



**STAR™ Asset Management**

**2<sup>nd</sup> Quarter Commentary**

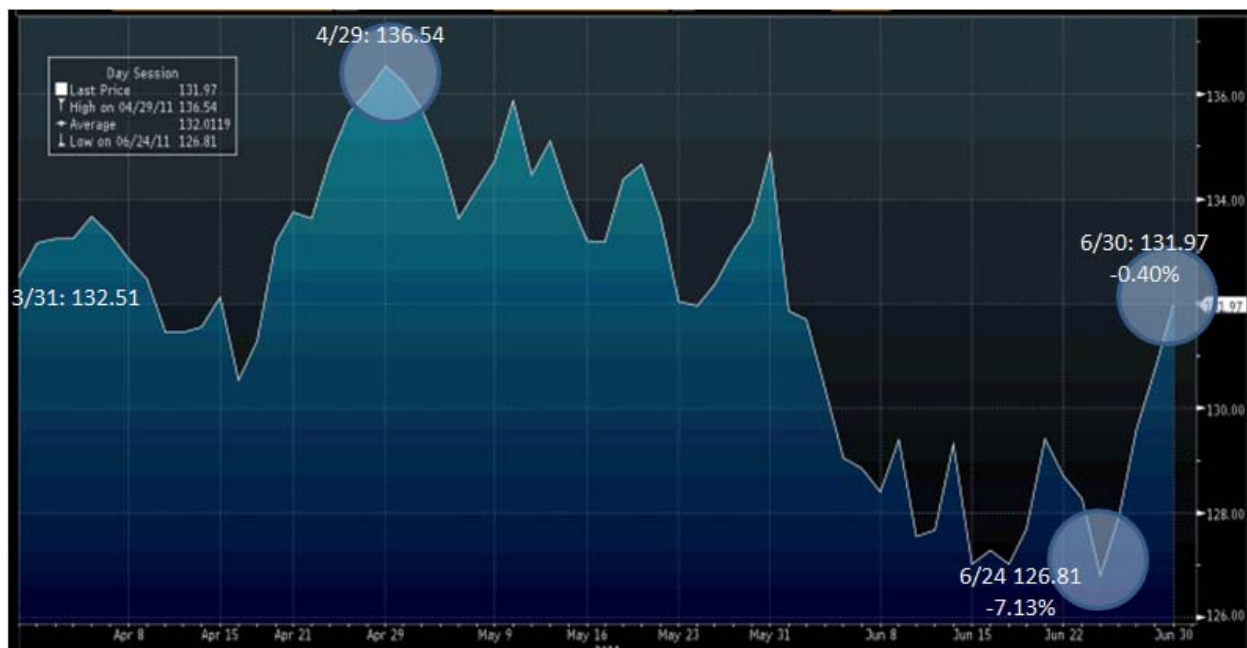
July 1, 2011

“Alternative strategies will be more widely used by advisers, and will become accepted daily practice. They won’t be seen as alternative investments in seven years.”

*Bloomberg Wealth Manager November 2001*

Dear Investor,

The date under the above quote is not a typo. As we cross over into the second half of the year, the benefits of including alternative investments <sup>1</sup> in one’s investment portfolio are once again apparent. This is especially true considering the markets in the U.S and abroad gave back almost all of their year-to-date gains before rallying strongly in the final week of the quarter. Consider the following chart, showing the S&P 500 ETF returns throughout the 2<sup>nd</sup> quarter:



Although most major equity indices ended the quarter down only slightly, the final numbers belie the underlying volatility that occurred during the period. While the resiliency of the global equity markets is encouraging, one should not ignore the tenuous nature of their returns. At Partnervest, alternative investments are helping add consistency to investment results by reducing volatility and tapping into non-correlated assets that offer the potential for positive returns across a variety of economic climates.

<sup>1</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.

Speaking of which, despite what you've heard or read recently, the economy may not be as bad as the headlines suggest. Perhaps the number one question we hear at Partnervest these days is "What will happen to stock and bond prices when the Fed stops buying Treasuries with money conjured out of thin air?" The simple answer is, most likely, nothing, at least not immediately. Prices today reflect future expectations. Even though it appears as if the U.S is attempting to "print its way to prosperity," the current yield of everything from 3 month Treasury Bills to the 30 Year Treasury Bond indicates investors feel interest rates are expected to increase in the future, which can only occur in an economic expansion. The Fed has kept short-term rates on hold for the longest stretch since the 1940s in order to stimulate the economy. Whether the current recovery takes hold remains to be seen, but the effect of low borrowing costs has already resulted in a surge in corporate profits and the quickest stock market recovery on record.

