



# **Annual Client Report**

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**Capital Advisory Group**  
7100 Forest Avenue, Suite 301  
Richmond, Virginia 23226  
(804) 648-3500

## The CapGroup Annual Report

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The *CapGroup Advisory Board* is an informal group of outside advisors that assists the firm's management with strategic business planning. This "interview" captures the essence of the semi-annual update to our Advisory Board on the state of the firm, as well as our outlook on the economy and the investment markets. We trust that it will be of interest to all of our Clients.

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**Advisory Board:** *When we survey the returns from financial assets in 2009 it was a very positive year, but the end results certainly belie the extreme uncertainty that plagued the global economy and financial markets, especially early in the year. For context, please give a brief review of the year.*

**CapGroup:** Yes, 2009 was an extraordinary investment year by any standard you want to apply. When it began, the global economy and banking industries were still reeling from a free-fall in the markets that would continue on to a major low in March. All of the Wall Street firms that sold toxic assets to their customers were receiving multi-billion dollar transfusions of taxpayer money, and AIG (the world's largest insurer), Fannie Mae and Freddie Mac and, soon, General Motors were effectively owned by the U.S. government. We would later learn that the economy had slipped into a recession over a year earlier, one that threatened to be the most severe in post-war history.

As a result of such high levels of uncertainty, much of the first quarter felt like a continuing free-fall in the financial markets. As a proxy for the domestic stock market, the S & P 500 Index dropped to 676.53 at the close of March 9th, down some 55% from its peak in late 2007, and the world markets were awash in gloom. The S&P 500 finished the first three months of the year down 11.7%, its sixth consecutive losing quarter ending down 48% from the market top. Wherever you looked abroad, the news was similarly gloomy--Japan down 36%, the UK off more than 48%, Germany down 50.6% , China and India down 34.7% and 52.3%, respectively.

As we spelled out in our Client Memorandum of March 6, we were fairly confident that the markets would eventually rise after such a hard fall, and that the rise would inevitably come earlier than anybody expected. As it turned out, we didn't have to wait very long. The S&P 500 Index rose 15.93% in the second quarter and 15.61% in the third, marking the best back-to-back quarterly rally in decades. International stocks rose 26.74% and 19.52% for the two quarters, and high-yield corporate bond indices posted double-digit returns, outperforming Treasuries by some of the biggest margins ever recorded. Though the gains were more subdued in the 4<sup>th</sup> quarter, they were still very strong, as the S & P Index gained 6%, ending the year up 26.5%. The results were even better in foreign markets, led by an astounding surge of 76% in the emerging markets.

The results in the fixed income markets were mixed. Treasuries had become massively overpriced in the liquidity panic and sold off during the year, punishing investors with losses. Meanwhile, the "credit sectors" that had suffered tremendously in the panic, came back strongly as investors realized that the depth of the economic downturn had been dramatically overstated by many respected forecasters. As an example of the extremes, high yield bonds returned over 56% for the year, while U.S. Treasuries actually lost about 3.6%.

**Advisory Board:** *So much for financial predictions from the so-called experts. Don't we remember that at this time last year a host of economists, led by NYU's Nouriel Roubini, were predicting a much more extensive worldwide economic calamity and more market destruction?*

**CapGroup:** It's a good thing that prognosticators and market pundits aren't paid based on the accuracy of their predictions. In every investment era, several financial gurus surface from relative obscurity and gain fame from making accurate forecasts, getting special attention when bad markets are accurately forecasted. With so many noted economists, money managers and Federal Reserve officials missing the severity of the real estate bubble and ensuing credit crisis, the opportunity for sudden fame was extreme.

Professor Roubini was correct in his assessment of the risks early on and continues to emphasize the challenges ahead. But following his investment advice can be dangerous. Early last year, Roubini told Kiplinger readers: "I expect that the recession will be very severe and that it won't be over before the end of 2009. I think there is a further 15% to 20% downside risk for global and U.S. stocks, and a further 15% to 20% downside risk for commodity prices. So 2009 will be a year of recession and deflation." Many investors who followed that forecast missed the massive gains that followed in the last nine months of the year and are still wondering what to do with their low-yielding money market funds and CD's.

