



Annual Client Report

January 2011

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Managing Risk in a Dangerous World: Despite the tailwinds of strong liquidity flows from the Fed and improving balance sheets in the private sector, the imbalances in the global financial system present an imposing threat to the financial markets. The three most critical are: the simmering Eurozone crisis, the spiraling U.S. Government debt and the growing financial imbalance between deficit (U.S.) and surplus (China) countries. [For more see page 3.](#)

CapGroup News: We are very pleased to announce the addition of **Todd C. Early** as a Managing Director in our Institutional Advisory Practice. [For more see page 5.](#)

Visit our New Web Site at www.thecapgroup.com: Over the past few months, we have totally renovated our web site to convey our services, our philosophy and our value proposition more simply and directly. In addition, we will be adding functionality that will be helpful in expediting client reporting and other forms of communications. We hope you agree that the new site is a major improvement, and you will feel free to provide us any feedback or suggestions that would improve how we present ourselves and our services.

The **Annual Client Report** is produced in January 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 **Mid-Year Client Report** in July. Copies of all of these past reports are available on our website at www.thecapgroup.com. The **Annual Client Report** includes information regarding the financial markets, the global macroeconomic environment, and significant events within our Firm.

The Macro Investment Environment – From Recovery to Expansion

Last year at this time, the global economy and financial markets were on the mend, although there were serious concerns over the pace of growth in the advanced economies and even greater worry over the underlying health of the world's banking and financial systems. Despite the sharp recovery in global markets in 2009, investor sentiment was subdued early last year, as the longer term economic challenges were formidable and the recovery still appeared to be very fragile. Economists forecasted a 20% chance of at least one negative quarter in inflation-adjusted U.S. Gross Domestic Product (GDP) during the coming year. Twelve months later, concerns about debt, the global financial system and sluggish growth in developed economies linger, but sentiment among economists has become more optimistic; instead of seeing the glass as half-empty, most economists now see it as half-full. In the view of many, the economic cycle has graduated from recovery to a more stable expansionary phase.

Not surprisingly investors have been far more upbeat than the economic soothsayers in recent months. Global equity prices have climbed more than 20% since the end of August, while bond yields have moved sharply higher in anticipation of a more vibrant economy. **The central question now facing investors involves whether or not this new-found optimism is justified.** As fears of a double dip recession fade, investors are increasingly showing a preference to invest in risk assets like stocks and commodities instead of holding cash. Also, in a surprise response to the Fed's latest round of monetary expansion ("QE2"), fears of inflation and credit problems have ignited, creating a reversal of fund flows out of bonds and bond funds. Again, the primary beneficiary has been global equities, as mutual fund flows for equity funds finally exceeded those for bond funds in November and December for the first time since late 2007.

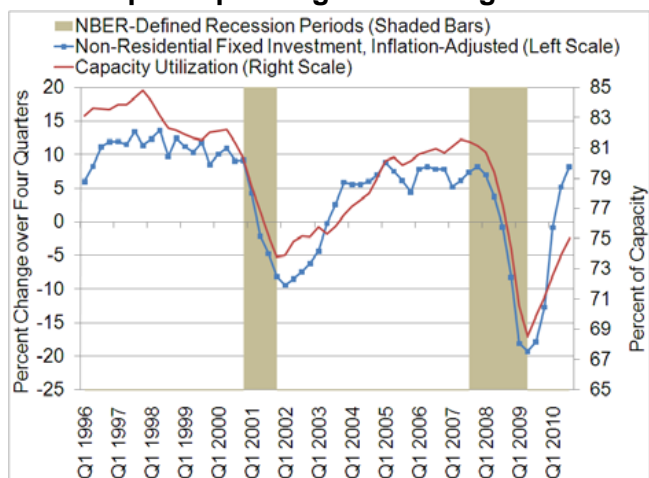
Reasons for Optimism

The reasons for optimism center on the resilience of the economy and changes in the political landscape that are viewed as beneficial for the economy. Economists were actually right last year: inflation-adjusted GDP rose about 2.8% in 2010, in line with the consensus forecast. They correctly anticipated the sluggish recovery in consumer spending as well as a stubbornly high unemployment rate. Business investment, however, turned out better than expected, and the forecasters badly underestimated corporate profitability—pre-tax GDP-based profits increased an estimated 30% last year, more than twice consensus expectations. This strong corporate bottom-line performance helped sustain the U.S. stock market in 2010.

