July 31, 2009

Dear Client:

During the second quarter of 2009, financial markets enjoyed an upswing after one of the most difficult periods in history. This quarter, Ernie Garrett, Towneley research analyst and portfolio manager, shares his thoughts about how far we've come in weathering the financial crisis, and how much further we have to go. A California native and amateur hockey player, Ernie resides in Mission Viejo, California with his wife Alysa. Ernie earned his CFP® certification in 2004, and is currently pursuing a master's degree in economics at his undergraduate alma mater, California State University, Fullerton.

Where are we in both the drawdown cycle and the recession cycle, and when do you think we'll see the end of both?

EG: The drawdown that began in October of 2007 hit its trough on March 9, 2009. During those 17 months, the market as represented by the S&P 500 Index lost a staggering 55% of its value. This is the second worst drawdown in the last 80 years, surpassed only by the market's 83% drop at the beginning of the Great Depression. As of March 9, the market needed to return a whopping 123% to gain its previous high. We've made some progress climbing out of the market trough. The market gained just under 37% since March 9, although it still needs to earn an additional 63% to reach its October 2007 level.

To put this drawdown in perspective, the recovery portion of the nine largest drawdowns in the past 80 years lasted an average of 34 months. During the drawdowns of 1972 and 2001, which were the last two of similar size to the current one, recovery took 21 and 49 months, respectively. If the market were to earn its 83-year annualized nominal return of 9.5% every year going forward, then we would be looking at another four and a half years of recovery.

The 19-month-old recession continues, although the economy is beginning to show signs of recovery. Global commodities prices are stabilizing. Oil futures are much less volatile than they were six months ago, and gold has held fairly steady at $900 an ounce for the past six months. The credit markets have shown signs of healing. Demand for the many short-term lending programs the Federal Reserve instituted over the last nine months has slowed significantly. Participation in the Fed's commercial paper support program has fallen to one-third its peak level, while overseas central bank borrowing has declined by more than 80%.

Due in part to purchases by speculators and investors, existing home sales have increased three months in a row, although prices remain constrained as foreclosures continue to depress values. On July 27, the Commerce Department reported that June 2009 new home sales rose 11%, the largest monthly increase in more than eight years. Also, prompted by the government's "Cash for Clunkers" program and rising confidence among ready buyers who've been waiting on the sidelines, new car sales have begun to increase.

These are all good signs that the economy is gaining momentum and that we have begun to clear the trough. But the economy is not out of the woods yet, as near-term uncertainty continues to keep consumers from spending and employers from hiring. However, the stock market, which tends to lead the economy by about nine months, is behaving as if economic recovery will be underway by the end of this year.

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If things are improving, why does unemployment keep rising?

EG: Nationwide, unemployment reached 9.5% in June, and is expected to hit 10% by the end of the year. Although unemployment continued to increase during the second quarter, the pace of layoffs appears to be moderating. Initial jobless claims may have peaked in early March, as they have been declining slightly since then.

The measure of changes in the number of non-farm employees provides important information about economic conditions. Six of the last nine U.S. recessions ended as the unemployment rate stabilized. In those recessions, the unemployment rate was a concurrent indicator of economic health. During the 1990 and 2001 recessions, however, recovery occurred even as jobs were lost, giving rise to the term "jobless recovery." It looks like the current recession will follow suit, and that employment growth will lag the overall economy, as productivity rose during the second quarter, despite dramatic payroll cuts.

Many economists expect Gross Domestic Product (GDP) growth to be sluggish for a long time while consumers pay down debt and increase savings. What do you see as the prospects for GDP growth and why?

EG: Consumer spending accounts for 70% of U.S. GDP, so when consumers change their spending habits, particularly if they do so quickly and/or drastically, economic growth is affected. During the first six months following the stock market meltdown last fall, the national savings rate jumped from 0%, where it had stood for nearly four years, to 6.9%. For the last 20 years, America has slowly moved away from being a nation of savers to a nation of spenders. During the 34-year period ending in 1993, Americans saved an average of 8.8% of their disposable income annually. Between 1993 and 2008, however, Americans annually saved only 2.7% of their disposable income on average, barely enough to keep pace with inflation.

