

January 28, 2010

Dear Client:

Glimmers of hope that the economy might finally be turning around gave investors the courage to keep buying stocks during the fourth quarter of 2009, as one of the strongest rallies in Wall Street memory continued. Yet while the tone was vastly improved from the near panic that gripped the world's financial markets a year earlier, faith in the recovery remained fragile, and those still wary of signs of renewed economic distress found plenty of news to ponder.

The Stock Market

After the spectacular gains of the third quarter, major equity benchmarks extended their advance somewhat more slowly during the year's final months. The Dow Jones Industrial Average rebounded another 8.1%, bringing its full-year rise to 22.7%. The Standard & Poor's 500 Index climbed 6.0% on a total return basis, posting a 12-month gain of 26.5%, while the technology-rich NASDAQ Composite finished up 7.2% for the quarter and 45.3% for the year.

Growth portfolios regained the upper hand as investors moved away from defensive stocks and returned their attention to the prospect of economic recovery. The large-cap Russell 1000 Growth Index, which tracks many of the world's leading technology and retail brands, gained 7.9% in the fourth quarter and 37.2% during the year. The Russell 2000 Growth Index, with its somewhat smaller constituents, fared nearly as well, up 4.1% for the quarter and 34.5% for the year. Value-oriented shares, which suffered in last winter's sell-off, lagged slightly, with the large-cap Russell 1000 Value Index gaining 4.2% in the quarter and 19.7% in 2009, while the small-cap Russell 2000 Value Index was up 3.6% for the quarter and 20.6% for the year.

Once again, corporate fundamentals remained weak despite rising stock prices. Third-quarter earnings reported during the fourth quarter by companies in the S&P 500 fell 13.8%, better than the 25% drop analysts had predicted. The urge to conserve cash in a tough business environment meant executives remained cautious about payouts to shareholders. U.S. companies reduced quarterly dividend payments by a total of \$58 billion, or 21%, during 2009, the biggest decline since 1938.

During this recession, most emerging markets fared better than developed economies; during the fourth quarter, the burgeoning industrial powerhouses of China and Brazil both saw their equity markets jump more than nine percent as capital flowed back to companies believed likely to lead the way out of the global recession. For the year, stocks in Shanghai and São Paulo surged 58.8% and 121.3%, respectively, in dollar terms. Russian stocks, helped by resurgent oil prices, fared even better, as did the technology-rich Indian market; both ended the year with gains of more than 100%. In comparison, the MSCI EAFE Index, which tracks share prices in Western Europe, Australia, and the urbanized economies of the Far East, had much more modest advances of 2.2% for the quarter and 32.5% for the full year in dollar terms.

The value to U.S. investors of returns on foreign stocks depends on the U.S. dollar's exchange rate—when the dollar weakens, gains in international markets are worth more—and the greenback ended the year with mixed results. The dollar actually gained 3.2% against the euro between October 1 and the end of the year, due as much to Europe's lackluster economic outlook as to strength in the U.S. For the year, the dollar declined 1.7% against the euro and 4.2% against a basket of other currencies. During all of 2009, the dollar gained ground only against the Japanese yen, while commodity-driven currencies such as South Africa's rand, Brazil's real, and the Australian dollar appreciated most against U.S. currency.

Worries that government spending and interest-rate policies would further weaken the dollar and eventually fuel inflation also boosted commodities. Because oil, metal, grain, and other raw materials are quoted worldwide in dollar terms, a weaker dollar translates into higher prices. Gold, a traditional hedge against inflation, reached a new high of \$1,212 an ounce before retreating somewhat in December, ending the year up 26% at \$1,096. Industrial commodities benefited from favorable exchange rates and recovering demand for raw materials. The price of copper (a proxy for global manufacturing activity) doubled during the year, while oil surged 13% during the quarter to nearly \$80 a barrel.

The Bond Market

Bond prices, buoyed during the financial crisis as investors sought safe havens, finally declined during the fourth quarter. As the federal government issued \$2.1 trillion worth of new debt to fund stimulus and bailout programs, waning demand drove prices lower and yields higher. By year's end, a representative portfolio of Treasury debt had shed 3.6% of its value, making 2009 the worst year for U.S. government bonds since the late 1970s.

Support for bond prices slipped further due to hints that the Federal Reserve's extraordinary efforts to help the economy may be ending. During 2009, the Fed purchased \$1.6 trillion in government, housing agency, and mortgage-backed securities to help boost the private credit and housing markets. But that bond buying now seems likely to end, possibly as early as the first quarter of 2010.

