

**1st Quarter Commentary**

April 15, 2011

*"In addition to trying to determine how to make money, one must also try to keep from losing money."  
Edwin Lefèvre – Reminiscences of a Stock Operator*

Dear Investor,

The first quarter of 2011 came in like a bull and went out like a bull with horns. The rally which commenced in 2009 continued, albeit with increasing volatility, as the quarter progressed.

At Partnervest, we devote considerable time and resources towards analyzing volatility and its impact on our clients' portfolios. It may come as a shock, but not all volatility is bad! For instance, no one complains when prices are *rising* more than average. As means of illustration, consider the returns of the iShares Emerging Markets ETF (EEM) compared to the S&P 500 in 2007.

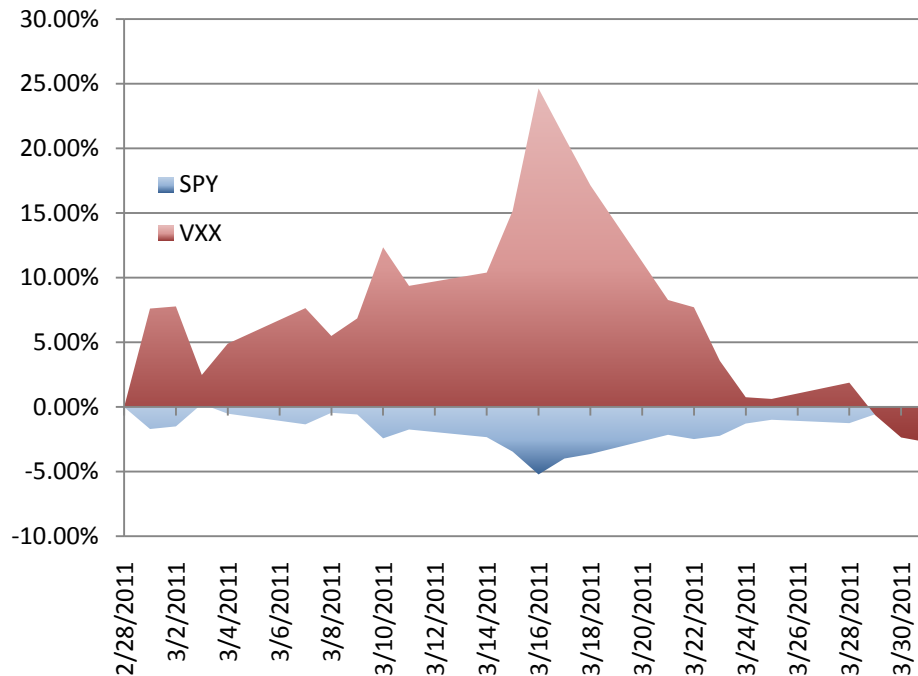
<u>Date</u>	<u>EEM</u>	<u>SPY</u>	<u>Difference</u>
3/30/07	1.70%	0.29%	1.41%
6/29/07	13.08%	5.85%	7.23%
9/28/07	13.60%	1.52%	12.08%
12/31/07	0.64%	-4.11%	4.75%
Year	<u>33.14%</u>	<u>5.23%</u>	<u>27.91%</u>

As humans, we are hard-wired to panic quickly, but we grow greedy by degrees. This was beneficial to our distant ancestors, who had to contend with saber-tooth tigers leaping at them from the bushes, and who learned to stockpile grain as a hedge against drought or famine. This same fight or flight response can be seen today whenever the market hiccups, and the volatility index spikes.

If there is one thing we can say for sure regarding volatility is that it is mean-reverting. In other words, when volatility is at an extreme high or low, it inevitably returns to more normal levels. In both STAR II and STAR III<sup>1</sup> we factor this in how we manage the strategies. As volatility declines the price of an option declines as well, and thus it becomes increasingly cheaper to either hedge or speculate. If volatility were to fall to 0%, then all options would be free! Conversely, if volatility were to climb above 100%, the market would be pricing a 100% chance of a 100% move over the ensuing year. If volatility were to remain at such elevated levels, investors could effectively hedge all of their downside risk by selling options on their existing portfolios, especially since index and ETF prices can't drop below \$0.00.

<sup>1</sup> STAR™ II denotes Partnervest's "fund of funds" investment allocation models. An investor's portfolio consists of both core and satellite funds, with the percentage allocated to each determined by the model selected. STAR™ III stands for "Structured Target Returns" and consists of two investment strategies, Alpha and VEGA, which invest in Exchange Traded Funds (ETFs) and options. For more information regarding both STAR II and III, please go to [www.partnervest.com](http://www.partnervest.com).

This does not mean that volatility can't reach elevated levels; rather it helps explain why volatility "spikes" in reaction to market sell-offs, then comes back down as uncertainty abates. A recent example, depicted on the chart below, is the Japan-led decline that shook global equity markets in March. The S&P fell 5.21% through mid month, and was negative for the year for a brief moment.