Not surprisingly, as Americans began to undersave, they also began to overspend, incurring more debt in the process. Between 1980 and 1994, the household debt service ratio (DSR), a quarterly estimate of the ratio of debt payments to disposable income compiled by the Federal Reserve Board, averaged 11.3%. Between 1995 and 2009, however, the DSR increased steadily, exceeding 14% through most of 2005 and all of 2006 and 2007, before dropping to 13.5% by the end of the first quarter of 2009. For much of the last 14 years, U.S. consumers have been saving far too little and borrowing far too much. As we've seen, there's a price for such overindulgence, and we'll be paying it for several years to come.

Consumers are spending less now because they've lost their jobs, are trying to get out of debt or recoup investment losses, or want to increase their cash reserves. In response to lower demand for their products, manufacturers have both reduced inventories and cut jobs to offset lower revenues. Although the best thing for overextended consumers right now is to spend less and pay down debt, our sluggish economy could use a boost from consumption. Until consumers reach their savings threshold (the point at which they have saved enough and paid their debts down sufficiently), recovery may proceed slowly.

Our economic engine has come to rely on American consumers spending more than they earn, and it will take time for the economy to adjust to a lower level of personal consumption. As companies compensate for reduced revenues and earnings stabilize, layoffs will slow, job security and outlook will improve, and many consumers will start spending again. I hope American consumers have learned a lesson and will choose to spend wisely, and not at the expense of personal savings and debt reduction.

I believe GDP will start to grow again later this year as the economic recovery gains traction, boosted, in part, by the government's many stimulus programs. Although beneficial in the short term to help jump-start economic recovery, the massive amount of government borrowing and spending fueling the stimulus could leave us with high inflation and sluggish growth for years to come.

In light of current economic and financial market conditions and your opinion about what lies ahead, what should both private and institutional clients be doing now to strategically position themselves for what's to come?

EG: With the market rebounding, some investors may be tempted to up their equity targets in an attempt to try to recapture last fall's losses. But Towneley clients know that it is one's age, health, employment status, time to retirement, spending and other needs and goals that determine the appropriate level of equity exposure in one's portfolio, not the ebb and flow of the market. As always, we ask you to consider your current financial situation.

If anything has recently changed, or is about to change in your life or your business, then call your portfolio manager to discuss whether your portfolio allocation may need to be altered. Also call if you have any concerns about your allocation or portfolio in general. Otherwise, continue to spend frugally, save liberally, and pay down as much of your debt as possible.

How is Towneley addressing these market conditions?

EG: During the last 12 months, we have made several strategic changes in client portfolios to capture current opportunities and to better position clients for the road ahead.

Fixed Income Strategy:
In accounts with taxable bond exposure, we reduced Treasury bond exposure earlier this year when Treasury yields reached historic lows; at the same time, we increased exposure to relatively more attractive corporate bonds. Over the past 18 months, we have doubled TIPS exposure in tax-exempt accounts in anticipation of the inflation that we expect to result from the government's stimulus efforts.

In accounts with municipal bond exposure, we eliminated state-specific funds to reduce risk. Many states' bonds, most notably California's, have been downgraded in response to statewide fiscal and budget crises. We increased national municipal exposure for greater diversification.

We increased high yield exposure in the fixed income segment of most client accounts from 2.5% to 7% of total fixed income, to take advantage of attractive valuations in the high yield sector. Overall, we have adopted a defensive fixed income strategy with a low 3.5-year duration, to help protect against losses in the fixed income portion when historically low interest rates begin to rise, as they inevitably will.

Equity Strategy:
The past year has been a challenging one for equities. The quickness and severity of the stock market drawdown led us to postpone our plans to fully rebalance client accounts last fall. The strategic changes that we did make over the past six months, however, along with the market upswing, have brought most clients back to, or very near, their equity targets.

Throughout the crisis, we have maintained existing international equity targets to both provide diversification and hedge against the declining dollar. In May, we raised indexed international equity exposure relative to managed exposure, from 44% to 50%. As discussed in last quarter's letter, we raised indexed domestic equity exposure from 50% to 60% in March. We increased equity indexed fund targets to minimize dilution of the equity portion by the large cash positions that many equity fund managers had built up toward the end of last year, and to ensure client equity holdings were fully invested to benefit from the coming market turnaround.

For the fifth year in a row, *Wealth Manager* magazine has named Towneley Capital Management one of the nation's top 100 advisors on the basis of assets under management per client. We thank you for your continued trust and loyalty, the foundation of this achievement. If you have family members or friends who could benefit from our expertise, we'd be pleased to discuss their needs with them.

