Stapp Financial Investment Letter

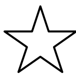
Stapp Financial Planning, PLLC **Fourth Quarter 2009**

We've enjoyed strong absolute and relative returns this year after a difficult 2008.

We continue to believe that we are in the midst of a major debt-driven transition in the economy that will keep risks elevated, result in continued economic headwinds, and have longer-term consequences due to the buildup of our public (government) debt.

We don't believe stocks are cheap enough to discount the period of weak growth that seems likely in an economy that is deleveraging. So we have built sizable bond positions while we wait for better opportunities.

Our goal is to wait patiently and then act when we see investment opportunities, which we believe can materially raise portfolio returns over our five-year investment horizon.



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Quarterly Investment Commentary

When the dust settled on one of the most eventful and upended years in memory, investors had generous gains in stocks and certain segments of the bond market to salve the wounds of a disastrous 2008 and first quarter of 2009. Stocks finished the year strongly, continuing their powerful run that began in early March. Large-cap stocks, based on the Vanguard 500 Index Fund, gained about 6% in the final quarter, and finished 2009 with a 26.5% gain. In both the quarter and the full year, growth sharply outpaced value, but between larger-caps and smaller-caps, returns were pretty similar. Mid-caps were a different story; while the iShares Russell Midcap ETF posted fourth-quarter returns in line with the overall market, full-year returns were just north of 40%.

On the domestic fixed-income side, returns varied widely in 2009. The Vanguard Total Bond Market Index Fund gained 5.9% for the year, but the iShares Barclays 7-10 Year Treasury ETF was down 6.4% and the iShares Barclays Credit Bond ETF gained more than 14%. High-yield bonds, which normally exhibit hybrid characteristics of stocks and bonds, instead crushed both, with Merrill Lynch U.S. High-Yield Cash Pay Index gaining 56% for the year.

Heading overseas, the story was emerging markets. Both equity and debt of emerging-markets countries left their developed-market counterparts in their dust. Vanguard's Emerging Market Stock Index Fund tacked on 8.2% in the fourth quarter to bring its full-year gain to 76%, versus a gain for the predominately developed market Vanguard Total International Stock Index of 3.2% for the quarter and a still impressive 37% for the year. For bonds the pattern was tighter but the same: Emerging-markets bonds (JPMorgan GBI-EM Global Diversified Index) gained 2.8% and 22% for the quarter and year, while developed-nation sovereign bonds (Citigroup World Government Bond Index) lost 1.9% in the fourth quarter and gained only 2.6% for the year.

We have been cautioning that our model portfolios are not particularly well positioned for the kind of robust environment we've seen in the financial markets. We are underweighted to equities and have a generally conservative bias. We offer that note of caution because if we continue to see strong gains and risk taking, we would expect to at least temporarily underperform. That said, we

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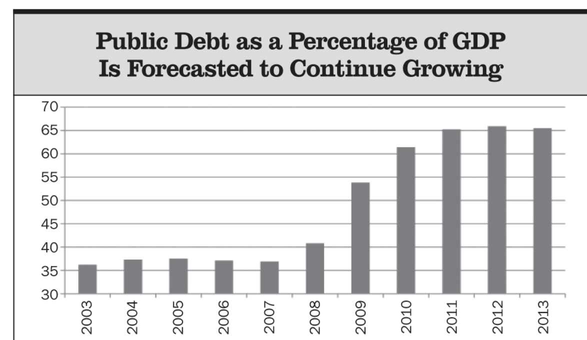
are pleased to report that all four of our models outperformed their benchmarks in the fourth quarter and the full year by considerable margins. The reasons are the strong gains of our tactical positions in high-yield bonds and both emerging-markets equities and debt (we recently unwound the equity position) combined with strong overall showings from both our active fixed-income and equity managers. As we'll note below, we aren't overly enthusiastic about the multiyear return potential from either stocks or bonds at current valuations, but are optimistic that periodic dysfunction in the markets will allow our managers to continue to find opportunities as well as allow us to take advantage of tactical opportunities. The incremental value of these opportunities may be much lower than it was this past year, where absolute returns were unusually high, but in a low-return environment they can make a material difference.