**Advisory Board:** *Investors making costly timing mistakes is nothing new and seems to be a lesson that has to be relearned over and over, does it not?*

**CapGroup:** Yes, the behavioral finance experts continue to remind us that our emotions cause us to make many bad decisions involving our money. Even those investors who stayed invested in the stock market for the downturn and then the rebound are far from fully recovered. By the perverse math of down and up markets, an investor who took the full brunt of the 55% decline in the S & P 500 in 2008 and 2009 would have required a 122% return just to break even. The rebound of 65% in 2009 still leaves them with a loss of about 26%.

In addition, there is unhappy evidence that many investors liquidated their investments during the latter stages of the panic last winter. Statistics compiled by the Investment Company Institute show that investors across 25 developed nations (including the U.S.) had \$10.4 trillion of their wealth in stocks at the end of the second quarter of 2008. Money continued to pour out, so that by the end of the first quarter of 2009, while the rally was already underway, total stock exposure had fallen nearly in half, to \$5.9 trillion. Money market funds, meanwhile, surged \$444 billion in the fourth quarter of 2008 and another \$63 billion in the first three months of 2009.

The pressure to sell was intense a year ago, to say the least, as no one knew when the losses would stop. That is why strategic planning is such an important part of our process. Working from a plan encourages us to view financial shocks and market disruptions from a longer term perspective, so that we are less prone to making knee-jerk decisions. The unhappy truth is that nobody can foresee the future, and the investment markets tend to be far less predictable than other areas of our lives. This is why effective investment management focuses on managing risk by "controlling the controllables" – asset allocation, manager selection, expenses and taxes.

**Advisory Board:** *With two Bear markets in the last decade, the risk management challenges were immense. Shouldn't we expect a much better environment for financial markets over the next few years as the economy recovers and financial markets become more stable?*

**CapGroup:** It is true we are emerging from a historically bad decade for stock investors. Only the Great Depression-era of the 1930s and our recent decade of the 2000s delivered negative stock market performance. Usually, decades with low returns are followed by decades with higher returns – the mean reversion effect you mentioned.

It is also true that the economic recovery began last summer, and it appears to be gaining traction early in 2010. This gives us some confidence that we won't experience a double dip recession like in the early eighties. Normally, the year after a recession brings a hard and fast recovery, with GDP growth in the 6-8% range over the following 12 months. But a recent survey of economists by the Bloomberg organization found a consensus expectation of just 2.3% growth in U.S. economic activity, largely because the deleveraging process--paying back debts on the federal, state, local, corporate and personal balance sheets--may continue far into the future.

Again, those predictions are merely educated guesses that are based on complex economic statistics that are constantly changing and very difficult to understand, even by the experts. As preeminent money manager Jeremy Grantham of GMO recently stated in his newsletter "It is certainly easy to be confused, as we live in remarkably complex times".

