

April 25, 2011

Dear Client,

The expansive economic sentiment that dominated U.S. financial markets during the closing weeks of 2010 persisted through much of the first three months of 2011. The first quarter ended with the U.S. economy growing and a bull market entering a third year of gains marred by few significant interruptions. However, mid-quarter events overseas, including revolutionary upheaval in North Africa and natural disaster in Japan, pushed oil prices higher and raised new questions about global and domestic growth.

### **Domestic Equity Markets**

U.S. share prices continued their post-election rally through the middle of February, raising major benchmarks to their highest levels since mid-2008. Although foreign turmoil then diverted investors' attention from the domestic economy, equities had largely resumed their advances by quarter's end.

The Dow Jones Industrial Average, which tracks the performance of shares in 30 top U.S. corporations, gained 7.07% during the quarter, counting dividend payments. The broader market, as represented by the Standard & Poor's 500 Index, surged 5.92% after dividends. The technology-rich Nasdaq Composite, stung by concerns about disruptions to many companies' Asian component suppliers, grew 5.05% during the quarter.

Two years into the bull market that began in March 2009, the S&P 500 ended the quarter just 9.35% below the all-time peak reached in October 2007, having advanced 114% from its post-credit-crunch low. Yet while the Nasdaq has soared 119% during the past two years, rising to within just 2.4% of its 2007 high, it remains far below the pinnacle (5,048 on March 10, 2000) it scaled at the height of the dot-com mania.

Once again, investors looked toward market sectors that typically outperform during economic recoveries—smaller-cap companies and growth-driven industries, especially those with a domestic focus. The small-cap Russell 2000 Growth Index remained the leader, up 9.24% for the quarter, while the small-cap Russell 2000 Value Index gained 6.60%. Among globally oriented large-cap companies, value had the upper hand, with the Russell 1000 Value Index up 6.46% during the quarter while the Russell 1000 Growth Index added 6.03%.

U.S. corporate profits continued to rise, though at a decelerating pace. During the first quarter, companies in the S&P 500 reported an average 27% improvement in fourth-quarter 2010 earnings, exactly in line with the expectations of analysts who now predict a further slowing in profit growth during the opening months of 2011.

Banks and other financial companies remained the most spectacular turnaround story, with profits soaring 152% on an annualized basis. Rising commodity prices helped energy and materials producers boost their bottom lines by 43% and 33%, respectively, while a wide range of other companies—from retailers to health care providers—saw much slower profit growth. Meanwhile, stock prices outpaced profit gains, leaving equities slightly more expensive on a price-to-earnings basis by quarter's end.

As the economic tone brightened, U.S. companies elected to give shareholders more of the \$940 billion in cash they had hoarded during the recession. In all, 117 members of the S&P 500 expanded their quarterly payouts. The aggregate increase came to a record \$16.6 billion, 60% of the amount those companies paid in dividends during all of 2010.

### **Global Equity Markets**

Though many analysts had expected this to be another banner year for emerging markets, during the first quarter many investors moved money out of developing nations and into the reviving economies of North America and Western Europe. Following Japan's disaster and the eurozone's credit problems that returned during the quarter's final weeks, the U.S. market emerged as a big winner. In contrast to strong gains in American markets, the MSCI EAFE Index, a leading gauge of blue chip stocks in the developed markets of Europe, Australasia, and the Far East, edged up only 1.07% on a local currency basis, or 3.45% in U.S. dollars.

The industrial superpowers of Western Europe fared well, with German stocks surging 7.57% and French stocks up 10.58%, while the bruised markets of Spain and Italy rebounded 13.80% and 13.77%, respectively. But stocks in Japan—still the world's third-largest economy—sank 4.85%. Regions closely tied to Japan faltered: Chinese stocks gained only 2.88%. Emerging market countries that produce commodities advanced. Stocks in oil-rich Russia, for example, climbed 16.29% during the quarter. However, Egypt, one of the most mature capitalist economies in the revolution-wracked Arab world, saw its market plunge 23.23%.

### **Currency and Commodities**

Despite some foreign investors fleeing to the relative safety of U.S. investments, the quarter was generally a bearish one for the U.S. dollar. Measured against a basket of global currencies, the greenback lost 3.77%, while the euro gained 6.38% during the three-month period. Although the Portuguese government's collapse in late March revived questions about the ability of the eurozone's weaker members to repay their debts, robust growth in Germany more than outweighed such worries.

