



Mid-Year Client Report

July 2010

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Macro Investment Environment: In our opinion, there are three chief concerns that have resulted in the second quarter's market disarray. They are, in order of importance, the sovereign debt crisis in the Eurozone, the fear that the United States and other developed economies are lapsing back into recession as government austerity measures take hold, and concern over China's policy response to its emerging property market bubble and its general inflation problem. [More...](#)

Longer Term Investment Outlook: We face an uncertain economic environment over the next few years with above average investment risks. A critical unknown is whether enough countries, including the United States, can thread the economic needle so that the recovery has time to gain steam while maintaining lender confidence that the deficit/debt problems will be addressed over time. [More...](#)

CapGroup's Evolutionary Investment Approach: To help with Client understanding of our evolving investment approach, we have defined our investment philosophy and proprietary investment advisory process as *Adaptive Risk Management* or ARM for short. The primary goal of ARM is to enhance investment risk management, thereby increasing the consistency of investment performance. [More...](#)

CapGroup News: CapGroup names Matt Buckley, Tommy French and Nick Zizzo as Managing Directors; CapGroup gains CEFEX certification; and improvements to portfolio accounting and reporting systems. [More...](#)

The **Mid Year Client Report** is produced in July of each year as a supplement to our Monthly Economic Updates and Quarterly Economic Summaries and as an update of our views expressed in our Annual Client Report in January. Copies of all of these past reports are available on our website at www.thecapgroup.com. The Mid Year Client Report includes information regarding the financial markets, the global macroeconomic environment, important trends and events in the financial services industry, and significant events within our Firm.

The Macro Investment Environment

Most equity markets fell sharply during the second quarter with most of the damage coming in May and June. The MSCI All-Country World Total Return Index, for example, fell more than 12% in U.S. dollar terms and the S & P 500 Index of U.S. stocks fell over 11%. Although credit markets, including high-yield and emerging-market debt, have held up relatively well, a strong flight-to-safety effect can be seen in the sharp drop in U.S. Treasury bond yields, which fell from 4% at the beginning of the quarter to less than 3% at the end. With the dramatic correction in the second quarter overcoming a positive first quarter, global stocks were showing losses of over 10% and U.S. stocks more than 6.5% over the first half of the year.

The question facing investors is whether the decline in equities since April is merely a bump in the road or a topping out of the global bull market that began early last year. It has been our view for several months that markets will continue to be fairly choppy as the global market rally entered its second year and some degree of correction should be expected after the sustained rally in stocks. Presently, we lean toward the more optimistic view that the current volatility will eventually fade in the face of solid economic fundamentals and reasonable equity valuations.

In our opinion, there are three chief concerns that have resulted in the second quarter's market disarray. They are, in order of importance, the sovereign debt crisis in the Eurozone, the fear that the United States and other developed economies are lapsing back into recession as government austerity measures take hold, and concern over China's policy response to its emerging property market bubble and its general inflation problem.

The European Welfare State Hits the Wall

It has been clear since the beginning of the year that Europe was facing an extended period of anemic economic growth relative to the rest of the world, so the deepening of the crisis was not particularly surprising. Following the unveiling in early May of a €750 billion rescue package aimed at bolstering confidence in Greece and the other weak credits in the Eurozone, stock markets in the region rebounded off their lows and the euro itself stabilized. However, another lurch downward in asset prices toward the tail end of the quarter has badly shaken investors' confidence. This saga, it appears, is far from over.

The actions taken to date within the Eurozone, while helpful in the short term, have not addressed the longer-term solvency concerns of the most precarious debtor nations. The difficulties facing Europe (fiscal austerity, stress in the banking system, slow growth or recession depending on the country and persistent worries over the integrity of the euro) are issues that will continue to adversely affect investor sentiment. Global companies based in Europe may benefit from the weakening of the pound sterling and the euro, but the negative outlook in Europe itself is expected to act as a serious drag on its performance relative to rest of the world.

