

July 27, 2011

Dear Client:

The robust bull market that has prevailed since early 2009 came to a crossroads during the second quarter of 2011 as the threat of resurgent inflation, and then signs of faltering economic growth in the United States and abroad, emerged. While neither possibility developed into an immediate threat, the prospect of trouble generated more aversion to risk, leaving stocks flat and Treasury bonds in demand.

Equity Markets

Although U.S. stocks continued their two-year rally into April, momentum slowed as the quarter waned. Even the commodity sector, a market leader earlier in the year on the strength of soaring oil and metal prices, faltered, and by June 30, key benchmarks had fallen back to near their March levels.

The Dow Jones Industrial Average edged up 1.42% during the quarter including dividends. The broader market, as represented by the Standard & Poor's 500 Stock Index, ended just 0.10% in the black after dividends. The technology-rich Nasdaq Composite continued to suffer from concerns about disruptions in the Asian supply of electronic components, dropping 0.04%.

Despite the quarter's restrained performance, the three major indexes have continued to enjoy solid gains two years into the bull market that began in March 2009. The S&P 500, for example, ended the quarter with a 30.69% gain for the trailing 12 months, 105% above its 2009 trough and just 9% below its 2007 record high. The Dow also prospered, advancing 102% since bottoming out and ending the quarter just 1% below its October 2007 peak. The Nasdaq, having soared 123% during the past two years, came to within 0.4% of its 2007 high (though it remains far below the all-time pinnacle of 5,048 it attained on March 10, 2000).

As the equity market's rise slowed, investors began shifting assets toward traditionally "defensive" blue-chip shares, leaving the large-cap Russell 1000 Growth Index barely in positive territory, with a 0.76% gain. The large-cap Russell 1000 Value Index finished just below even, down 0.50%, partly due to worries about the value-oriented financial sector. The shares of smaller companies, which may be more vulnerable to an economic speed bump, fared worse, with the Russell 2000 Growth Index dropping 0.59% and the Russell 2000 Value Index down 2.65%.

Additionally, U.S. corporations found it harder to squeeze profitability out of their existing businesses as the economic recovery that officially began in June 2009 approached its second anniversary. The second quarter saw members of the S&P 500—which account for more than 70% of total U.S. market capitalization—report 16.59% higher operating profits per share, considerably below the 27% growth they had enjoyed just six months earlier. When these companies begin reporting spring results in July, analysts expect to see earnings growth slow even further.

Once again, U.S. companies elected to reward shareholders with some of the \$940 billion in cash hoarded during the recession. In all, 444 publicly-traded companies expanded their second-quarter payouts while only 21 cut dividends. The aggregate increase came to \$11.2 billion for the quarter, adding to strong first-quarter growth as dividends rose 11.1% during the first half of 2011.

Global Equities

After the first quarter's upheavals, wariness towards overseas markets increased as the second quarter wore on. Rising inflation in Asia—and government efforts to control it—seemed likely to imperil growth in the region, which at first sent global capital back to the developed nations of North America and Western Europe. But then Europe's credit problems flared again and tepid U.S. economic data rekindled fears of a slowdown.

Against this backdrop, the MSCI EAFE Index, a leading gauge of blue-chip stocks in the developed markets of Europe, Australasia, and the Far East, edged down 0.53% on a local currency basis, though a weaker U.S. dollar gave domestic holdings a 1.83% gain.

Once again, the industrial superpowers of Western Europe outperformed the eurozone's debt-plagued nations, although fears of a slowdown even in Germany and France limited ebullience in those markets. Stocks in Ireland, beaten down in 2010 as that nation's debt crisis nearly destroyed its banking system, rebounded 5.30%, but in Greece stocks plunged another 18.03%.

Among emerging markets, commodity producers initially held up better than their oil-importing counterparts. But as commodity prices receded, gains in oil-rich Russia and metal-heavy Peru evaporated, leaving those once-bullish markets down 6.79% and 15.16%, respectively. In inflation-fighting China and India, losses were milder, with even the unpopular Indian market ending the quarter down only 3%.

Currency and Commodities

As anxiety surrounding Japan's post-earthquake reconstruction faded, the U.S. dollar initially went back on the defensive as investors seemed relatively complacent about the European Union's willingness to rescue its debt-plagued members. But as government austerity programs sparked riots in Greece and heaped fresh pressure on the euro, a renewed flight to safety helped the greenback reverse course. During the first three weeks of May alone, the dollar regained 4.21% of its value against Europe's common currency. For the full quarter, however, the U.S. dollar lost 2.17% against a basket of global currencies while the euro gained 2.06%.