Investors' retreat from Treasuries was especially hard on longer-term issues, which offer investors higher interest payments in exchange for greater risk that inflation and rising interest rates will erode returns. While short-term yields remained close to zero, in line with the Fed's overnight interest rate targets, declining demand for longer-term bonds pushed their yields upward, widening the gap or "spread" between two- and ten-year bond yields to a record 2.8 percentage points by mid-December.

Investors continued to turn to corporate bonds. Although fourth quarter returns were modest, investment-grade short-term and intermediate-term issues, as represented by the Merrill Lynch U.S. Corporate Short-Term Bond Index and Merrill Lynch U.S. Corporate Intermediate Bond Index, respectively, finished the year with double digit returns: up 14.7% and 17.9%. Those hungry for higher yields, and with a higher tolerance for risk, reaped even bigger rewards from less investment-worthy issues. High-yield corporate debt, as represented by the Barclays Capital High Yield Bond Index, returned 6.2% during the fourth quarter, and a whopping 58.2% for the year. By the end of the quarter, the spread between speculative or "junk" corporate yields and Treasury debt of the same duration had narrowed to 6.75 percentage points—far from the 20-point premium investors received in late 2008—but still a considerable incentive. Risks remain high, however, as analysts expect some 14% of high-yield corporate borrowers to default on their obligations during the first quarter of 2010.

Treasury Inflation Protected Securities (TIPS) also fared well during the quarter and the year. TIPS, as represented by the Barclays Capital U.S. TIPS Index, finished the fourth quarter neck-and-neck with intermediate-term corporate bonds: both were up 1.8%. For the year, TIPS returned a healthy 11.4%, reflecting higher demand driven by impending inflation fears.

Three-year municipal bonds, as represented by the Barclays Capital Municipal 3 Year Bond Index, slightly outperformed five-year issues, represented by the Barclays Capital Government Obligation 5 Year Bond Index, during the fourth quarter, 0.8% to 0.4%, respectively. But the five-year bonds did better for the year, returning 7.4% compared to 5.8% for three-year bonds. For investors subject to a 30% effective federal tax rate, those results are equivalent to 11.3% and 8.9% taxable yields, respectively.

The Economy

While the Federal Reserve reported that economic activity "continued to pick up" between October and December, jobs remained scarce, and the Fed seemed likely to maintain its short-term interest rate targets at near zero. While low borrowing costs ordinarily feed inflation, the Fed expects the slow recovery in business activity to keep price rises "subdued" for some time.

U.S. gross domestic product (GDP) increased at an annualized rate of 2.2% during the third quarter, reflecting slightly higher consumer spending. While consumers spent more as the year wound down, sales paled in comparison to the ebullient retail environment of 2007 and early 2008. Households bought only slightly more in November than they did going into the disastrous 2008 holiday season. Everyday purchases increased modestly but spending on big-ticket items at furniture and department stores remained significantly depressed on a year-over-year basis.

Public perceptions of the economic environment remained deeply ambivalent, though hope for better times in 2010 has begun to develop. According to the Conference Board, which tracks consumer confidence, American families were more pessimistic about their present financial state than at any time since the recession of the early 1980s. However, expectations about future prospects improved throughout the quarter and ended the year at the highest level since the recession began in late 2007. Relatively few (21%) of those surveyed believed conditions would improve much during the winter, but only half as many thought things would get much worse.

Economists adopted a similar attitude toward the labor market, where U.S. companies continued to eliminate jobs throughout much of the fourth quarter, but at a slower pace. The 75,000 positions lost in December represented a dramatic improvement from the monthly rate of 600,000 to 700,000 layoffs seen earlier in the year, and revised data showed that 4,000 jobs had been created in November. Yet unemployment remained at the psychologically critical 10% level, with businesses reluctant to add new jobs while so much economic uncertainty remained. Roughly 6 million Americans had been out of work for 27 weeks or longer in December, and millions more had accepted part-time positions or left the work force entirely.

One bright spot for the unemployed has been the absence of significant price increases. Still, inflation is not dead but merely “subdued,” in the Fed’s terms, with the Labor Department’s consumer price index (CPI) edging 1.8% higher during the 12-month period that ended in November. The price of gasoline rose almost 25% during that time, while food and home heating costs declined. Health care costs, a primary component of elderly Americans’ spending, outpaced the broader economy, rising 3.5%.