The weaker dollar helped commodity prices, which are quoted in U.S. dollars and so are higher when it takes more dollars to buy a barrel of oil or a bushel of corn. At the same time, investors flocked to commodities to hedge against inflation and geopolitical risk, driving the widely-quoted Thomson Reuters/Jefferies CRB Commodity Index up 8%. Early in the quarter, grain and other agricultural products led the way as demand for food surged in booming emerging markets—including Egypt, which is one of the world's leading grain importers. In fact, high food prices helped fuel the political upheavals in North Africa.

Food took a back seat to fuel once it became clear revolutionary forces might cut Middle Eastern oil transport lines or destabilize the export regimes of the Persian Gulf. Questions about the viability of nuclear power as an energy alternative in the wake of the Japanese catastrophes further heightened oil's attraction and by quarter's end, the price of a barrel of crude was back above the psychologically crucial \$100 level in the U.S.

Volatility in world markets also helped keep gold prices near record levels. Considered the ultimate hedge against currency weakness, political instability, and inflation, the metal edged up another 1% during the quarter to end at \$1,434.40 an ounce.

### **The Bond Market**

With benchmark interest rates at record lows and the Federal Reserve buying a reported \$6 billion to \$8 billion in government debt every day, Treasury yields remained too low to appeal to income-hungry investors, and U.S. bonds lost ground during the quarter. Corporate debt fared better.

Fed chair Ben Bernanke and his colleagues on the Federal Open Market Committee, still concerned about the pace of economic recovery, kept their target for overnight interest rates at an effective level of zero. However, the Fed's policy statements became appreciably less gloomy. In January, for example, Bernanke and company described the economic recovery as "insufficient," but a March statement noted "gradual improvement." That change in tone could eventually lead the Fed to focus on the risk of inflation, though for now, at least, it expects to keep short-term interest rates exceptionally low. But the current campaign of depressing long-term interest rates via quantitative easing—the \$600 billion bond-buying program known as "QE II"—is widely anticipated to end as scheduled on June 30<sup>th</sup>. With the Fed no longer an active participant in the Treasury market, bond prices and yields will then again be left to rise and fall in accord with normal supply and demand.

Dampened by the Fed's intervention and investor fears about rising inflation, the total return on Treasury securities, as represented by the Bank of America Merrill Lynch Treasury Intermediate-Term Index, was flat during the first quarter, up only 0.01%.

Many investors sought higher yields in the booming corporate bond market. High-yield ("junk") bonds issued by companies with lower credit ratings continued to pay significantly higher yields than their investment grade counterparts. High-yield bonds, as represented by the Barclays Capital High Yield Bond Index, registered a 3.9% total return for the first quarter.

Despite broad concerns about the health of the municipal bond market, the number of defaults declined by half compared with the preceding three months, and issuers that did fail to meet their obligations tended to be at the smaller and less stringently regulated end of the scale of municipal bond offerings.

### **The Economy**

As Ben Bernanke and his fellow government bankers indicated in their public statements, signs of economic recovery multiplied during the first quarter. Industrial activity ramped up and even the long-battered labor market

showed signs of life. While problem areas remained, some economists believe the U.S. economy may finally be on the verge of weaning itself from high levels of government support.

Gross domestic product (GDP), the widest gauge of U.S. economic strength, grew at an annualized rate of 3.1% during the fourth quarter of 2010, in line with expectations. Whether higher oil prices ate into first quarter growth won't become clear until the final numbers are released during the next few months. As March came to an end, economists suspected GDP was still growing at around 2.7%, the same rate as during the third quarter of 2010.

A 4% increase in personal consumption accelerated GDP growth in late 2010, and during the first quarter, it became clear U.S. households were once again spending at a record pace. Retail sales touched a new peak of \$387 billion in February, reflecting a 15% increase since sales bottomed out at \$336 billion in March 2009. In part, that rise reflected growing confidence among consumers—who, for example, finally felt good enough about their financial situations and the housing markets to resume home renovations. Yet some of the spending increase was attributable to an unwelcome surge in fuel costs that pushed the average price of gasoline to \$3.65 per gallon by late March.

U.S. companies created a net 478,000 new jobs during the first quarter, again hiring at a reasonable pace after years of massive layoffs. Yet while the unemployment rate sank to a two-year low of 8.8% during the quarter, there remained 7.2 million fewer jobs in March 2011 than there were in February 2008.