Grains, metals, and especially fossil fuels continued their recent outperformance early in the second quarter. But as the dollar spiked in May, demand for these volatile investments, which are quoted worldwide in U.S. currency and so tend to weaken as the dollar rises, waned. Worries that Asian industrial demand for raw materials might weaken helped to push down the widely-quoted R/J CRB Total Return commodity index nearly 6% for the quarter. A plunge in contract prices for wheat and corn, which fell 20% and 10%, respectively, also contributed to the decline, while prices for copper, aluminum, iron ore, and other industrial metals oscillated. Oil prices reversed course as the United States elected to open its strategic petroleum reserves, sinking 11% between April and June to leave the key West Texas Intermediate grade at \$95.42.

Gold, considered the ultimate hedge against currency weakness, political instability, and inflation, fared better. After rising to a record \$1,577.57 an ounce on May 2, the price of the precious metal fell back to end the period ahead 4%. Silver, on the other hand, retreated 8.1% from its own record peak during the quarter.

The Bond Market

The end of the Federal Reserve's \$600 billion bond-buying program known as "QE II"—under which the Fed had been buying \$6 billion to \$8 billion in government debt every day—suggested that the U.S. central bank now considers the bond market healthy enough to operate on its own. But it also dashed the perverse hopes of some bond holders that the economy would weaken so much that the Fed would decide to continue its support.

With economic progress continuing to be elusive, particularly in the jobs and housing markets, no one expected that Fed chair Ben Bernanke and his colleagues on the Federal Open Market Committee would raise their target for overnight interest rates. Instead, the public listened carefully to the bankers' policy statements, which became more guarded as the quarter wore on. After the Fed's April meeting, Bernanke and company still believed the economic recovery was "proceeding at a moderate pace" and that the labor market was "improving gradually." But by June, they had to acknowledge that job creation was still lagging and that rising food and energy prices were having a "damping effect" on consumer spending.

As represented by the Bank of America Merrill Lynch Government Bond Index, the total return on Treasury securities was 2.6% during the quarter. That gain came despite the looming end of the Fed's bond-buying program and concern that Washington's impasse over raising the nation's borrowing limit could imperil the credit rating on U.S. bonds. The relative safety of Treasury debt remained attractive globally, with high demand raising prices and pushing short-term yields back down to the levels of late 2010. Longer-term government bonds, whose value would be hurt if inflation eventually picked up, weren't as popular.

Once again, high-grade corporate bonds underperformed Treasury securities as the urge to avoid risk overwhelmed the hunger for higher yields. Corporate debt generated a net return of 2.2% in the second quarter. But tax-advantaged municipal bonds continued to perform better than analysts predicted, rising 1.4% as embattled state and local governments avoided widespread defaults on their obligations.

The Economy

While most observers seemed convinced that economic growth was continuing, others focused on signs of apparent weakness, as persistently high unemployment prevented any sustained recovery in consumer spending. Still, no new financial disasters emerged during the quarter, and the Federal Reserve continued to wind down the extraordinary measures it had used to protect the economy from the worst of the credit crunch.

Growth in the gross domestic product, the widest gauge of U.S. economic strength, decelerated during the first quarter, rising at a lower-than-expected annualized rate of 1.9%, and few economists anticipate that the second quarter's numbers will be much better. But a troubling slowdown in first-quarter business activity was largely a factor of a 5.1% increase in imports, which are treated as a negative in GDP calculations. "Real" GDP, which reflects only domestic production and consumption, expanded by 3.4%.

Though personal consumption has helped keep the economy afloat, U.S. households curbed their spending during the second quarter. Retail sales, which totaled a record \$387 billion in February, have since plateaued as consumers have had to confront higher gasoline prices and the prospect of harder times ahead. Still, while month-to-month sales figures appeared flat, retail activity in May was 7% above its level of a year earlier on a seasonally adjusted basis. Gas stations got many of those consumer dollars, with outlays for fuel soaring 22% year over year.

Even though wage increases proved elusive, the cost of living accelerated during the second quarter. As manufacturers and refiners passed along higher commodity prices, retail inflation increased to historically normal levels, rising 3.6% in May on an annualized basis. But most of the gain was fueled by a 21.5% year-over-year increase in energy costs. Not counting energy and food, prices edged up 1.5%, with health care and transportation in particular becoming more expensive.

The pace of U.S. job creation slowed sharply during the second quarter as companies filled a scant 304,000 new positions from April through June. Meanwhile, as even extended unemployment benefits expired, many workers returned to the difficult job market, helping to push the broad unemployment rate back up to 9.2% in June.



