



## **1st Quarter Commentary**

**April 1, 2010**

Dear Investor,

Equity markets in the U.S. rose again in the first quarter, making this four straight positive quarters in a row. The pace of the advance has moderated, but remains solidly positive. The “tortoise rally” dubbed by CNBC seems to be getting a little routine.

The end of the quarter gives us the opportunity to assess the current investment environment on the 1-year anniversary of the new bull market. Like the White Queen states in *Alice in Wonderland* “It’s a poor sort of memory that only works backward.” Not being gifted with the forward-looking sort of memory, we will do our best to set our expectations based on the evidence at hand.

### The Economy

The Federal Reserve has kept the Fed Funds rate at or near zero since October of 2008. They have issued statements at every meeting indicating that they plan to keep rates “exceptionally low for an extended period of time.” One of the key components factoring into the Fed’s interest rate policy is the level of unemployment which remains historically high at 9.7%. The unemployment rate will likely begin to improve as the economic recovery takes hold, resulting in a gradual increase of short-term rates eventually.

There are indications that the market is expecting a measured pace of rate hikes beginning this year. Looking at the Fed Funds futures, overnight rates are expected to climb to 0.50% by December, 2010, and rise to 2% by December, 2011. It is important to note that the yield on the 10 Year Treasury bond, currently hovering near 4%, has already risen in anticipation of higher rates. Such a flattening of the yield curve is typical during economic expansions, and may be viewed as an encouraging sign.

Inflation, as measured by the year over year change in the consumer price index (CPI) remains low and does not appear to be of any immediate concern. A little inflation is a good thing, as it gives corporations pricing power and improved earnings prospects, as well as supporting the value of real assets, such as real estate and precious metals.

## Valuations

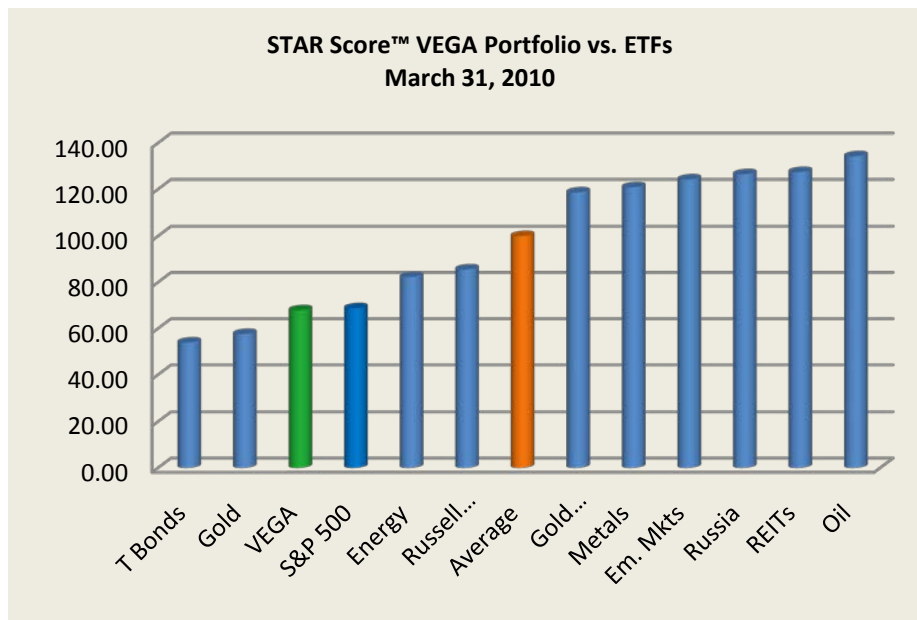
The S&P 500 has gained close to 50% over the last 12 months. According to Ned Davis Research, the S&P 500's average gain has been 29% on average in the first year of a bull market, and 9% in the second year. Therefore, a more moderate, but still positive, rate of change in equity prices seems reasonable at this juncture.

Currently, the market trades around 16 times earnings, which is in line with the long-term average P/E ratio. Global equity markets appear to be similarly valued. The dividend yield has fallen considerably, however, both as a result of companies lowering their payout during the financial crisis, and the rise in the index. Suffice to say, the slowdown in the rate of advance makes sense in this light.

ETF	YTD	ETF	YTD
S&P 500 (SPY)	5.4%	U.S. REITs (IYR)	9.5%
Russell 2000 (IWM)	9.2%	Russia (RSX)	10.2%
Emerging Mkts (EEM)	1.5%	Oil (USO)	2.6%
Gold (GLD)	1.5%	Gold Mining (GDX)	-3.9%
Treasury Bonds (TLT)	0.2%	Energy (XLE)	1.3%

One of the primary advantages of our STAR II and STAR III portfolios is they are not limited to stocks and bonds. The benefits of a diversified portfolio can sometimes be difficult to discern when the stock market is rising, especially after a large advance such as the most recent one. In order to quantify the contributions of a portfolio's holdings to both limit risk and offer higher returns, we've created a metric called the **STAR Score™**. In order to show the relative riskiness of an investor's portfolio compared to both the individual securities and the linear average of those holdings over the previous 12 months. By setting the average to 100, we can determine the degree to which the combined portfolio holdings either raise or lower overall volatility or riskiness. In the graph below, using the Exchange Traded Funds in our VEGA strategy, we derive a score of 68, meaning the equally weighted ETF portfolio has experienced 32% less risk quarter-to-quarter than the simple average of the group.





The benefits of this approach to investing are perhaps best explained in the [2008 Yale Endowment Report](#). The Yale Endowment gained 11.8% annually during the 10 years from June, 2000 through June, 2009.

How did Yale achieve such high and consistent returns? In their own words they state: “In 1988, nearly 75% of the endowment was committed to U.S. stocks, bonds and cash. Today, 14% is allocated to domestic marketable securities, while the diversifying assets of foreign equity, private equity, absolute return strategies and real assets dominate, representing 86% of the target portfolio. “

The similarities between Yale’s portfolio and our STAR II and III strategies are striking. Yale adds “The heavy allocation to nontraditional asset classes stems from their return potential and diversifying power. Today’s target portfolios have significantly higher expected returns and lower volatility than the 1988 portfolio.” This is a powerful statement in support of the merits of broad diversification.

As always, we thank you for your continued support and encourage you to contact your financial advisor with any questions or comments.

Sincerely,

James Herrell, CFA

## STAR™ Asset Management

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