Long dormant, inflation returned during the first quarter as customers began to feel the effects of rising commodity prices. In February, consumer prices edged up 2.1% on an annualized basis—well below a historical average of 3%, but high enough to give economists pause. Subtracting food and energy costs (largely tied to volatile commodity markets rather than to consumer demand), prices inched up 1.1%, as health care, transportation, and even shelter became more expensive.

The long, painful recession that officially began in December 2007 and ended in June 2009 is now receding into memory for many people, though for others the trauma lingers. Housing remains a sore spot, while the labor market has a long way to go. Meanwhile, as the Federal Reserve shifts from an emergency stance and looks toward the once-remote prospect of inflation, investors also may need to shift to confront a new set of challenges—and to exploit new opportunities.



### **Your Portfolio**

During the first quarter, we finished rebalancing most clients' portfolios to their equity targets. In order to reduce exposure to interest rate risk, we also shortened duration in client portfolios by increasing short-term bond exposure. In May, we will mail a copy of our new disclosure brochure (containing detailed information about our business and advisory services), along with a copy of our privacy policy to all clients. In addition, our individual clients will receive our annual client information update form. In order to keep us apprised of changes in your health or other circumstances that may affect your portfolio, we will ask that individual clients complete and return the form to us promptly upon receipt.

If you have any questions or concerns about your portfolios or your financial situation, please contact your portfolio manager.

Best regards,

Tracy Kuntz, MBA, CFP®  
President

Enclosures

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**GLOBAL EXCHANGE TRADED FUND STRATEGIES**  
**1st Quarter 2011 Performance Review**

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***Global Balanced Strategy***

Our Global Balanced Strategy, which invests in bonds, stocks, and commodities around the world, returned 3.9% during the first quarter, and 15.1% over the past 12 months.

The first quarter of 2011 opened with a successful citizens' uprising in Tunisia, which inspired Egyptians to follow suit. These peaceful demonstrations ended two long-standing dictatorial governments. In February, demonstrations in neighboring Libya turned into a bloody civil war which shut down part of the country's oil production. Libya's supply interruptions sent the price of Brent crude oil to a 2-year high, fanning the flames of inflation. Three weeks before the quarter ended, a deadly earthquake struck economically stagnant Japan. Worse, the post-quake tsunami ruined key nuclear reactors in Japan's northern region, disrupting roughly 10% of their power supply, and prompted comparisons to the 1986 Chernobyl disaster. With the cost of lost fuel supplies estimated at \$300 billion, Japan's nuclear disaster has put additional stress on global energy supplies and driven up non-nuclear energy prices around the world.

Despite an otherwise raucous first quarter, global financial markets were relatively calm. A steep sell-off occurred after the Japanese catastrophe, but asset markets recovered quickly. By quarter's end, all major financial markets posted solid gains. Commodities, as measured by the Thomson Reuters/Jefferies CRB Commodity Index, led the way, gaining 7.8% due primarily to strong energy prices. Stocks also rose. Led by the U.S. markets, the MSCI World Index advanced 4.9%. The S&P 500 Index gained 5.9% during the quarter, while the MSCI EAFE Index earned 3.4% in dollars, hindered by Japan's disasters and Europe's lingering debt crisis. Emerging markets, as represented by the MSCI Emerging Markets Index, rose a meager 1.7% from the previous quarter.

During the first quarter, the equity portion of our strategy advanced 5.5%, outperforming world stocks by 60 basis points due to higher commodity prices, particularly silver. The white metal surged to a 30-year high of \$38 per ounce in dollars, delivering a spectacular 22% return for the quarter.

Global bonds, as measured by the Barclays Capital Global Aggregate Bond Index, gained 1.2% during the quarter. The bond portion of our strategy, in comparison, outperformed the index by 50 basis points, driven primarily by gains in inflation-protected securities (TIPS). Foreign TIPS returns were stronger than those of U.S. TIPS due to the dollar's continuing slump. Within a basket of currencies, the greenback declined 4%; losing 6% of its value relative to the euro, and 2-3% of its value relative to two major commodity currencies: the Canadian and Australian dollars. Despite the Libyan war and a number of other protests in the Middle East, geopolitical tensions failed to give the dollar a boost.

At quarter's end, the equity and commodities portion constituted 59% of the strategy, while bonds accounted for the remaining 41%. Specifically, at the end of the first quarter, 23% of strategy assets were invested in U.S. equities, 22% in foreign equities, 20% in U.S. bonds, 21% in foreign bonds, and 14% in commodities.