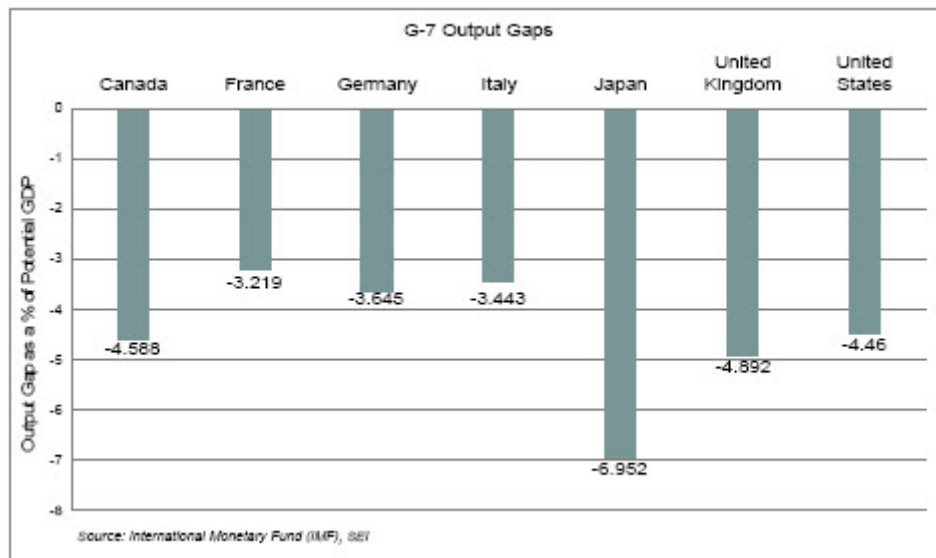
We certainly agree with this sentiment, as never in our lifetime have we experienced a financial and economic bust of similar depth and global reach. In addition to the wealth destruction in the financial markets over the past decade, perhaps reaching \$20 trillion at its worst point, we have witnessed a rapid deterioration of federal and state finances. As a result of the massive abuse of debt that brought on the credit crisis and the ensuing government interventions, it appears the economic tailwinds of most of the past three decades - low interest rates, disinflation, growing public and private debt levels, deregulation and a younger workforce - are being reversed. Add to these trends concerns about climate change, terrorism threats, and increasing shifts in global economic power, and it is difficult to envision anything but a continuation of the challenging investment environment we have experienced in the last few years.

**Advisory Board:** *We read a lot about the threat of increasing inflation due to the excessive levels of monetary and fiscal stimulus the government has used to quell the financial crisis, heal the financial system and short circuit the recession. You seem to be worried about inflation as well. What is your outlook?*

**CapGroup:** In our view, inflation is not an immediate problem. But as the world economy recovers, commodities are again running to the upside, and there is growing concern that inflation is beginning to accelerate. These worries have been fanned by the ballooning fiscal deficits of the developed countries and the extraordinary monetary stimuli put in place during the previous two years. But inflation is unlikely to be an issue for at least two to three years, at least in the major developed economies, as there is simply too much excess capacity and unemployment for serious price inflation to take hold.

The following exhibit examines the output gap (i.e. the difference between actual and potential GDP) across the G-7 developed countries, as measured by the International Monetary Fund.

With the exception of Germany, the gap in each of these countries is the highest since at least the 1970s. Not surprisingly, Japan has the biggest gap, following two decades of recession and sluggish growth, amounting to almost 7% of GDP. In the United States, the lowest operating rate in post-World War II history and the highest unemployment rate since 1982 generated a 4.46% output gap in 2009. It explains why outright deflation remains a serious threat to the United States economy and justifies the Federal Reserve's determination to keep short-term interest rates very low until the economy is on more solid footing.



**Advisory Board:** *These are pretty grim statistics suggesting significant economic weakness and the potential for a “double dip” recession, maybe after the stimulus wears off later this year or in 2011. Do you expect the economic recovery to continue?*

**CapGroup:** Yes, a balanced view of the economic and financial landscape, at least at this point, suggests a broad recovery is underway. But after a decade of shocks and slumps, many find it hard to embrace the idea of sustainable improvement, especially given the continuing problem with high unemployment. In the early stages of this recovery, the economic growth is coming from monetary and fiscal stimulus and pent up demand from postponed spending over the past few quarters. But as these effects wear off later this year, returning job growth will be crucial to sustaining the recovery into 2011 and beyond.

Notwithstanding some recent setbacks in the data, the trend is for improving employment, led by continuing reductions in new unemployment claims and a surge in temporary workers. Also, there is still plenty of monetary and fiscal stimulus in the system. By the end of 2009, the Federal Government had spent less than one-third of the \$787 billion in stimulus funds approved last February, and, as mentioned above, the Fed is likely to keep short-term interest rates below 1% for the rest of the year. Finally, there is a very high historical correlation between steep yield curves (the difference between short and long term government securities yields) and periods of economic expansion, and the shape of the present curve is one of the steepest in history. Basically, a steep positive slope in the yield curve encourages the productive use of financial leverage (borrowing) which works to stimulate economic growth; usually, the steeper the better.