Despite the recession’s lingering shadow, many on Wall Street and Main Street are relieved that the Federal Reserve and other government entities seem to have contained the worst of the financial crisis. Slow growth is better than no growth, and early signs of an upswing in manufacturing activity may be cause for optimism. Forecasts for economic growth during the fourth quarter range from 3.5% to 4.0%.

Your Portfolio

Towneley clients experienced outstanding double digit total portfolio returns for the twelve months of 2009. Taxable fixed income segments returned, on average, a healthy 13.5% due to the inclusion of corporate bonds, TIPS and high-yield funds. Tax-exempt fixed income segments also had relatively high returns. Total equity returns averaged 32.3%, making back much of the losses from 2008 and surpassing comparative indexes.

With most clients back to or very near their equity targets, we continue to make tactical changes to client portfolios. In addition to phasing in gold and silver exposure, we plan to add a new fund to the domestic equity segment, and make a few fund substitutions and replacements in the other segments. To learn more about our decision to add gold, please see the enclosed special report on gold.

In the domestic equity segment, we will add Columbia Dividend Income fund, a large-cap value fund, while maintaining our roughly equivalent growth-value weighting. To return small-cap exposure to target, we plan to add T. Rowe Price Small Cap Value in place of Laudus Rosenberg U.S. Discovery fund, a mid-cap fund that absorbed Laudus Rosenberg U.S. Small Cap in November.

On the international side, we plan to diversify out of Tweedy Browne Global Value, which is hedged to the U.S. dollar, and into Tweedy Browne Global Value II, which is not hedged to the U.S. dollar. Once this fund exchange is completed, clients' international equity exposure will be entirely non-dollar, which will better position clients to reap currency-exchange benefits from the weak U.S. dollar.

Because we expect interest rates to start moving up again later this year, we plan to shorten average duration and make other defensive adjustments in the fixed income segment. Specifically, we plan to liquidate long-term corporate bonds in taxable accounts and to reduce high-yield bond exposure in all client accounts. We also intend to slightly reduce TIPS exposure from 30% to 25% of fixed income, as we believe that TIPS are now overvalued. Finally, we are adding the PIMCO Low Duration Bond Fund in the tax-exempt accounts and the Columbia Short Term Municipal Fund and T. Rowe Price Short/Intermediate Term Municipal Fund in taxable accounts to better diversify client portfolios.

News from Towneley

Robert Seaman has joined our portfolio management team. With Towneley since 2005, Robert has previously focused on client services and marketing. With over 20 years experience in management and financial consulting, we are confident that Robert will be a valued resource for our clients as he assumes this new role.

Operations Manager Sheila Lagrand, a member of the U.S. Coast Guard Auxiliary, supported relief efforts in Haiti. She monitored a spreadsheet of compiled text messages and Twitter posts sent by people trapped in the rubble and by others requesting aid. When messages in French were added to the spreadsheet, she translated them into English and reposted them to the spreadsheet so the information could be relayed to rescuers.

Portfolio Administrator Christina Elmore, husband Antonio, and big sister Alana welcomed a new addition. Baby brother Andre was born on September 3, 2009.



As always, we urge you to keep us abreast of any changes in your health or other circumstances that may affect your portfolio, such as job loss, planned or unplanned early retirement, or substantial losses in other investments.

Best regards,

Tracy Kuntz, MBA, CFP®
President

Towneley Special Report: Gold

Last quarter, we introduced our plan to use exchange traded funds (ETFs) to provide client portfolios with exposure to certain asset classes not currently available from mutual funds, such as gold and other precious metals. This report provides more details about this asset class, which is new to some Towneley clients. For those clients who are already invested in precious metals, this discussion will provide a review of our strategy.

What is the best method of investing in gold?

As we have advised clients over the years, the best method for an investor to directly invest in gold is to take physical possession of coins or bullion and to provide for its safekeeping. With the advent of ETFs that purchase and store gold bullion, however, clients can now receive some of the same benefits via their Towneley portfolios as if they directly owned gold, with greater ease and without the security concerns.

Direct gold ETFs actually buy and hold gold bullion in vaults located in the U.S., London or Switzerland. These ETFs provide direct exposure to gold price fluctuations, so the price of these funds tends to move closely in line with the price of gold. Other gold ETFs either invest in gold futures or in the stock of companies that mine or process gold. Neither of these latter two types of ETFs tracks the price of gold as closely as do the ETFs that actually buy and hold gold bullion, so we prefer the direct gold ETFs.