In the coming year, the consensus is calling for a nearly identical outcome for inflation-adjusted GDP, driven by better gains in consumer spending and business investment. We believe this forecast is overly conservative, as many economists we respect are predicting real GDP growth in the U.S. to be between 3% and 4%, primarily driven by stronger business spending which could also open the door to additional upside surprises in earnings as the year proceeds.

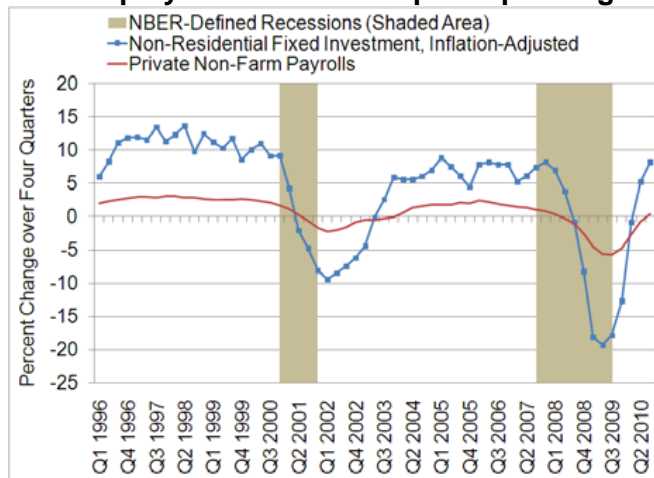
Stronger business spending also tends to go hand in hand with higher private sector employment as shown in the following charts. All this is good news, and should help to offset the continued weakness expected in construction and government-related jobs.

Capital Spending Is Climbing



Source: National Bureau of Economic Research, Bureau of Economic Analysis, Federal Reserve Board, SEI Investments

Employment Follows Capital Spending



Source: National Bureau of Economic Research, Bureau of Economic Analysis, US Department of Labor, SEI Investments

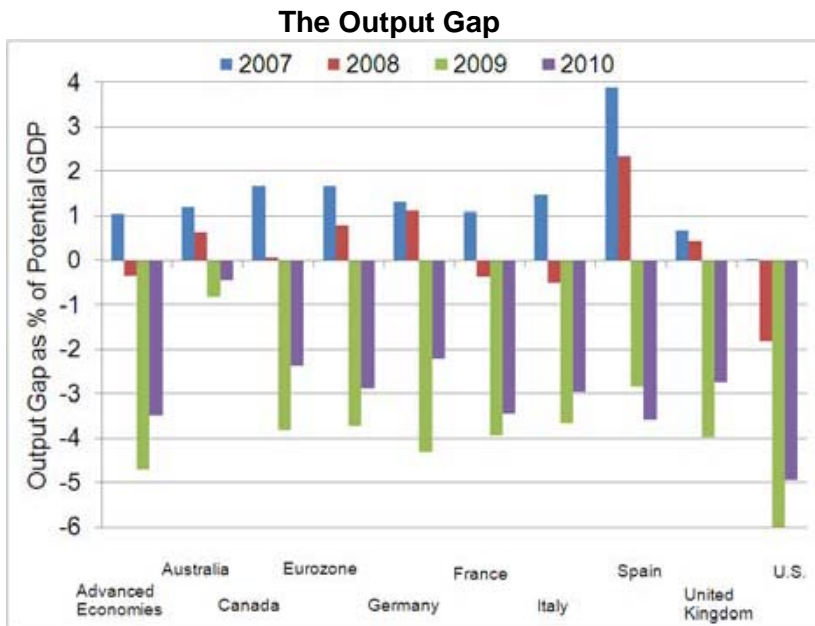
Also, in contrast to the situation one year ago, the financial position of households has also improved quite a bit. To be sure, household net worth is still quite depressed, amounting to 480% of disposable income, which is well below the peak of 640% recorded during the housing bubble in 2006 and the 610% that marked the top of the tech-stock mania in 2000. However, if the past decade of back-to-back debt-driven bubbles are excluded, the current reading is comfortably within the 500% range that had been considered normal since 1952. In similar fashion, the personal saving rate has returned to a level that is approaching the historical norm and household deleveraging is proceeding faster than expected this time twelve months ago. Though achieved largely through debt write-offs and home foreclosures (basically, lenders are taking the losses), as well as an outright decline in borrowing, households have reduced debt service as a percentage of disposable income to less than 12%, which is the lowest level in more than a decade.