Best regards,

Tracy Kuntz, MBA, CFP®
President

Enclosures

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GLOBAL EXCHANGE TRADED FUND STRATEGIES
2nd Quarter 2009 Performance Review

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Global Balanced Strategy

Our Global Balanced Strategy, which allocates among bonds, stocks, and hard assets around the world, gained 13.3% in the second quarter. The bond portion rose 5.5%, and the equity portion, which includes stocks and hard assets, advanced strongly: 18.7%. At quarter's end, equities and hard assets accounted for roughly 65% of the strategy.

The strategy benefited from rising optimism during the second quarter. The bond portion finished the quarter 80 basis points ahead of global bonds, as represented by Barclay's Capital Global Bond Index, due to the strategy's exposure to U.S. corporate bonds. Reaping the benefits from shrinking interest rate spreads, high grade U.S. corporate bonds returned 9% in the second quarter, while lower grade U.S. corporate bonds inched up a mere 2%.

The equity portion had a strong quarter, gaining 18.7%, compared to the MSCI World Index' 21% return in U.S. dollars. The strategy's hard assets exposure accounted for much of the 2.3 point difference. Led by energy and industrial metals, commodities rebounded from their March low. The CRB Index finished the quarter up just under 10%, while gold, which accounts for 7% of the Strategy, closed only $4 ahead of its first quarter closing price.

At the end of the second quarter, 17.2% of the strategy was invested in U.S. bonds, 18.5% in foreign bonds, 25.6% in U.S. equities, 28.1% in foreign equities, and 10.6% in hard assets.

Developed Markets Strategy

Our Developed Markets Strategy, which invests in industrialized countries, delivered a strong gain of 28.0% for the second quarter, bringing the strategy's year-to-date return to 10%. The strategy outperformed the MSCI EAFE Index by 2.2% during the second quarter, and 1.6% year-to-date.

U.S. investors reaped excellent second quarter returns from developed market stocks largely due to the declining U.S. dollar. In the three months ending June 30, the dollar lost 5.6% of its value against the euro, 2.6% of its value against the Japanese yen, and a whopping 16.5% of its value against the Australian dollar.

Currency has regained its influence over returns. A few months ago, when panicked investors abandoned stocks and bonds, and fled to cash, the U.S. dollar rose swiftly against other major currencies. As the financial crisis wanes, however, and investors move their dollars back into the market, the variables that have long exerted downward pressure on the dollar–U.S. debt levels and rock-bottom interest rates–regain their influence. Currency aside, international stocks only slightly outperformed U.S. stocks during the quarter.

America's spending moratorium has slowed economic recovery, not only in the U.S., but also in Japan and Germany. Exports to the U.S. have declined sharply in both countries, and fiscally responsible Japanese and German consumers are unwilling to spend or borrow more, despite government attempts at encouragement.

The economic outlook for many developed countries, in our opinion, is less than optimistic. During the second quarter, we sold Australia, Japan, Sweden, and the U.S., and reduced the overall equity exposure to less than 90% of the strategy. The remainder is invested in world bonds and cash. At quarter's end, the equity portion was invested as follows: 16% in Asia, 68% in Europe and 4% in Canada.

Emerging Markets Strategy

Our Emerging Markets Strategy, which invests in less-developed economies, outperformed our other two strategies, finishing the second quarter up 29.9%. The bond portion gained 10.1%, and the stock portion earned a record 36.3%.

During the second quarter, emerging markets outperformed their more developed cousins across-the-board: emerging market stocks, bonds and currencies all prevailed. Emerging market investments generally thrive during a weak dollar, declining interest rate environment. Over the past three months, the U.S. dollar has declined more than 10% compared to emerging market currencies on a capital-market-weighted basis.

The bond portion, which is invested in a mix of foreign sovereign bonds to reduce portfolio risk, underperformed emerging market bonds, as represented by the JP Morgan Emerging Markets Debt Index, by less than 1%, but finished approximately four points ahead of international treasuries, as represented by the Barclay's Capital International Treasury Bond Index. Emerging market bonds benefited from currency gains and improving credit conditions.

The stock portion outperformed the MSCI Emerging Markets Index by more than 2%. At the beginning of the second quarter, we increased the equity portion target to 80%, with approximately 30% of the strategy invested in Asia. Brazil rose 40% in the second quarter owing to Brazilian real appreciation and higher commodity prices. South Africa, one of the five fastest developing market economies, was up 29.8%.

By the end of the second quarter, the strategy was invested 18% in bonds and 82% in equities, allocated as follows: 44% in Asia, 24% in Latin America, 11% in the Middle East and South Africa, and 3% in Eastern Europe.

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