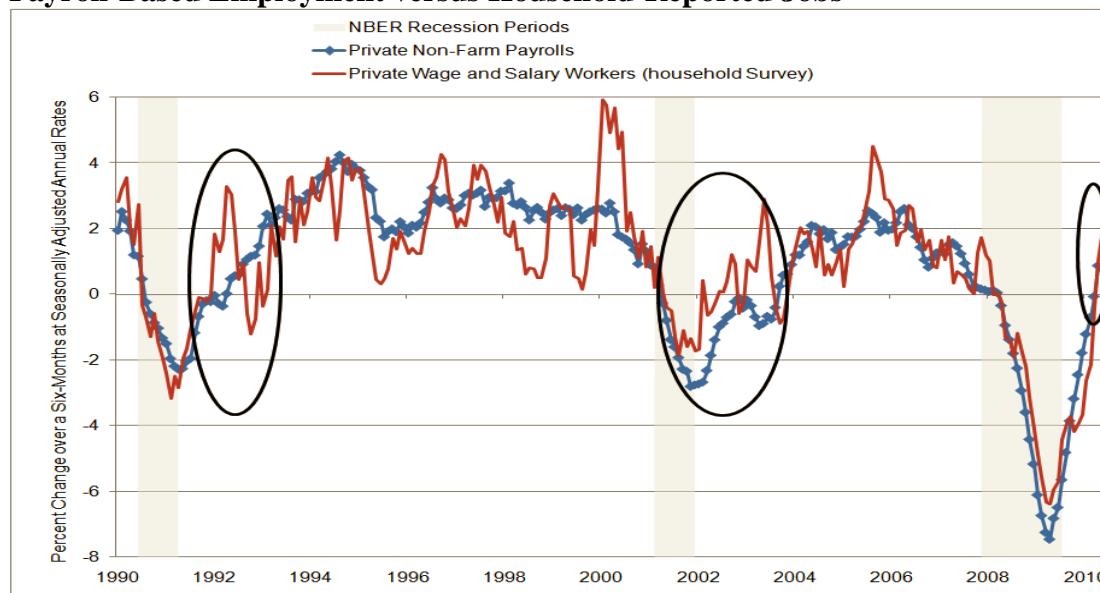
The Growth Scare in the U.S.

The outlook for U.S. economic growth has been relatively benign in this recovery, due to the strong headwinds from consumers reducing their debt load and massive government deficits. In light of the data released in recent weeks, the possibility of a "double dip" recession seems more probable than at the end of the first quarter. In particular, the housing sector has been dealt a meaningful setback, as sales slid to new lows upon the expiration of the homebuyers' tax credit. In addition, it cannot be denied that employment and income growth remain disappointing, even by the standards of the jobless recoveries

during the past two economic cycles. If it weren't for government transfer payments (such as unemployment benefits), income growth over the past six months would be minimal. Many market participants are concerned that the shift toward fiscal restraint, which will become increasingly evident over the coming year for individual states, as well as at the federal level, will result in a double-dip recession.

Despite the spate of weak economic data and the pullback in risk-related assets, we expect the world economy to continue to grow, led by emerging-market economies and, to a more moderate extent, the U.S. First, employment conditions in the U.S. may not be as bleak as they seem from the published private payroll reports. In contrast, private employment based on the government's survey of households is posting impressive month-to-month increases. For example, the *payrolls-based* survey shows 590,000 new jobs gained though the first half of the year, while the *household survey* reported an addition of nearly 1.3 million jobs. Which one is more reflective of reality? The following exhibit shows that, in the early expansion phase of recovery, household employment tends to outpace payroll employment. It boils down to methodologies and assumptions, but the point is that this recovery may be more conducive to job creation than currently recognized.