Much of the brighter outlook for 2011 stems from the passage of the bi-partisan stimulus package in mid-December. Although the word “stimulus” is somewhat misleading, since the tax legislation merely (1) maintains the current level of marginal rates on income and capital gains, (2) tempers the increase on estate taxes that would otherwise have taken place, (3) extends income support for the long-term unemployed and (4) offsets the sun-setting of previous stimulus programs through the payroll-tax holiday. Thankfully, the danger of a severe fiscal drag on the U.S. economy from a tax increase in 2011 has been eliminated.

However, the government deficit will continue to hold near 10% of GDP, so the tax cut package only delays the need to deal with federal deficits and the national debt. It may be no coincidence that bond yields have climbed sharply despite the Fed’s quantitative easing program. Not only has the near-term threat of deflation receded, but the fear of longer-term inflation pressures and the prospect of increasing stress on the country’s fiscal position could be leading to an upward shift in the risk premium accorded U.S. Treasury bonds (the spread that must be paid over the inflation rate).

Subdued inflationary forces are presently a positive influence, allowing the Fed and other central banks to expand the liquidity in the financial system and economy, thereby buying time for the broader economy to heal and for unemployment to begin its gradual decline to tolerable levels of around 6%. As we

mentioned in last year's *Annual Client Report*, it is very difficult for inflation to emerge when the output gap (the difference between actual and potential GDP growth at full employment) is negative. Though narrowing in the U.S. and other developed countries (see chart below) from 6% to 5% in the U.S., the rate will remain high for at least another year or two due to persistent high unemployment in the developed countries. Likewise, inflation is likely to stay low for at least another year or two.



Source: International Monetary Fund (IMF), SEI

Managing Risk in a Dangerous World

Despite the tailwinds of strong liquidity flows from the Fed and improving balance sheets in the private sector, the imbalances in the global financial system present an imposing threat to the financial markets. The three most critical are: the simmering Eurozone crisis, the spiraling U.S. Government debt and the growing financial imbalance between deficit (U.S.) and surplus (China) countries. Though virtually all markets have rallied on stimulus and quantitative easing, the financial crisis of 2008-2009 revealed how dangerously fragile the global economy has become. The heroic reflation policies of central banks over the past two years have revived the global economy and triggered a massive stock market recovery, but they have not corrected the imbalances that are certain to cause economic problems ahead. In our view, the positive short-run outlook must be tempered with a realistic assessment of the risks and uncertainties that still prevail.

In general, this environment of heightened systemic risk is being reflected in the capital markets projections developed by large investment consulting firms like Callan Associates, Inc. to assist institutional clients with developing asset allocation strategies to meet their ongoing financial obligations. Through our affiliation with Callan, we are able to access their capital markets research and asset allocation modeling tools to assist us in developing realistic expectations for risk and returns going forward, as well as for building appropriate asset allocation strategies for our clients. The following chart summarizes Callan's expectations for risk and return over the ten year period starting in 2011, based on an average annual inflation assumption of 2.5%.

Asset Class	10 Year Returns	Real Returns	Risk as Standard Deviation
Broad Domestic Equity	8.00%	5.50%	18.10%
International Equity	7.85%	5.35%	19.75%
Emerging Markets Equity	8.35%	5.85%	27.50%
Domestic Fixed Income	3.75%	1.25%	4.50%
High Yield Fixed income	5.60%	3.10%	11.60%
Foreign Fixed Income	3.35%	0.85%	9.70%
Cash Equivalents	3.00%	0.50%	0.90%
Real Estate	6.75%	4.25%	16.35%
Private Equity	9.05%	6.55%	30.00%
Hedge Funds	5.90%	3.40%	10.00%
Commodities	3.75%	1.25%	24.00%

Source: Callan Associates, Inc.

