Quarterly Investment Update

April 15, 2011

Market Performance Recap

Equities had spent much of this year's first quarter alternately climbing the classic "wall of worry" and then falling back. After returning in February to levels last seen in June 2008, U.S. equities turned volatile in the wake of Middle Eastern turmoil and Japan's triple disaster before climbing again in the quarter's last week. When the results were tallied for the quarter, domestic equities had posted returns ranging from roughly 6% to 8% depending on the asset class (smaller-caps generally beat larger-caps).

Foreign equity markets also rose to add gains to their strong 2010 advance, but returns of 3.4% lagged U.S. equities due in large part to fears over the ramifications of events in Japan and the Middle East. Emerging markets struggled early in the quarter but posted a very strong rise in March to end the quarter up slightly above 2%.

In fixed income markets, results were largely positive albeit somewhat muted, as investment grade taxable and municipal bonds, returned 0.4% and 0.5%, respectively. Developed country foreign bonds returned 3% and emerging markets local currency bonds earned 1.8%.

Fueled by inflation concerns, gold hit a record high above $1,400. Oil prices pushed above $100 a barrel--a level last seen in fall 2008--primarily because of concerns about the potential impact of supply disruptions from the spreading unrest in the Middle East.

Market/Index	End of Quarter	Quarterly Change	YTD Change
DJIA	12,319.73	6.41%	6.41%
Nasdaq	2,781.07	4.83%	4.83%
S&P 500	1,325.83	5.42%	5.42%
Russell 2000	843.55	7.64%	7.64%
Global Dow	2,168.41	4.74%	4.74%
Fed. Funds Target	0.25%	0 bps	0 bps
10-year Treasuries	3.47%	+17 bps	+17 bps

Equities data reflect price change, not total return

Quarterly Economic Perspective

- Gross domestic product (GDP) for the final quarter of 2010 rose at an annualized rate of 3.1%, which put economic growth for all of 2010 at 2.9%. Both the manufacturing and services indexes of the Institute for Supply Management showed continuing expansion, though durable goods orders declined over the quarter. Retail spending also was up from the year before.

- Unemployment fell more than half a percent during the quarter, from December's 9.4% to 8.8% by March.

- Economic recovery began to take a toll in the form of rising prices. The primary culprits were agricultural commodities and energy. At an annual rate of 2.1%, consumer inflation remained within the Federal Reserve's target range. However, higher energy and food costs helped push wholesale prices up 5.6% annually by February.

- Housing continued to suffer. By the end of the quarter, bad weather had helped send February new-home sales down 28% from the previous February--their lowest point since record-keeping began--and sales of existing homes saw their fourth straight month of declines. Foreclosures fell 27% from the previous year, largely because of slower processing by banks

- The Federal Reserve said it anticipates continuing to buy bonds--so-called QE2--through the end of June as scheduled, but said it will keep an eye on signs of inflation.

- Japan's triple crisis left bulls and bears debating whether rebuilding efforts would contribute to future economic growth or the massive disruption and disaster would impede global economic recovery. As investors bought yen in anticipation of rebuilding efforts, the crisis sent the yen up against the dollar to the point that the G7 nations began selling yen to stabilize the currency.

- Fresh downgrades of the credit ratings of Portugal, Greece, and 20 Spanish banks fanned renewed concern about European debt, particularly after the Portuguese parliament rejected an austerity package.

Investment Outlook

The global rally in equity markets is now over two years old and has recovered over 90% of its pre-crisis high in the fall of 2007. In our view, the recovery in asset prices, especially for stocks and commodities, have been largely driven by unprecedented levels of central bank liquidity injections that were directed at restoring consumer confidence through increasing levels in financial asset prices – the so-called “wealth effect”. Notwithstanding the continuing distress of the housing sector and the protracted headwind from consumer deleveraging, this policy has worked to advance the economic cycle from recovery to expansion. Absent unforeseen shocks to the global system, we expect real GDP growth to continue at the rate of 3% or more for the next several quarters.

The central question now is whether the expansion is self-sustaining over the longer term. That is, when the government’s massive policy support and monetary “reflation” is removed in the coming quarters and years, can the economy continue to grow? How will the financial markets

react when evidence surfaces that the "liquidity punch bowl" is about to be removed? Understanding this dynamic is our primary focus, as it has the potential for damaging a weakened global financial system that continues to labor under excessive amounts of public and private debt. The massive liabilities and emerging entitlement program funding problems of the U.S. government preclude another heroic rescue of the financial system, so investors should expect risk to remain elevated for the foreseeable future.

At this point, we believe that financial market risk is concentrated in the fixed income markets, as the secular decline in inflation and interest rates that began in the early eighties has finally run its course, and rates are sure to head back up. The only questions are how high, how fast and for how long? Many respected economists believe the fixed income markets will be stressed by increasing rates for a decade or more, as inflation increases wears away at the value of fixed payments and creates a volatile pricing environment.

The stock market will probably continue to benefit from the system's excess liquidity, as well as the stresses in the bond market, as investors seek higher returns and inflation protection. Unlike Treasury Bonds, which are clearly overvalued in our view, the S&P 500 Index is trading at only 13.1 times projected forward earnings versus a 15-year average of 17.1. Other valuation ratios indicate that the stock market is at full or fair value, so increasing profits will be critical to rising stock prices going forward. While the rapid pace of earnings growth is expected to slow, domestic corporations are flush with cash and enjoying a manufacturing resurgence (as a share of overall GDP) that hasn't been seen in four to five decades.

Investment Responses

In summary, economic conditions are still supportive of continued expansion, but growth rates are likely to slow appreciably when government support is removed. Therefore, we are preparing our portfolios for a higher risk environment. While we are not yet compelled to move away from our neutral allocations to equities and fixed income in the core segment of our Portfolio Strategies (typically 70% of the total), we are increasing our allocations to investment managers/funds with investment processes that are more focused on risk management. For example, we are avoiding bond managers/funds that hold Treasury securities, and we are using more bond managers who have unconstrained sector mandates and management teams dedicated to actively managing interest rate and credit risk.

Our alternatives module (typically 30%) is comprised of two-thirds in global tactical asset allocators and one-third in funds that are skilled at capturing returns through hedging strategies. This is an increase in our allocation to tactical managers/funds, as we believe that their increased flexibility and agility will be important in adding value in the emerging environment.

As always, we recommend that investors work closely with their CapGroup Advisors to ensure that their portfolio strategies continue to be consistent with future income and capital needs.

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DATA SOURCES--Economic: Based on data from U.S. Bureau of Labor Statistics (CPI/PPI inflation, unemployment); U.S. Dept. of Commerce (GDP, housing starts, retail sales). Performance: Calculated based on data as reported in WSJ Market Data Center (indexes); U.S. Treasury (Treasury yields); U.S. Energy Information Administration/Bloomberg.com Market Data (oil spot price, WTI Cushing, OK); www.kitco.com, www.goldprice.org (spot gold, NY close); Oanda (currency exchange rates).

The Dow Jones Industrial Average (DJIA) is a price-weighted index composed of 30 widely traded blue-chip U.S. common stocks. The S&P 500 is a market-cap weighted index composed of the common stocks of 500 leading companies in leading industries of the U.S. economy. The NASDAQ Composite Index is a market-value weighted index of all common stocks listed on the NASDAQ stock exchange. The Russell 2000 is a market-cap weighted index composed of 2000 U.S. small-cap common stocks. The Global Dow is an equally weighted index of 150 widely traded blue-chip common stocks worldwide. Market indexes listed are unmanaged and are not available for direct investment.

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