As we look ahead over the next several years, we continue to believe that the weight of the evidence makes a strong case for a tough road for the economy and the financial markets, despite the beginnings of an economic recovery -- which at this point have been mostly government supported.

Debt, Debt, and More Debt
We continue to believe that we are in the midst of a major debt-driven transition in the economy that will keep risks elevated, result in continued economic headwinds, and have longer-term consequences due to the acceleration of the buildup of our public (government) debt.



Stimulus spending and falling tax receipts have caused a spike in public debt. The debt burden is forecast to worsen significantly due to the increasing cost of entitlement programs like Medicare and Social Security, and of servicing the national debt.

Household Debt: Households have hit a debt wall and are in the process of deleveraging. Despite the huge government stimulus, this process is not close to being over.

Consumer Spending Headwinds: Because consumer spending is 70% of the economy it is hugely important to overall economic growth. The desire among households to rebuild balance sheets, along with high unemployment and low perceived job security, makes it very likely that consumption growth will be subpar compared to what we've been used to.

U.S. Government Debt Explosion: The U.S. Government's actions in aggregate probably saved us from a 1930s-type depression. However, the resulting leap in the government deficit comes at a terrible time. This increase, coupled with a coming explosion of Social Security, Medicare, and Medicaid benefits to retiring baby boomers, means that the U.S. faces extremely challenging times in the coming years.
As debt continues to grow, at some point it will become difficult to get investors to lend to a fiscally challenged U.S. in the amounts needed without paying a significantly higher interest rate. Though some increase in borrowing costs is likely soon, the risk of a sharp increase in rates is not imminent if the recovery is subpar (as seems very likely). But looking out over the next 10 years and beyond, the math is impossible to ignore. There is little question that taxes will have to increase and spending will have to decrease. If this doesn't happen in a significant way, and maybe even if it does, there is a great risk of both a dollar and an interest-rate crisis that could be extremely painful for the U.S. and global economies.

There are still many variables in play that relate to these concerns, including a slower than anticipated recovery for the labor market; the wave of upcoming foreclosures and continued high unemployment; small businesses suffering from weak demand and a larger decline in profits than bigger firms; states and municipalities suffering from the steepest decline in tax revenue on record; and loan delinquency rates continuing to increase.

Given the challenges, there is risk of policy mistakes as the Fed and the Treasury attempt to maneuver through the next few years. Unwinding of the stimulus at the right time and in the right way will be one of the big challenges. At what point the economy can stand on its own remains an open question, not just in the United States but in most of Europe and Japan as well.

There are some positives, however. This is the largest global stimulus ever to occur in peace time. Strong emerging-markets economies are feeding back into the global economy, which is a positive for exports and manufacturing. Corporate balance sheets, outside of financials, are in good shape with the best liquidity in 50 years. Inventories are low and a rebuilding cycle is beginning, which will support growth. And, the severity of the economic contraction and corporate cost cutting may mean that businesses overreacted and will need to aggressively increase investment and hiring (not likely in our view).

We don't dismiss the positives as they explain why some recovery is likely to be sustained. However, we continue to believe that the weight of the evidence makes a strong case for a sustainable but subpar economic recovery, with a risk of falling back into recession at some point in the next two years as the stimulus is unwound.

Return Expectations

We assess return potential via scenario analysis that incorporates our assessment of asset-class pricing and fundamentals and how they are likely to be impacted under various economic possibilities (discussed above) over the next five years.