Therefore, the odds are high that the recovery will be sustained but, again, with muted growth levels due to the headwinds from deleveraging and other global imbalances.

**Advisory Board:** *What does this mean in terms of expected risk and returns in investment portfolios? What is Callan Associates telling you?*

**CapGroup:** We have just received Callan's 2010 Capital Markets Projections. As you know, these statistics reflect their current thinking on the returns for the capital markets and are used as the inputs for their asset allocation modeling software. We use them to make reasonable projections of risk and return to guide the strategic planning and investment policy design work we perform for our clients. Over the next five to ten years, they project gradually increasing inflation (averaging 2.75%) and for returns in all asset classes to be below historical averages. Here is a summary of their current projections:

<b>Asset Class</b>	<b>10 Year Returns</b>	<b>Real Returns</b>	<b>Risk as Standard Deviation</b>
Broad Domestic Equity	8.50%	5.75%	17.30%
International Equity	8.30%	5.55%	19.30%
Emerging Markets Equity	8.80%	6.05%	27.00%
Domestic Fixed Income	4.50%	1.75%	4.50%
High Yield Fixed income	6.10%	3.35%	11.25%
Foreign Fixed Income	4.00%	1.25%	9.60%
Cash Equivalents	3.00%	0.25%	0.80%
Real Estate	6.80%	4.05%	16.10%
Private Equity	9.65%	6.90%	38.00%
Hedge Funds	6.10%	3.35%	10.00%
Commodities	4.40%	1.65%	22.50%

Source: Callan Associates, Inc.

It is clear that Callan and many other credible market researchers are expecting lower returns over the next few years, as the repair process takes place in the global economy and the financial markets. The effects on investor portfolios would not be insignificant. For example, a typical balanced blend of 60% global equities and 40% fixed income would generate a median annual return target of about 7.45% (CPI + 4.7%) versus the 8.3 % (CPI + 5.55%) expectation of a year ago, with risk levels being marginally lower this year. This reality will put additional pressure on investors to enhance returns with a greater emphasis on active investment management (less indexation) and by expanding the diversification strategy to include more nontraditional investments like private equity and hedge funds.

**Advisory Board:** *But after ten years of negative stock market returns, why shouldn't we expect returns going forward to be higher than the historical norm, especially coming out of a deep recession?*

**CapGroup:** We think that argument was far more valid last winter at the market lows, but it is true the S & P 500 Index is still some 27% below its high reached in November of 2007. But we have been through an extraordinarily damaging crisis, and it may take several years to reach the old highs. From here on, we expect economic fundamentals to be the primary driver of returns, and the economic headwinds we face are more likely to suppress economic growth and asset values over the longer term perspective that Callan uses in its projections.

Shorter term, the news may be better. Even after the big run-up last year, most cyclical and longer term measures indicate that U.S. stocks are near "fair value" by historical standards. And equity values are more compelling in relative terms, as the forward earnings yield on the S & P 500 Index is some 3.6% above the yield on ten-year Treasuries, which is well above the average for the past 30 years. Overall, we think that equity market valuations are still supportive of a continuation of the cyclical bull market that began early last year, though not without periodic corrections like the one we are presently experiencing.

**Advisory Board:** *What does this mean for the asset class positioning in your modular mutual fund models?*

**CapGroup:** We are maintaining the neutral weightings for both equities and fixed income in the 80% invested in the core component of the Portfolios, as our indicators do not compel us to be over-weighted in stocks or bonds. The remaining 20% is allocated to our "alternatives module" to better manage risk through diversifying into mutual funds that invest in low-correlating, non-traditional investments.

