



July 10, 2009

To Our Clients and Friends:

Thank Goodness! Markets DIDN'T stink last quarter! To lose last quarter you needed to go long a short fund or short a long asset, long on the dollar or into a market neutral or alpha fund, or have been skittish and out and in the market inconsistently. That last sentence was both easy to say and made sense to me! I'll translate into English. What that sentence said was that traditional conservative, (risk avoidance) assets, long term US Treasuries for example, and bet-the-market-is-going-down types of assets, were almost all down substantially for the quarter. "Risk" assets, those that take a stake in volatile, investment oriented securities(either stocks or lower -not lowest! - credit quality bonds), went up.

### **Our Portfolio Models**

Even with the S&P 500 with dividends up 15.93% for the quarter and short term treasuries flat at 0.03% for the quarter, every one of our portfolios beat their benchmark except for the All Equity. Not only that, even our Capital Preservation and Income Portfolio averages were up more than 10%! On a year to date basis all of our portfolios are up more than their benchmarks and all but the Moderate (12 accounts), up more than the S&P 500 as a whole.

The returns our models have accumulated so far this year have accumulated slowly, primarily on the days that the market has been flat, or down. For example as the market has lost 4.25% over the first eight days of July, our Portfolios have dropped an estimated:

|                       |   |
|-----------------------|---|
| Capital Preservation, | -0.38%, about 9% of the market's loss vs. a 20% benchmark   |
| Conservative,         | -0.59%, about 14% of the markets loss vs. a 37% benchmark   |
| Mid-Point,            | -0.63%, about 25% of the market's loss vs. a 50% benchmark  |
| Moderate,             | -1.60%, about 38% of the market's loss vs. a 67% benchmark  |
| Opportunity,          | -2.05%, about 48% of the market's loss vs. an 80% benchmark |

### **Recession Recovery (?) Investing**

I describe this short term performance information simply to help you understand how we are trying to navigate the investment waters for you. We are very focused on the risk management side, trying to ensure that gains made, are kept, as much as possible. Normally at this point in a recession I would expect to be saying, "it is now time to embrace risk assets fully. Markets will begin their repairs and bring assets back to fair valuations, or even above". Unfortunately, a normal recovery appears less likely to many... at the moment, and markets are reacting to that. Please remember that what is normal now is that the opinions about the future change from dismal to hopeful and back again, very quickly. When it comes to people, I find "normal" to be highly over rated, but it sure would be nice for our economy, politics, and markets for awhile.



## Portfolio Model Changes

We noticed a fairly distinct difference in the reactions among our clients to the past year's extraordinary losses. It was primarily evident in our Moderate Portfolio clients. For those with whom we have spoken about how you were feeling, you split into three camps. The majority of you did not have specific concerns about our techniques or strategies, simply hopes (that we shared) that things would be back to normal soon. Those that did have specific concerns fell into the remaining two camps: those very concerned about how we would control the downside, and those more concerned that we stay positioned to enjoy the recovery. Neither approach is wrong, but it is difficult to satisfy both in the same portfolio. This year's recovery has to date, made it easier to satisfy both than I would have hoped with markets racing ahead and falling back in very short intervals.

We have begun the process of allowing the Moderate Portfolio to take on a slightly lower risk profile than before. We have not changed it as of yet, but we have created a new Model, the Growth Portfolio, which will invest to a 70% Equity Target. The Moderate will be allowed to float down to a 60% Equity Target, but not until we have given all Moderate Portfolio investors a chance to elect either model for their accounts. The big difference will be in the nature or personality of the portfolios in volatile environments. The personality of our portfolios changes as you increase the risk level past the Moderate to the Growth portfolio and beyond. This difference will be most noticeable in down markets, and in the immediate aftermath, wherein the Growth, Opportunity, and All-equity portfolios will more aggressively approach such periods as opportunities. Moderate and below will retain their patient, highly diversified approach, erring, as best we can, on the side of caution.

## Trading & Tactical Activity

We are using an extraordinarily diversified approach in all of our portfolios, attempting as possible to ensure that our managers are exposed to market segment in which we feel opportunities far outweigh downside risks, and avoid segments which we believe pose extraordinary risks to principal.

We continue to be slightly more active than in the past. We reallocated portfolios in March of this year, and that allocation performed very well in the second quarter. At the end of June, we rebalanced that portfolio allocation, as we had several securities which had done quite well and had grown larger in the portfolios than their original allocation, thus increasing the risk in the portfolios. By rebalancing, we reduced the risk back to the level that we implemented in March.

In March, we added two, 3% commodity positions, PIMCO Commodity Real Return and Direxion Commodity Trends Strategy Funds. The reason for commodities was that we felt they had been beaten down too far, and that IF we were going to see the beginnings of a recovery from a recession, commodities often do well. The reason for two funds is that PIMCO is always "long" (invested in), their commodity exposures. The Direxion Fund uses a "moving average" strategy to decide whether to be long or short (invested against or goes up when the asset goes down), each commodity excepting the oil & gas positions which can be long or in cash, never short. When we placed the funds, PIMCO was fully invested in the commodities index, and Direxion was fully short and in cash. PIMCO gained and Direxion lost during the quarter so they balanced each other's performance out which was expected for the short term. Over the course of the quarter, the long term reasons for a commodities exposure (recovery from a recession and protection from inflation)



again began to appear to investors to be more remote. So the last thing we did last quarter was take all of the PIMCO commodity out of the portfolio and dropped the Direxion exposure to just 1% to 1.5%. The allocations were moved to the PIMCO All-Asset (All Authority) Fund to further increase our portfolio model's overall asset, investment techniques, and tactics diversification.

### **Thoughts for the Quarter Ahead**

I would expect to see the last of the Direxion Commodity Trends Strategy Fund sold and the exposure also moved to the PIMCO All Asset (All Authority) Fund, unless the former begins to provide very good performance. We will use a performance gauge as opposed to a fundamental analysis gauge for this decision as it is a fairly direct indicator of worldwide economic expectations. Good performance now would be an early signal that either a possible recession recovery has begun or that inflation is likely to rise.

If the markets do well, we expect to rebalance again, out of those "risk assets" that go up with the markets, realizing gains and rebalancing to the original target allocations. The expectation being that this would help us to retain more of the gains if the market were to turn south again. On the other hand, if the markets continue to do poorly as they have the first week of this month, expect us to be more patient in rebalancing out of the more conservative securities, those that have held up better. These tendencies will be more pronounced in our portfolios from Capital Preservation through Moderate portfolios, and less so in Growth through All-Equity.

I am well past due to sign off on this letter to you. I deleted three more pages of letter before I sent this, the bad news; you'll be getting that communication in two more upcoming letters! Thank you for your patience! Have a great summer!

Sincerely,

A handwritten signature in black ink, appearing to read 'Ben', written over a light blue horizontal line.

Benjamin G. Baldwin III CFP® ChFC  
President