While “gold” mutual funds exist, we prefer ETFs over mutual funds for gold exposure because they offer liquidity, intraday trading and a way to track the price of gold that is not easily captured through mutual funds. Also, due to their structure, mutual funds cannot purchase and store gold, and investments in gold futures or the gold-industry-related stocks typically held by “gold” mutual funds do not provide pure asset class exposure.

Why gold?

Gold and other precious metals tend to appreciate in value during times of economic uncertainty. A modest position in gold can provide a hedge against rising price inflation and currency declines while helping to diversify a long-term portfolio.

Treasury Inflation Protected Securities (TIPS) provide a hedge against moderate price inflation, but the inflation adjustment component of TIPS cannot adjust quickly to fast-rising price inflation. One of gold’s primary roles in a long-term portfolio is to hedge against fast-rising price inflation. Although inflation is currently low, we believe that there is an increasing risk of price inflation.

For U.S. dollar-based investors, gold also helps hedge against the impact of the declining U.S. dollar. As the value of the dollar relative to other currencies falls, investors seek the stability of gold and other precious metals, driving up their prices. In this respect, gold acts more like an insurance policy than an investment.

Unlike securities, gold has intrinsic value. Should the worst occur, and world currencies collapse, gold and other precious metals could themselves be used as currency. Barring a government confiscation of gold in ETFs, your portfolio will be partially protected in such an environment. Nevertheless, the ultimate protection is a small amount of gold coins in your possession.

At times, gold has also hedged domestic equity performance. Through most of the last four decades, the price of gold has moved inversely to that of the U.S. stock market, as represented by the S&P 500 Index, making gold an excellent hedge against market volatility during this period. During the last decade, the correlation between the daily spot price of gold and the S&P 500 was near zero. In the two worst years for the S&P 500 in the last decade, 2002 and 2008, the index lost 22% and 37%, respectively, while gold gained 24.7% and 5.4%, respectively.

Of course, gold doesn't always outperform equities. Indeed, over the very long term, a well-diversified global equity portfolio has outperformed gold by a wide margin. Gold doesn't always produce positive returns either, which is why we recommend a relatively small investment in gold: up to five percent of one's assets at cost. Our research and experience have convinced us that, for most investors, the benefits of such a relatively small position in gold may outweigh the potential risk that the gold in your portfolio does not perform as well as the balance of your portfolio.

Why buy gold now?

You've probably heard or read recently that the price of gold is at an all-time high. This is true in nominal terms. However, when historic gold prices are adjusted for inflation, it is still only half its 1980 price of \$2,200 an ounce in today's dollars. We believe that the combination of the current Federal Reserve's low interest rate policy, mounting budget deficit and increasingly burdensome government debt will provide a nexus for increased demand for gold.

Why not buy other precious metals too?

We have and/or are adding silver exposure to client portfolios in addition to gold. (Note: clients in the Global Balanced Strategy already have exposure to direct investments in silver). Two other precious metals often purchased by investors, platinum and palladium (PGMs), are primarily industrial metals, so their prices are driven by growth in the industries in which they are used: automobiles, computers and chemicals, to name a few. Because of the cyclical nature of their price fluctuations, PGMs do not hedge currency fluctuations as well as gold and silver do. Silver is also used in industry, although not as extensively as are its white metal cousins.

How much gold?

We plan to initially allocate five percent of total portfolio assets at cost to precious metals, 80% of which will be allocated to gold and 20% to silver.

What triggers a rebalance of the gold position?

In general, we rebalance a client portfolio when necessitated by:

1. Contributions or withdrawals;
2. Changes in client's circumstances or goals; and
3. Changes in market value that alter the original allocation beyond the targets we have set for the various market segments, resulting in increased risk.

For gold and silver to truly hedge against a substantial collapse of the currency, rapidly rising price inflation or hyperinflation, the portion of the portfolio allocated to precious metals should not be actively rebalanced. This is particularly important when the risks of currency devaluation or rapid price inflation are high or increasing. In this case we would continue to rebalance the portion of each client's portfolio that is not allocated to precious metals in accordance with our normal practices. Should there be a clear indication that monetary policy and the government deficit and debt is under control, we would consider rebalancing the gold/silver position. In a more extreme case, should a new global gold-based reserve currency be created and/or should the U.S. dollar be officially devalued against gold, we may make substantial changes to the gold/silver position.

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