As compared to Callan’s 2010 expectations of a year ago, estimates for returns have been reduced and estimates for risk have been increased. These conclusions reflect the extraordinary returns of the past year and the likely influence on the continuum of returns over the next ten year period. Please remember that these assumptions are used for portfolio planning purposes to better understand the changing risk environment from a ten year perspective and potential ranges of returns for various static asset mixes. They are not useful in predicting specific returns in any given twelve month period and do not reflect the immediate risks facing investors at any point in time due to economic shocks and other unpredictable market events.

In fact, Callan agrees with us that the path to higher long-term capital market outcomes will likely lead us through an ugly shorter term period of rising interest rates, capital losses in fixed income and volatile equity markets. As we have stated often in the past two years, we believe we have entered a new economic/investment era or a new reality that requires much greater attention to risk management to protect and grow investment capital. In this environment, market prices for securities and asset classes are now more susceptible to sudden shocks, causing potentially severe market dislocations and dramatic portfolio draw downs. In short, classic “buy and hold” strategies have been, and most likely will continue to be, relatively ineffective in managing the risk and protecting investor capital.

Our response to the new environment has been based on integrating innovations in our investment research with advances in operations management technologies. Over time, we have developed a much more proactive approach to investment management we call *Adaptive Risk Management* with the goal of reducing investment risk to substantially improve the consistency of performance. Our process centers on three overriding principles: 1. Diversify broadly in traditional and non-traditional investments; 2. Reduce exposures to overvalued asset classes; and 3. Implement portfolios using asset class modules comprised of synergistic managers and strategies.

CapGroup News

CapGroup Adds Todd C. Early to the Institutional Advisory Practice

We are very pleased to announce the addition of **Todd C. Early** as a Managing Director in our Institutional Advisory Practice. Prior to joining the firm, Todd was director of the Nonprofit and Institutional Division at Edelman Financial Services and was previously Vice President of Institutional Services at Trusco Capital Management, the institutional investment division of SunTrust Bank. Todd's experience and credentials are in concert with the other members of our professional staff. For more than 15 years, he has specialized in supporting the strategic investment priorities of nonprofit organizations, corporations, and municipal entities. Todd holds a BA from the Virginia Military Institute and an MBA from the University of South Carolina. In addition, he has also completed studies at MIT, the Harvard School of Business, and New York University.

CapGroup Renews the CEFEX Certification

As we reported in our *Mid-Year Client Report* last July, early in 2010 we joined a select group of investment advisors nationally that have been certified by the Centre for Fiduciary Excellence, LLC ("CEFEX") as an Investment Advisor for providing client services that are in conformance with the best practices in the Global Fiduciary Standard of Excellence. This certification must be renewed each year through an audit of a credentialed analyst, and we have begun the process to renew our certification by March 31st. CEFEX is an international organization that provides comprehensive assessment programs to assist both individual and institutional investors in evaluating the services of investment advisory firms like CapGroup. Currently, only 37 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. In our view this is because very few would actually achieve fully certified status and therefore will not expose themselves to an independent assessment of their investment processes and practices.

CapGroup Implements Enhanced Portfolio Management Platform

As most of our Clients know, we have worked for several quarters on developing an enhanced investment management platform that accommodates the efficient operation of our Adaptive Risk Management ("ARM") investment process. Since our investment process and operations needs are unique to CapGroup, we enlisted the help of Focus Financial Partners to assist in the design of the systems and the negotiations with the service providers. Ultimately, we settled on using Charles Schwab & Co. as the broker/custodian and Adhesion Wealth Advisors of Charlotte, NC for the operations technology. Basically, Charles Schwab holds the securities in safekeeping and executes the trades for a heavily discounted institutional cost; the Adhesion investment platform links with Schwab to facilitate our custom designed portfolio accounting and performance tracking/reporting systems.

While this sounds extremely complicated, the separation of the custody/trading function from the accounting and investment management functions allows us to customize our own investment management strategies with reduced portfolio operating costs and minimal constraints on the investment managers that we select for our investment strategies. In general, this integrated provider approach is both more flexible from an investment management perspective, as well as being less expensive as compared to single provider programs like SEI Investments. In short, it allows us to fully implement our ARM investment process, which we firmly believe will work to the benefit of our Clients in expediting the achievement of their long-term financial goals and objectives.

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.