It is relatively easy for the naked eye to discern the inverse relationship between volatility and the market. What is not as apparent is the magnitude of the spread between the two returns. We use the iPath S&P 500 Short-Term VIX ETN (VXX) in STAR III. As the SPY approached its nadir on March 16<sup>th</sup>, the VXX rose 25%, *five times* more than the market lost. Simply put, 1 share of VXX hedged 5 shares of SPY. All this benefit would be for naught however, if we simply bought and held the VXX. The SPY managed to pull out of its dive, finishing the month close to where it started. The VXX however, ended March down 2.72%. We hold VXX in our VEGA portfolios, and manage the position by exiting the VXX when it spikes, and collecting option premium via cash-secured puts<sup>2</sup> by agreeing to repurchase the ETF at lower prices.

#### Diversification: Never Too Much of a Good Thing

Of course, we don't invest in the S&P 500 ETF exclusively. In both STAR II and STAR III we hold a diverse portfolio of U.S. and foreign stocks and bonds, as well as several alternative assets<sup>3</sup>, such as energy, real estate, and gold. Your Advisor can provide you with a current report detailing the composition of all our strategies, as well as their composite performance.

<sup>2</sup> *Cash-Secured Puts are similar to covered calls. An investor is required to hold sufficient cash as collateral to purchase the underlying ETF at the strike price of the put. For example, 1 SPY put with a strike price of \$125 requires \$12,500 (100 shares x \$125) in cash be available in the account.*

<sup>3</sup> *Broadly speaking, "Alternative Assets" denotes those securities or investment strategies with little or no correlation to stocks or bonds. Examples include: real estate, precious metals, and commodities along with market neutral and long/ short funds, amongst others.*

Because bonds have garnered a fair amount of press recently, I'd like to highlight the Wisdom Tree Dreyfus Emerging Currency ETF (CEW) that we are in the process of adding to our core foreign fixed income allocation in STAR II, and the U.S Treasury ETF (TLT) that we use in STAR III.

Wisdom Tree Dreyfus Emerging Currency ETF (CEW): a Wise Addition to STAR II

Many investors are spooked by any investment that has the word "emerging" in it. In fact, the opposite of emerging is "declining." CEW tempers the higher volatility inherent in emerging market fixed-income investments by geographically diversifying across regions, and equally weighting each currency. The net result is a higher potential yield than U.S. money market funds, and a more diverse core foreign bond allocation.

In addition, CEW distributes the income it generates once a year, with approximately 75% of the distribution classified as a long-term capital gain, not ordinary income. The yield for 2010 was 3.72% as compared to 0.04% for the average U.S. money market fund.

1<sup>st</sup> Quarter Performance by ETF

ETF	March	YTD	ETF	March	YTD
S&P 500 (SPY)	-0.05%	5.80%	Energy (XLE)	1.96%	17.33%
Russell 2000 (IWM)	2.52%	7.81%	Coal (KOL)	6.80%	7.36%
Emerging Markets (EEM)	6.33%	2.25%	Gold (GLD)	1.52%	0.79%
Emerging Europe (RSX)	1.76%	9.78%	Gold Miners (GDX)	0.38%	-2.29%
U.S REITs (IYR)	-1.09%	7.06%	Materials (XME)	8.08%	3.74%
Treasury Bonds (TLT)	0.17%	-1.46%	U.S. Bonds (AGG)	-0.22%	-0.17%

U.S. Treasury Bonds: Love 'Em or Leave 'Em?

Recently, PIMCO made headlines when Bill Gross, manager of the Pimco Total Return Bond fund (PTTDX), announced that he no longer held any U.S. Treasury securities in his portfolio. The reasons he cited; namely that the combination of mounting debt and rising entitlement payments made the current low yields unattractive, were certainly valid and worth consideration. However, there are a few issues to consider:

1. PIMCO's selling of U.S Treasuries is not large enough to have any material impact on the price of those securities. In fact, by the time PIMCO made the announcement, they had already sold all their Treasury holdings.
2. PIMCO has exited the U.S. Treasury market before, most recently at the start of 2010 when the Treasury completed its first round of purchases (dubbed "QE 1"). Bill's timing was a little off. Treasury Bonds (as measured by TLT) gained 20.5% over the next 9 months, and finished the year with a total return of 9.07%.
3. Bill Gross acknowledged that the U.S. Government would never default on its debt. U.S. Treasuries are still rated AAA, the highest grade possible.



In addition, Partnervest manages the iShares Barclays 20+ Year Treasury ETF (TLT) differently than simply buying and collecting coupons. Currently, TLT has an indicated yield for the next 12 months of 4.98%. However, this yield doesn't come without any risk. Interest rates on Treasury Bonds are currently at the high end of their range for the last three years. Should they rise over the next year by 1%, the return on the TLT will most likely be close to -10%. Importantly, the premiums we collect from selling covered calls, between 10 – 15% annually, offsets the price risk from a rise in rates of this magnitude. And, similar to how we manage the VXX, when prices are high, rather than owning the ETF and selling covered calls we go to cash and sell puts secured by the cash.

Going forward, the challenge lies in protecting one's investments against *downside* risk, while allowing for some degree of upside participation. That, of course, is at the heart of our investment philosophy, and we will continue to adhere to this belief, and hopefully continue to improve upon it, in the quarters to follow.

Thank you for your continued trust and support. Please feel free to contact your Advisor if you wish to discuss any of the topics mentioned in this letter in greater detail.



James Herrell

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