Payroll-Based Employment versus Household-Reported Jobs



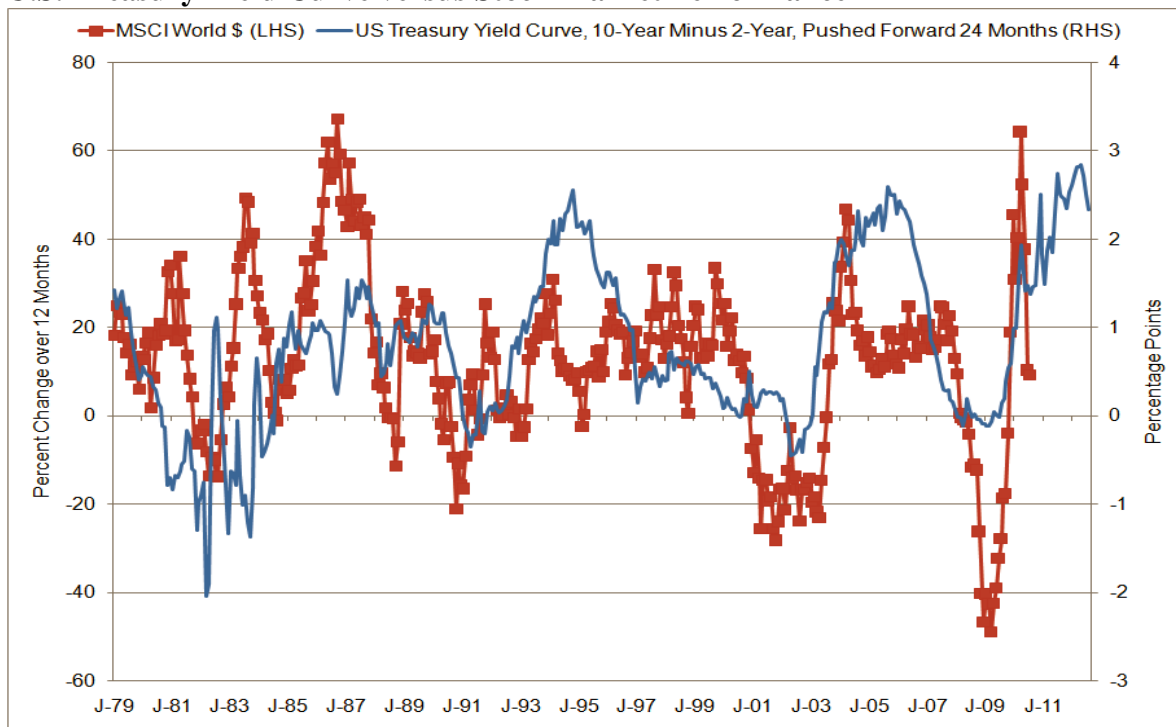
Sources: U.S. Department of Labor, National Bureau of Economic Research, SEI Investments.

Another positive factor is the financial health of U.S. corporations who were quick to respond to the recession by chopping payrolls and investment spending. This has led not only to a faster recovery in profits and cash flow due to less overhead, but also to sharply improved balance sheets. The liquid assets of non-financial corporations have reached their highest point as a percentage of short-term debt in 55 years. In other words, companies are in a position to spend, and corporate purse strings appear to be loosening. Business investment on inventories and capital goods has rebounded sharply in the past year from a near-record decline. Since cash-flow generation tends to lead business investment by roughly a year, it would be normal to see additional business spending gains through the next several quarters.

In our opinion, extremely expansionary monetary policies in the U.S. and Europe provide a critical counterforce to the gathering fiscal squeeze. Interest rates remain very low, spurring economic healing

and growth, and creating a positive yield curve that should have a positive influence on stock prices. The following chart underscores the point that the yield curve has predictive properties – a positive yield curve (occurring when the 10-year Treasury bond yield is above the yield on the 2-year Treasury note) is typically associated with a gain in stock prices 12 to 24 months into the future. In other words, equities today are still feeling the beneficial influence of monetary easing that occurred in 2008, and the impact should be positively biased at least through 2011. Bear markets (when share prices decline by 20% or more on a year-over-year basis) have been associated with an inversion of the yield curve one to two years prior to the event. There is no threat of a yield-curve inversion anytime soon, indicating a more positive environment for stocks.

U.S. Treasury Yield Curve versus Stock Market Performance



Sources: MSCI, Federal Reserve Board, SEI Investments.

Other compelling reasons to be more optimistic about the economy and the direction of stock prices relate to reasonable valuation levels and large amounts of cash on the sidelines. On a 12-month trailing price/earnings (P/E) ratio of less than 15 times and a forward P/E ratio of less than 13 times (using S&P 500 data), stock market valuation is reasonable to low in our view. While value does not help much with timing decisions, it does provide a cushion against a significant drop in stock prices. Cash levels remain at extremely high levels while earning near zero returns; ditto for bond yields. An increase in positive economic news should cause investors to rethink their recent defensive asset allocation decisions and could trigger a self reinforcing move into riskier equities.