In going through this process we come away discouraged. With the run-up in prices of global equities, most of our valuation metrics suggest stocks are somewhat overvalued based on history, and more overvalued if the subpar growth we expect becomes reality. Corporate and high-yield bonds are not overvalued but they are no longer cheap. U.S. government bonds are priced to deliver poor returns over five years, barring a severe deflationary world. With historically low dividend yields of less than 4%, REITs are also overvalued. Only emerging-markets local-currency (non-dollar) bonds look reasonably attractive in most scenarios but even they are subject to a fairly high level of short-term risk stemming from currency fluctuations. In short, no asset class appears priced to generate fabulous returns—though some asset classes will do better than others and there are specific investments that look somewhat attractive. Only in our most optimistic scenario are the expected returns for equities into double digits, with developed-market returns above 10% and emerging-markets equities returns in the mid teens. However, we put a low probability on this optimistic scenario playing out. In the other scenarios, mainstream asset-class returns are very low and in some cases slightly negative.

Bad Odds and Not Much of a Payoff

Investing requires one to make decisions with incomplete information and therefore uncertain outcomes. For this reason we believe we must have an understanding of the odds and the payoffs. We use our scenario analysis and valuation work to help us play oddsmaker and understand the upside we gain in exchange for taking risk. Ultimately we want the odds heavily in favor of the decisions we make. But having the odds in our favor does not mean that we will be right immediately or even at all, especially in the short run. But over the long run our discipline, which implicitly requires us to

be willing to be wrong in the short run, has added value by putting us in a position to be right far more than we have been wrong.

Given the risks we see, coupled with the return outlook in most scenarios, we must conclude that we do not like the odds nor are we tempted by the potential rewards for taking risk. Risk reduction seems the prudent course of action and that is the decision we have made across all of our balanced accounts. Most recently, we eliminated our emerging-markets equity positions in all of our balanced portfolios (but not in our equity portfolios) following their big rally. That leaves our overall equity exposure now significantly below our neutral weighting and our overall risk exposure further reduced in all of our balanced portfolios. We continue to maintain some equity exposure 1) in case we are wrong and something akin to our optimistic scenario plays out; and 2) because we believe that over time our active managers will add value over the broad market indexes and get us closer to acceptable returns. We are also likely to reduce our high-yield bond exposure in the near future after benefitting from its huge run-up in 2009.

Getting Paid to Wait

As discussed above, we don't believe stocks are cheap. Moreover, we are headed into a period of increased regulation and taxation which will add to growth headwinds. With respect to bonds, while it is true that rates are low and this will limit returns, much of the non-government bond market (corporate and agency mortgages), while no longer cheap, is priced to deliver mid-single-digit returns over the next few years with far less risk than equities.

So, we have built sizable bond positions while we wait for better opportunities. It is extremely unlikely that we will need to maintain these large bond allocations for most of our five-year horizon, but for now we are quite comfortable holding these positions. We should note that we are cognizant of inflation risk, which would be bad news for bonds, though we don't see that risk as imminent. Nevertheless, a significant portion of our taxable bond positions are in funds that have flexibility to make adjustments in a rising-interest-rate environment or give us exposure that can mitigate the impact of rising inflation.

Looking out over our five-year window, if we simply invested in equities and bonds and held them without making any tactical moves, we would expect returns to be in the low single-digit range. However, we expect some of the bond niches we have access to will add incremental value. There is also potential added value from active management in equity and fixed-income funds. These factors could raise expected returns into the mid-single-digit range (depending on the risk level of the strategy). However, though we are long-term investors, this static buy, hold, and simply rebalance approach has never made sense to us. Market swings occasionally give us opportunities to do much better.

Looking forward over the next five years we believe higher returns can be captured by patiently waiting for compelling opportunities and then making aggressive tactical moves when they appear. We have a long-term track record of adding value over full market cycles via tactical moves. Especially in a low-return world, this source of added return could be quite material.

We are now postured significantly away from our benchmarks with a sizable underweight to stocks in all of our portfolios. If stocks slump in the near term we will look smart and we could have an opportunity to take risks with much better odds and higher payoffs. But if stocks do well over the next months or year we will almost certainly underperform our benchmarks and our decision won't look "smart" when assessed solely based on a single, shorter time period. But we seek to do well when judged over the entire race, not just any particular mile. We're investing with that in mind, and as always appreciate your confidence and trust.—*Stapp Financial Planning, PLLC*

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