Thoughts from Towneley

After the deepest recession in generations, we did not expect the path to recovery to be smooth. Ambivalence about the economic outlook, which led to the sideways activity in financial markets during the recent quarter, seems likely to continue. But because we don't know what the future will bring, we take seriously our obligation to manage your risk.

The current deadline to increase the federal debt ceiling or face default presents a prime example of uncertainty. We know that historically, difficult decisions from Washington, D.C. are often announced at the last minute. We also know that during uncertain times, the discipline to stick with a well-diversified portfolio, allocated to suit your specific circumstances and risk tolerance, is critical: switching strategies in anticipation of what *may* come is a form of market timing. For that reason, we have not made adjustments to client portfolios in anticipation of market response to the default deadline. As always, if you have had changes in your health, income, or other key life circumstances, please contact us to discuss your portfolio.

News from Towneley

As Signal Class shares of the Vanguard Total International Stock Market Index Fund recently became available, we upgraded client portfolios from Investor Class shares in this fund to Signal Class shares. This class of shares offers a lower expense ratio than the Investor Class shares carried, reducing investment costs for our clients.

In May, we sent all clients a copy of our new disclosure brochure (containing detailed information about our business and advisory services) and our privacy policy. In addition, we sent all private clients our annual client update form. It is important, both for regulatory purposes and so that we can provide you with the best service possible, that you keep us apprised of important events and changes in your lives. If you have not yet completed the annual update form and returned it to us, please do so as soon as possible. Depending on the information you provide in that form, we may need to consider making changes to your portfolio holdings or allocation.

In the same mailing we sent clients the latest edition of our newsletter, *WealthWise*, featuring a thoughtful article by our founder, Dr. Wes McCain, on gold's history and unique properties. This article has already been reprinted on the internet. If you would like additional copies to share with friends, please let us know. We can provide hard copies or an electronic version of the newsletter.

On May 20, we welcomed local dignitaries, members of the chamber of commerce, and friends and neighbors to our offices as we celebrated our grand re-opening and ribbon cutting. Our state senator and assemblywoman sent certificates honoring Towneley on this occasion, which also coincides with Towneley's fortieth anniversary.

As always, if you have any questions or concerns, please contact your portfolio manager.

Best regards,

Tracy Kuntz, MBA, CFP®
President

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GLOBAL EXCHANGE TRADED FUND STRATEGIES
2nd Quarter 2011 Performance Review

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Global Balanced Strategy

Our Global Balanced Strategy, which invests in bonds, stocks, and hard assets around the world, returned 1.3% during the second quarter and 22.4% over the past 12 months.

It was a turbulent quarter for global financial markets. In early April, investors' risk appetite was high, but it faded rapidly as poor key economic data in April pointed to a weak recovery. A less promising outlook dented investor confidence, deflated the rally in riskier assets, and ebbled money's flow into income producing securities. U.S. 10-year bond yields, for example, reached a year-to-date low in early June before closing the quarter higher at around 3.2%. The U.S. yields set a trend for their peers in Europe and Japan. As a result of lower yields, most bond markets around the world had a positive quarter; the Barclays Capital Global Bond Index rose 3.1%; U.S. bonds gained 2.3%, and foreign bonds were up 3.4%. In addition to cheaper borrowing, foreign bonds also benefited from stronger local currencies as the U.S. dollar hovered near a historic low.

The U.S. dollar trade-weighted index, which measures its value against six major currencies, lost 2.5% for the quarter. The U.S. dollar lost the most value—8.6%—against the Swiss franc, and suffered modest losses against the euro and yen, losing 2.4% and 2.7% against each of those currencies, respectively.

As the economic gloom deepened, prices of more speculative assets retreated, which hit stocks and commodities violently. In addition to bad economic news, mounting fiscal problems in the west reduced investor confidence. Lower-quality asset prices ballooned in April following late March's rally. As May began, however, sour sentiment sent asset prices into a six-week descent.

The weakening economy was not the only factor driving the selloff. In fact, the pending Greek debt rescue mattered even more. As the quarter drew to a close, a silver lining emerged from the overcast of the Greek rescue deal, resulting in a strong bounce in risky assets. Prices of global shares rebounded energetically, while commodities climbed more discreetly. By quarter's end, the MSCI World Index was up an encouraging 0.7%. Developed market shares, as represented by the MSCI EAFE Index, outperformed their emerging market counterparts, finishing the quarter up 1.8%. In contrast, while fast-growing emerging markets recorded a second-quarter loss, the S&P 500 Composite Index was flat, and commodities, as measured by the R/J CRB Total Return commodity index, declined severely, losing 6% during the quarter.