The China Syndrome

Investors continue to be attracted by the growth potential of emerging economies and the superior fiscal positions these countries generally enjoy relative to the developed world. The hope is that the emerging markets will continue to lead the global recovery. As the leading emerging market country, China's softening economic conditions and growing inflation have been troubling the markets. China is aware of this and is taking meaningful corrective steps to stem inflation in property prices and the threat of an

overheated economy that may be headed for a bust. China must continue to implement policies that will help reduce the large internal and external imbalances that have been created by China's trade-oriented economic model. While the transition toward a more balanced economy will be challenging, growth in China should remain robust relative to other countries.

Summary – The Macro Investment Environment

The painful bear market and global recession from 2007 to 2009 remain firmly lodged in our psyches, leaving most of us a bit gun-shy, especially since our memory of the “dotcom crash” a few years earlier is still a fresh memory. The following chart illustrates the stock market return patterns for the past four severe bear markets that are being referenced in the media.



A central point of the chart is that, by comparison, the present recovery is only 17 months old and a “teenager” by comparison to the other stock market recoveries. To be sure, there are economic and financial problems that justify a somewhat defensive response, but we believe the prevailing consensus view at this point is too pessimistic and ignores important influences that may result in a more positive outcome and an extension of the cyclical bull market in stocks.

The Longer Term Investment Outlook

While the current pessimism is probably overdone, it is no secret that there is too still much debt in most of the developed world - the United States, Europe, and Japan. In coming years the developed world must walk a tightrope as it deals with the pressing need to slow and ultimately reverse debt growth without also seriously harming economic growth rates.

The United States and other countries with excessive household sector debt are in the early stages of what is likely to be a long process of deleveraging. Though it is dropping, household debt relative to income remains excessively high. Most of these countries must also dramatically reduce public sector

(government) debt growth and in some cases they will need to reduce the absolute amount of debt. This huge challenge has not yet begun, but it is imminent.

The timing and aggressiveness with which public sector debt and deficits are attacked will be extremely tricky to get right given current economic headwinds. On the one hand, too much austerity coming from very tight fiscal policy can be counterproductive because it risks smothering already weak growth that would result in lower tax revenues. Lower federal revenues could result in fewer jobs, increased social safety spending, and weaken the political will that is needed to follow through on spending discipline. Waiting too long to tackle rising debt levels digs a deeper hole and risks a lenders' strike, which could result in government borrowers (and all others too) being forced to pay a much higher interest rate to finance their debt. At the extreme, as we are seeing with Greece, debt levels could become unmanageable as borrowing costs become untenable, resulting in a crippling crisis for the global economy as a whole.

Slowing and ultimately reversing the growth of debt is further complicated by aging populations - a reality that most of the developing world faces to different degrees. An aging population presents several challenges. It means that savings rates will face downward pressure as more of the population moves from working and saving to retiring and depleting savings, and paying fewer taxes given lower income. More retirees also mean more government retirement and health care expenses (Social Security and Medicare in the United States). This is fine if pensions and health care are fully funded, but that is not the case.

While the private sector gradually reduces debt levels, and we wait for the public sector to do the same, at least the United States is experiencing an economic recovery, albeit a tepid one. As outlined above, the economic cycle is, for now, a plus, but the big problems have not been resolved. Therefore, we face an uncertain economic environment over the next few years with above average investment risks. A critical unknown is whether enough countries, including the United States, can thread the economic needle so that the recovery has time to gain steam while maintaining lender confidence that the deficit/debt problems will be addressed over time.

CapGroup's Evolutionary Investment Approach

As explained above, the systemic risks in the global economy appear to be far higher than in the previous post-World War II years, causing investment volatility to remain high and financial system shocks more likely over the next few years. In such an environment, investment strategies will need to be flexible enough to integrate new risk management technologies and to facilitate timely adjustments to changing economic and market conditions. The traditional buy and hold approach to asset allocation may carry more embedded risk than most people expect.

Given our roots in institutional investment management consulting, we have always centered our investment solutions on an open architecture approach to investment management. By open architecture, we mean not relying on a single investment approach, a limited number of resources or the closed investment product systems that are mass marketed by major financial companies. Rather, we seek to build investment strategies that are tailored to the Client's goals and objectives and use a variety of specialized investment managers with complementary processes. This approach has served our clients well and allows us to face an uncertain future with the confidence that we can continue to effectively adapt Client investment strategies to the challenges that lie ahead.