***Developed Markets Strategy***

Our Developed Markets Strategy, which invests in equities and fixed income securities of industrialized countries, returned 3.1% during the first quarter, and 9.1% over the last 12 months.

Despite geopolitical upheaval in the Arab world and Japan's devastating earthquake on March 11, developed market equities in general earned positive returns during the quarter. First quarter events helped steer the price of Brent crude up over \$100 per barrel. Rising fuel prices worried European policymakers who increased the euro's key interest rate by 25 basis points to 1.25% on April 7. In contrast, the Federal Reserve either doesn't believe we have inflation in the U.S., or if we do, that it will likely be temporary. Japanese authorities, on the other hand, have hoped for inflation for decades. After the nuclear disaster, the Bank of Japan injected even more liquidity into the banking system, spending billions of dollars to reverse plunging Nikkei share prices.

Developed market bond yields did not rise during the quarter, despite rising inflation fears. Instead, after yields peaked in February, the trend moved downward during the remainder of the quarter in spite of looming debt troubles in Portugal and Spain. By the end of March, the Barclays Capital International Treasury Index posted a 1.9% gain for the quarter, largely due to the weak dollar. The bond portion of the strategy, which is invested in mixed international treasuries, solidly advanced 4% during the quarter buoyed by the weak dollar and by inflation-protected securities, which outperformed the index by 1.7%.

The dollar's weakness also boosted developed market stocks. The MSCI EAFE Index gained 3.5% during the quarter in dollars, and only 31 basis points in local currency terms. European stocks outperformed the index by nearly 2%, benefiting from both the strong euro and Germany's decision to aid indebted EU members. In contrast, battered Japanese stocks lost 5% under a devalued yen, which gave up 2.5% of its value against the dollar during the quarter.

The equity portion of the strategy gained 2.3%, lagging the MSCI benchmark by 1.2%. The low position within the European markets early this year was to blame.

At the end of the quarter, roughly 50% of the strategy was invested in bonds and 50% in equities, allocated as follows: 17% in Asia and 33% in Europe.

### ***Emerging Markets Strategy***

Our Emerging Markets Strategy, which invests in less-developed economies, finished the first quarter up 1.8%, advancing 14.8% in the past 12 months.

It was another uninspired quarter for emerging market equities which lagged their more developed peers by 3%, while emerging market bonds tracked their benchmark index. During the first quarter, food inflation, followed by civil protests and outright war in several Muslim countries, and the nuclear disaster in Japan, all helped drive crude oil prices higher. The worldwide reaction to Japan's plight, and the 18-month low in the trade-weighted dollar index, however, helped reverse emerging markets' first quarter slump. By quarter's end, emerging market stocks had gained 1.7%, according to the MSCI Emerging Markets Index.

The equity portion of the strategy benefitted from the benchmark's gains. Since early February we have maintained a market neutral position with 47.5% of the strategy invested in an emerging markets index fund. In February we added Russian equity exposure and reduced our position in Latin American countries, which helped the equity portion outperform its benchmark by 40 basis points during the quarter. Russian stocks performed best during the quarter, gaining 16.3% in dollar terms. Japan's loss of 10% of its nuclear power production capability, and Germany's possible closure of several of its nuclear facilities, may mean a big boost for Russian natural gas exportation.

During 2009 and 2010, the most buoyant markets were those in countries that sold raw materials to China, such as many Latin American countries. However, since the beginning of this year, China's demand for raw materials has dropped as the Chinese government tries to put the brakes on rampant inflation and cool down the economy. Not surprising, Latin American stocks, after a two-year run-up, have traded weaker against the index since the beginning of the year. Among Latin American markets, Chile and Peru have been hardest hit due to their less-diversified economies. At quarter's end, Latin American stocks in general lagged the index by 1%, while Chile and Peru lagged the index by 8.3% and 14%, respectively.

The bond portion of the strategy, which is invested in developed and emerging market government bonds, gained 1.5% during the first quarter. The bond portion outperformed the JP Morgan EMBI Index by 60 basis points, due primarily to our position in international treasuries which benefitted from the strong euro.

At quarter's end, roughly 53% of the strategy was invested in equities, of which 28% was allocated to Asia, 13% to Latin America, 8% to Eastern Europe, and 5% to the Middle East and South Africa. The balance of the strategy was invested in bonds.

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