year's cost reductions, a Fed-driven low interest rate environment and a firming of consumer and business confidence that resulted in increased revenues. Performance of the equity markets reflected these positive developments. For the calendar quarter ending March 31, 2010, the Dow Jones Industrial Average increased 4.82 % and the S&P 500, Russell 1000 and Wilshire 5000 indices generated gains of 5.39%, 5.70% and 6.17% respectively. The Russell 2000 Small Cap Index and the S&P 400 Mid Cap Index increased 8.85% and 9.09% respectively.

As investors, we continue to endeavor to strike the appropriate balance between structural capital market and economic risks presented in the current environment and the cyclical opportunities available as a result of highly stimulative government policies supporting and catalyzing economic recovery. In our 2009 year-end letter, we discussed the ongoing challenges facing the economy and the structural and "overhang" risks that remain coming out of the financial crisis. We also reiterated our belief that the Treasury and the Federal Reserve Bank will continue to embrace policies that will support the recovery.

During the first quarter of this year we concluded that in these circumstances increased participation in the near-term recovery was desirable but wished to effect this in part with managers that have historically positioned their portfolios defensively as risk elevated. To this end, we have established a 25% target allocation to tactical managers in most client portfolios, and have invested with both tactical fixed income managers and global asset allocators (managers who invest in both equity and bonds).

In the near future we will assist our clients in investing in a long/short equity fund of funds as the final component of our tactical asset allocation. Our objective continues to be providing increased exposure to equity markets with managers that have historically taken a tactical approach to risk mitigation. We have sought out a fund of long/short equity managers that have maintained some short side exposure that in aggregate has historically served as a risk mitigator in falling markets (albeit a rate of return limiter in rising equity markets). We view this addition to the portfolio as integral to the tactical allocation component.

The long/short fund will generally be comprised of two types of long/short managers—high hedge managers and opportunistic (or directional) managers. High hedge managers typically maintain a tighter band of net long exposure (i.e., long exposure minus short exposure) to the equity markets. Opportunistic managers will increase or decrease their net long exposure (as they deem appropriate based upon economic, sector and capital market conditions) to a greater extent than high hedge managers. Long/short equity investing is grounded in fundamental analysis at the security level by the individual managers, but also is focused upon macroeconomic and market factors that impact the performance of the broader capital markets and individual companies purchased or sold.

As we have discussed many times in the past, risk and reward are correlated. Consequently, where there is the opportunity for a long/short equity strategy to produce superior returns, it is also possible that such a strategy produces greater losses. Simply put, the long/short manager can be right as to both long and short selection or can be wrong as to both long and short investment decisions. In addition, there is an element of reduced liquidity in exiting this type of investment. The fund contemplates quarterly tender offers, with aggregate limitations in place on withdrawals. In order to mitigate these risks, we believe it imperative to utilize a fund-of-funds vehicle that encompasses many managers. Over time, with sufficient diversification among managers and sectors, it is reasonable to expect risk to be mitigated.

In sum, the risk/reward profile of this type of investing is different (not necessarily greater, and not necessarily less) than a dynamically managed portfolio investing in fixed income and equities. We believe that it will prove to be a good addition to client portfolios as the economic recovery opportunities and structural risks seek equilibrium.

Perhaps the most significant development during the first quarter of the year was the increased fiscal pressure that Greece has come under. With reduced revenues, increased public services and benefits and ballooning government debt, there is concern that the economic situation of Greece foreshadows that of other countries in the European Monetary Union. Some have suggested comparisons with the United States. Just as Greece has experienced swelling government payroll and benefits, our own federal government and the states have experienced much the same at a time when tax revenues have declined. State credits have come under pressure and have caused us during the past year to further diversify credit risk in our municipal bond portfolios for our clients. We have adapted to a changing environment and will continue to do so as the regulatory framework, tax policy and entitlement programs evolve and as capital markets respond.

While at some point rising interest rates and inflation will be a concern, there are still the counterbalancing headwinds of high unemployment, consumer pay down of indebtedness and a soft housing market to offset these issues in the near term.

Finally, each KLS account is managed separately; please discuss your individual account performance with your KLS Managing Director. We will also be speaking with you in the near term regarding investment in the long/short equity fund discussed above.