Our equity portion of the strategy lagged world stocks by 60 basis points, due primarily to losses in commodities, particularly silver, the price of which plummeted 8% during the quarter.

At quarter's end, the equity and hard assets portion made up 58% of the strategy, while bonds accounted for the remaining 42%. Specifically, 23% of strategy assets were invested in U.S. equities, 21% in foreign equities, 21% in U.S. bonds, 21% in foreign bonds, and 14% in hard assets.

Emerging Markets Strategy

Our Emerging Markets Strategy, which invests in less-developed economies, finished the second quarter up 1.0%, advancing 21.6% in the past 12 months.

Emerging markets had a perplexing quarter; bonds were beloved, but stocks were out of favor. Emerging market bonds attracted investors because of their higher yield returns amid low growth environments. That encouraged investors to pour more money into debt issues in fast-growing economies, despite increasing sovereign debt risk. Investor appetite for emerging market debt issues helped shrink their yield spread over U.S. Treasuries. Tighter spreads indicate that emerging economies are in better fiscal health than in the past. By quarter's end, the JPMorgan Global EMBI index had returned 3.8%, outperforming global bonds by 70 basis points.

Rising inflation and Chinese monetary tightening have caused emerging market stocks to lose their glow this year. While late March's rally pushed prices up near two-year highs, prices drifted during April. Following early May's commodity selloff, emerging market stocks declined for almost two months, finishing the second quarter down 2.3% as measured by the MSCI Emerging Markets Index. The BRIC countries, Brazil, Russia, India and China, along with Latin America, experienced greater-than-average losses in local currencies. The resource-sensitive Russian and Brazilian markets led the decline, both plunging as much as 9%. India and China, already burdened by high inflation, also lost more than 3% each. Commodity-rich Latin America also tanked as much as 7% for the quarter. Across the board, only a handful of emerging market countries, like Chile and the Association of Southeast Asian Nations ("ASEAN") countries, were able to deliver positive quarterly returns.

During the second quarter, we reduced the equity portion of the strategy to 48%. As a result, during the second quarter we held 4% less in Latin America than during the first quarter, but 5% more in Eastern Europe. These changes boosted performance by 60 basis points compared to the benchmark. At quarter's end, the equity portion of the strategy was allocated as follows: 23% in Asia, 9% in Latin America, 12% in Eastern Europe, and 4% in the Middle East and South Africa.

Developed Markets Strategy

Our Developed Markets Strategy, which invests in equities and fixed income securities of industrialized countries, returned 2.6% during the second quarter and 24.8% in the last 12 months.

Developed market assets had a relatively strong quarter. Foreign bonds have been steadily gaining in price since early April. Declining yields belied the widening debt crisis in Europe. The trouble should have increased European borrowing cost to some degree, but bond investors stood firm, believing that European leaders would do what was necessary to keep the EU united. Such a view assumes that richer countries will now need to fund debt-troubled European nations to prevent default. Assistance has already been provided to Greece, Ireland and Portugal. The focus now is to contain the problems in Belgium, Spain and Italy. During the second quarter, heavily-indebted European nations sharply raised their cost of debt, but the average bond yield on European bonds continued to decline.

Asian bond yields also trended downward. In Japan, JGB yields once again headed toward 1%. At the end of June, the Barclays Capital International Treasury Index posted a 3.4% gain for the quarter. Our bond portion of the strategy, which is invested in mixed international treasuries, advanced similarly during the same period.

Beside lower yields, currency also played a major role this quarter, enhancing developed market equities in dollar terms. Developed market stocks gained in dollars but lost in local currencies. The MSCI EAFE Index delivered a 1.8% dollar return, but lost 2% in local currencies. From Japan to Europe and the Pacific, most equity and commodity markets suffered. Commodity-rich countries like Australia and Canada were hit hard, giving up 4.7% and 5.9%, respectively. To a lesser degree, European stocks declined sharply from May to June, but their losses were eased by resilient German stocks and a strong quarter end's bounce. Smaller losses also occurred in Pacific regions, including Japan, where share prices remained in a trough after the March plunge, finally ending the quarter with a loss.

By quarter's end, the equity portion of the strategy gained 2.2%, beating the MSCI benchmark by 40 basis points. Roughly 49% of the strategy was invested in equities, of which 19% was invested in Asia, 28% Europe, and 2% in North America.

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