## 2<sup>nd</sup> Quarter and Year-to-Date Returns

Index (ETF)	2nd Qtr	YTD	Index (ETF)	2nd Qtr	YTD
S&P 500 (SPY)	0.08%	5.89%	Energy (XLE)	-5.24%	11.18%
Russell 2000 (IWM)	-1.63%	6.06%	Coal (KOL)	-6.44%	0.45%
Emerging Markets (EEM)	-1.25%	0.96%	Gold (GLD)	4.40%	5.23%
Emerging Europe (RSX)	-7.45%	1.60%	Gold Miners (GDX)	-9.10%	-11.20%
U.S REITs (IYR)	2.44%	9.68%	Materials (XME)	-6.41%	1.15%
Treasury Bonds (TLT)	3.38%	1.87%	U.S. Bonds (AGG)	2.36%	2.35%

That is not to say the road ahead won't have any bumps or turns. Volatile markets are where alternative investments and strategies prove their mettle. I'd like to highlight a few that Partnervest incorporates into client portfolios.

Even stodgy old Treasury Bonds can be volatile. Consider the return of U.S Treasury Bonds as represented by the iShares Barclays 20+ Year Treasury ETF (TLT) year-to-date:



Even though TLT was virtually unchanged on June 30<sup>th</sup> from the start of the year, year-to-date TLT has had a virtually identical monthly standard deviation <sup>1</sup> of 2.72%, versus the S&P 500's 2.77%. But it is that same volatility that drives how Partnervest manages the bond ETF in our Structured Target Return (STAR III™) strategies.

### **An Alternative Bond Strategy**

Knowing in advance that TLT can often be volatile gives us an advantage. The price will sometimes exceed, but ultimately returns, to a price range. In a nutshell, when prices get too high, we exit our position. With our TLT position now sold, we then use this cash as collateral to repurchase the ETF at lower prices via the use of cash-secured puts. <sup>2</sup> Thus, we continue to collect option premiums, and get paid for waiting. Should the price of TLT remain above our buy-back point, we simply sell another put. It's not much different from knowing that Nordstrom's will be having a shoe sale, and getting paid in advance for agreeing to buy a pair at a discount.

*<sup>1</sup> Standard deviation is a measure of the volatility of returns. For example, a standard deviation of 2% means that 2/3 of the time monthly returns were within 2% of the average monthly return. A standard deviation of 3% means that 2/3 of the time returns were within 3% of the average, etc.*

*<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.*

### **Alternatives in STAR II**

In our STAR II™ fund of funds program, we've maintained and in fact, added to our investments in alternative assets. One advantage of investing today versus just a few years ago is that a whole range of investments are now accessible. Once the sole domain of institutions; precious metals, commodities and real estate are a few examples of assets available to the individual investor.

Partnervest continues to actively assimilate new funds that adhere to our investment philosophy. In our STAR II™ models we are replacing the Hussman Strategic Growth Fund with the Credit Suisse Commodity Return Strategy (CRSAX). While we feel the Hussman fund was a good selection at the time, it is managed in a discretionary manner and is largely equity-based. As our management of the STAR II portfolios has evolved, we feel CRSAX is an excellent choice in terms of equally weighting our investments and remaining independent of market-timing to generate a positive return. According to Morningstar, "Contained volatility, combined with competitive returns over time, makes this fund an attractive option for commodity exposure, particularly for the risk-sensitive investors."

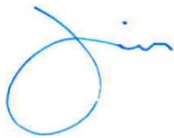
## Tail Risk

At Partnervest, we seek to follow Warren Buffet's advice, "Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it." A market decline of 20% or more in a given year actually occurs more frequently than the laws of probability suggest, hence the term "tail risk." Alternative strategies play a crucial role in buffering one's investments from the slings and arrows of market misfortune.

In conclusion, we don't know what the stock market, or the price of shoes for that matter, will do over the next 6 months. However, without predicting whether prices will go up or down, we can know, with a fairly high degree of accuracy, the degree to which they are likely to move. Furthermore, we also know what assets are likely to move in tandem, and those that are likely to move opposite the S&P 500. This is why diversification, including alternative investments and strategies, plays a central role in both the construction and management of our STAR II and III strategies.

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.

Sincerely,



James Herrell, CFA

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