



Quarterly Investment Update

July 15, 2011

Market Performance Recap

The momentum that carried stocks higher through the first four months of the year fizzled in May. Following April's year-to-date highs, when the Russell 2000 hit its highest level on record, week after week of declines battered all four major U.S. indices. However, a rally in June's final week left the Dow Jones Industrial Average as the only one of the four major indices with a gain for the quarter, taking the lead from the small caps for 2011's first half.

After breaking below 1,300, the S&P 500 barely managed to claw its way back to that level just before quarter end, though it was negative for the entire quarter. The Russell 2000 suffered the most as investors preferred the reassurance of defensive sectors and large caps, while the NASDAQ escaped with barely a scratch. Meanwhile, saddled with Greece's woes, the Global Dow continued to stagger.

Greece's debt problems caused investors to decide that, despite the United States' budgetary woes, Treasuries didn't look so bad after all. As demand pushed prices up, yields on the 10-year fell below 3% before rebounding a bit.

Market/Index	End of Quarter	Quarterly Change	YTD Change
DJIA	12,414.34	0.77%	7.23%
NASDAQ	2,773.52	-0.27%	4.55%
S&P 500	1,320.64	-0.39%	5.01%
Russell 2000	827.43	-1.91%	5.59%
Global Dow	2,134.29	-2.38%	2.24%
Fed. Funds	0.25%	0 bps	0 bps
10-year Treasuries	3.18%	-29 bps	-12 bps

Equities data reflect price change, not total return

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 indices listed are unmanaged and are not available for direct investment.

Quarterly Economic Perspective

- The financial markets heaved a sigh of relief as the Greek parliament agreed to implement a €8 billion, five-year program of spending cuts, tax increases, and asset sales. European leaders said the measures were a condition for receipt of the next slice of existing aid before key bond payments in July. Despite differences over whether and how to let bondholders such as banks suffer losses on Greek debt, the country's European colleagues also agreed to a new aid package for Greece.
- U.S. economic growth continued, but at a much slower pace. The Bureau of Economic Analysis said gross domestic product (GDP) rose by 1.9% compared to the previous quarter's 3.1%.
- Consumer inflation over the last year hit 3.6%, though the Bureau of Labor Statistics said volatile food and energy costs were responsible for more than half of that. However, oil prices fell back to roughly \$90 a barrel, helped by the release of some of the world's strategic reserves in the wake of ongoing conflict in oil-rich Libya.
- The nation maxed out its credit card as it went over the current \$14.3 trillion debt ceiling in May. Treasury officials warned that accounting measures could postpone the day of reckoning until August 2, but that after that date the Treasury will face the question of which bills go unpaid. As the clock kept ticking, congressional leaders argued over whether spending cuts, tax increases, or some combination of the two would be required before increasing the limit on how much the Treasury can borrow to pay existing obligations.
- The Federal Reserve's bond-buying program, nicknamed QE2, came to an end on schedule at the end of June. Fed Chairman Ben Bernanke said the Fed will continue to reinvest the proceeds of existing holdings, and that those efforts will end before the Fed raises interest rates. It also forecast slower economic growth (2.7% - 2.9%) for the rest of the year, but said some of the causes of the sluggishness should be temporary.
- Unemployment rose slightly to 9.2% during the quarter, consumers were slower to spend, housing continued to struggle, and retail sales were hurt by supply-chain problems in the auto industry caused by the spring's Japanese disasters.

Investment Outlook

The risk appetite of investors has abated over the past few weeks due to a weaker U.S. economy, increasing tensions over Eurozone debt problems, and mounting anxieties over the debt ceiling debate and the related government deficits. These issues are reminiscent of last summer's worries, serving as a reminder that the underlying economic issues have never been fully addressed. Rather than institute comprehensive measures to deal with pervasive debt problems, global policymakers have sought to buy time with temporary fixes. The hope is that economic growth will relieve some of the financial stresses over time and allow for less painful austerity solutions. This failure to craft solutions that directly address the structural debt issues limits economic growth in the U.S. and Eurozone. The financial markets hate uncertainty, and there's

no argument that uncertainty is at a high level as we head into the second half of the year. In our opinion, there is some good news to balance out the negatives:

- Corporate earnings continue to grow and appear to be stable. Given the recent pullback in the stock market, price-to-earnings multiples have actually contracted over the past few months, improving the attractiveness of current valuation levels.
- The Greek debt restructuring has been given a reprieve, relieving some of the pressure on global financial markets for the time being.
- The debt limit debate in Washington will likely reach an at-least-partially satisfying conclusion by early August.
- Most economists, including the Fed, view the current slowdown as a mid-cycle correction and expect economic growth to revive in the second half of the year.
- The volatility of commodity prices, especially oil, may well diminish as other uncertainties are resolved.
- The monetary tightening phase in China and other Asian economies is closing and growth is likely to resume.

In summary, the global economy and financial system remains fragile and susceptible to a higher frequency of financial shocks. At this point, our base case is for muted, below trend, growth for several years as consumers continue to pay down debts and governments at all levels struggle to cope with fiscal challenges.

Investment Responses

We continue to position our portfolios for the extended “muddle through” environment discussed above, and our portfolios are positioned for a subpar recovery. The Fed is being forced to employ a “financial repression strategy” (keeping interest rates below inflation) to deal with the fragility of the banking system and lessen the impact of servicing our huge government debt levels. The net results for fixed income investors is generally negative – extremely low yields on all instruments over the short to intermediate term and ultimately principal damage from rising inflation and interest rates. In response to these increased risks, we are focusing our fixed income module investments in flexible mandate managers/funds that are skilled at opportunistic investing in the global fixed income markets.

We believe that after the mid-cycle economic correction has played out, a resumption of the cyclical bull market in equities is likely, driven by a continuation of earnings, reasonable growth and a slow reduction in unemployment. However, the range of potential outcomes is unusually wide, so our core equity positions are emphasizing managers/funds that we expect to outperform benchmarks in an environment of heightened volatility.

Our alternatives module allocation of 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. Our emphasis on tactical managers/funds demonstrates our belief that increasing the latitude given to highly skilled managers should be beneficial in managing risk in the slow growth/deleveraging 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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