**Advisory Board:** *We were intrigued by your development of the "alternatives module" when you introduced it back in the late summer of 2008. How has it worked out so far?*

**CapGroup:** So far, it is living up to our expectation, which is to deliver returns between those of traditional equities and fixed income, yet from differentiated sources with low correlations. The objective is to improve long-term returns and reduce overall portfolio risk by increasing the levels of diversification, similar to the approach used successfully by large educational endowments for over two decades. However, we implement this strategy with standard mutual funds instead of complex and illiquid partnership vehicles.

The mutual funds we use invest in hedging strategies, such as long/short equities and arbitrage, global tactical asset allocation and commodities. The list of strategies and funds is growing and will soon include private equity, real estate and other strategies that are included in the asset classes listed above in Callan's Capital Markets Projections. These additions should allow us to build out portfolio strategies with the diversification dimensions of much larger institutions.

In general, we had expected returns for the module to substantially underperform traditional investments in periods of returns like 2009, as it is not designed to track the return patterns of the stock and bond markets. However, the module met our objectives of delivering returns between those of the fixed income and equity market, and also outperformed the HFRI Hedge Fund of

Funds Index. Importantly, the module reduced overall portfolio volatility during the year. Many of our colleagues in Focus Financial Partner Firms and the Callan Independent Adviser Group recognize the value of this innovation and are using our research to build similar investments for their own clients.

**Advisory Board:** *We know that Focus Financial and Callan are very important resources for the Firm. Are there any new developments with them?*

**CapGroup:** As you remember, we became one of four Founding Partners of Focus Financial Partners back in January of 2006, so we just completed our fourth year as a Focus Partner Firm. Over that period, Focus has grown to eighteen firms across the nation, including one firm located in Manchester, England, and now advises on close to \$35 billion of client assets. Focus is clearly the largest and most successful organization of independent investment advisory firms, and all of the Partner Firms have successfully weathered the financial crisis and are now on strong growth trajectories. We continue to benefit from their financial backing, as we seek to grow our Firm by merging in smaller investment advisers. Our Clients benefit from our access to the intellectual capital and investment ideas of the other Partner Firms, as well as our enhanced ability to negotiate with service vendors, such as custody platforms and money managers.

Callan has been a wonderful resource since we joined the Independent Adviser Group as a Charter Member in 1992. As the largest independent investment consulting firm with client assets totaling over \$1 trillion, Callan has immense resources we use to design and manage client investment strategies.

Over the past year, we have been selected to work with Callan's senior researchers in the design of an investment service we call "implemented consulting". Basically, implemented consulting addresses ways to use rapidly evolving investment technologies to build and manage customized investment strategies more efficiently, without giving up the independence and objectivity of our traditional "open architecture" approach. Essentially, implemented consulting systems work to improve performance by closely managing portfolio construction and manager selection and by automating manager changes and asset allocation rebalancing. This approach assigns the responsibility for managing the entire investment process to us, leaving the Client in the more appropriate role of policy making and performance monitoring. In addition to improved performance, we expect overall investment management costs to decrease, as well as the amount of time required of our Clients.

**Advisory Board:** *As always, it sounds like you are at the forefront of evolutions in the investment advisory industry. We look forward to your next report later this year. Hopefully, by then the economy will be healthier and there will be more clarity in the economic outlook.*

**CapGroup:** We couldn't agree more, but we recognize we are really in uncharted waters this time. We'll keep you posted with our *Monthly Economic and Markets Summaries*, and we always welcome your calls.

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### **Important Disclosure**

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this memorandum, will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio. Due to various factors, including changing market conditions, the content of this writing may no longer be reflective of our current opinions or positions. Moreover, you should not assume that any discussion or information contained in this memorandum serves as the receipt of, or as a substitute for, personalized investment advice from Capital Advisory Group. Please remember to contact Capital Advisory Group if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services. Please also advise us if you would like to impose, add, or to modify any reasonable restrictions to our investment advisory services. A copy of our current written disclosure statement discussing our advisory services and fees remains available for your review upon request.