To help with Client understanding of our evolving investment approach, we have defined our investment philosophy and proprietary investment advisory process as ***Adaptive Risk Management*** or ARM for short. The primary goal of ARM is to enhance investment risk management, thereby increasing the consistency of investment performance. Our discipline enforces decision making based on three fundamental principles and a corresponding three-step process.

1. Increase levels of diversification to include liquid alternative investments
2. Minimize exposures to overvalued asset classes by employing a more dynamic asset allocation discipline
3. Generate excess returns within asset classes through modular manager structures

The first step in our ARM process is to establish an asset allocation framework that includes both core positions in diversified stocks and bonds plus a dedicated allocation to a module of mutual funds that invest in various nontraditional investments like hedging strategies, commodities and tactical asset allocators. Since the core investments in stocks and bonds are not fixed, the second step is our execution of a more dynamic approach to asset allocation management. This means that allocations to stocks and bonds can vary within ranges to better control risk by allowing for some flexibility at important market junctures.

The third step in the implementation of our ARM process is the use of multiple manager modules for each asset class. For example, our allocation to domestic stocks will typically include a team of 4 to 5 managers with complementary approaches to investing in domestic stocks. Our goal is to generate excess returns by combining proven managers whose investment processes offer differentiated sources of risk and returns. A particular benefit for taxable investors is that ARM can accommodate the use of tax management overlay systems to improve after tax returns.

Though we recognize some of the positive influences at work in the present economic environment, we see significant challenges on the horizon, and we are structuring our process and investment systems to address higher levels of financial risks going forward. But while the emerging investment environment is exceptionally challenging, it is also important to remember that it is highly likely we will work through our debt problems over time, probably with far better average performance in the financial markets than we have seen in the tumultuous past decade. Despite the higher risks, opportunities will present themselves, and we are in a position to recognize and take advantage of them as they emerge.

CapGroup News

Introducing Matthew J. Buckley, CFP[®], CTFA

We are very pleased to announce the addition of Matt Buckley as a Managing Director in our Private Client Practice with primary responsibility for working with high net worth individuals and families in providing wealth management services. Prior to joining the firm, Matt was a senior advisor for thirteen years with the Private Wealth Management Group of SunTrust Bank where he specialized in the development and implementation of integrated, holistic wealth management solutions for high net worth individuals and families. Matt holds a BA in Economics from the University of Virginia and an MBA from The College of William & Mary. Matt is a CERTIFIED FINANCIAL PLANNER[™] professional, holds the Certified Trust and Financial Advisor professional designation and is a member of the Estate Planning Council of Richmond, Virginia as well as the Financial Planning Association.

Nicholas P. Zizzo and Tommy R. French are promoted to Managing Directors

In addition to Matt Buckley, Tommy French and Nick Zizzo have been named as Managing Directors and will serve on our Executive Committee. Tommy joined the firm in 2003 and has served ably as our Business Manager for the past seven years. He will continue in that capacity. Nick Zizzo joined us in 2004 as an investment analyst and now leads our Research Team, with responsibilities for organizing and coordinating the ongoing work in asset allocation analysis and investment manager research that supports our Adaptive Risk Management process (see above).

CapGroup Earns the CEFEX Certification

In March we joined a select group of investment advisors worldwide that have been certified by the Centre for Fiduciary Excellence, LLC (“CEFEX”) as an Investment Advisor for providing services that are in conformance with the Global Fiduciary Standard of Excellence. CEFEX is an organization that provides comprehensive assessment programs to assist both individual and institutional investors in evaluating the services of investment advisory firms like CapGroup. To date, only 38 investment advisers in the United States have been certified, so relatively few advisory firms have submitted to the intense scrutiny of a CEFEX certification assessment. The essence of this certification is a formal acknowledgment from an independent third party that we are living up to a high standard of fiduciary conduct. We trust that this is a reassuring confirmation of our commitment to excellence in the delivery of our services for our Clients.

Portfolio Accounting and Reporting Systems Improvements

Over the past several quarters, we have researched a number of accounting and reporting systems that could be used to increase our operational efficiency and improve our client reporting for both our Private Client and Institutional Consulting Practices. Given the uniqueness of our open architecture investment approach (see Adaptive Risk Management discussion above) and the wide variety of investment management products we employ, it has been quite a challenge to find a system that meets all of our needs. However, we continue to make good progress and look forward to announcing our new system later this year.

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.