



**3rd Quarter Commentary**  
October 1, 2010

*The “Great Recession” of 2008-09, the longest since WWII, is officially over.” NBER*

*“It requires a very unusual mind to make an analysis of the obvious.” Alfred Whitehead*

Dear Investor,

I am pleased to report that markets resumed their upward trajectory in the 3<sup>rd</sup> quarter. This was true not just in the U.S., with the S&P 500 index gaining 10.56% for the quarter, but for foreign markets as well, with the MSCI Index of Emerging Markets equities gaining 19.96%. In fact, everything seemed to appreciate during the quarter, with Gold rising 5.12%, Energy up 12.84% and U.S. REITs up 12.01%.

Despite these gains, there is still a great deal of debate as to whether or not Americans as a whole are better off. Fears of a “double dip” in the economy linger, and this may explain why Treasury Bonds continued their rise, gaining 4.67% during the 3<sup>rd</sup> quarter. This brings their total return so far in 2010 to 20.57% higher than either equities or gold. Such high correlation amongst asset classes is rare, but certainly not unwelcome.

As we round the bend into the final quarter of 2010, I’d like to examine a few recent developments, as well as highlight some of the innovations and enhancements we’ve implemented during the year.

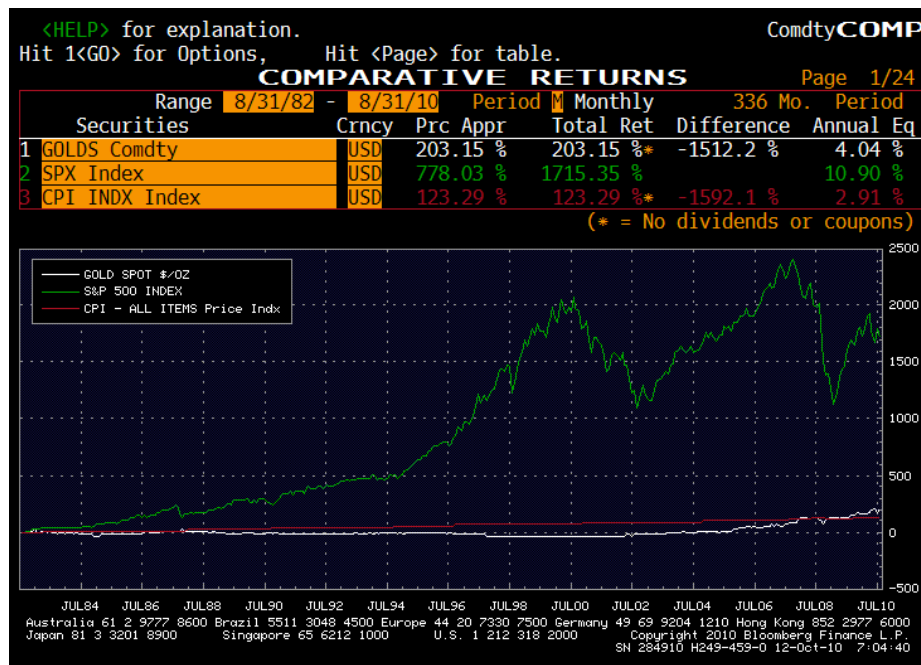
Gold: Is it the next bubble?

Although the equity markets in the U.S and abroad had a strong quarter, they are up modestly for the year. Gold, on the other hand, has appreciated considerably as the dollar has weakened.

The price of an ounce of gold has gone up over 20% so far in 2010, closing recently above \$1,300/ ounce. In fact, gold has appreciated steadily over the last 10 years, up from \$250/ ounce in 2000. Is gold another bubble waiting to burst?

As the chart below illustrates, gold may just be playing catch up when compared to other investments such as the stock market. Since its last peak, in 1982, gold has increased 200%, barely outpacing inflation, while the S&P 500 has gained over 1,700%.

In addition, gold is a natural hedge against a declining dollar, as well as being negatively correlated with the U.S equity markets. Measured in Euros, the price of Gold has appreciated less than half as much over the last 10 years.



Whether the recent advance in the price of gold represents a bubble or not, we continue to believe that there is value in holding it in our portfolios.

### Bonds: How Low Can Yields Go?

Unlike the price of Gold, bonds are limited in their appreciation potential. Rates can't go below zero. At the moment, bond yields in the U.S., Treasury Bonds in particular, are at historically low yields. Over the next *five* years, bond investors are accepting a *negative* potential real return.

<u>Term</u>	<u>Yield</u>	<u>Inflation-Adjusted Yield</u>
6 months	0.19%	-0.46%
3 Years	0.65%	-0.81%
5 Years	1.19%	-0.61%
10 Years	2.55%	0.37%

Despite the risks of negative real returns and potential drop in principal, investors continue to purchase record amounts of fixed-income securities. According to ICI, in September alone, despite a 10% rally in the U.S equity markets, investors sold \$18 billion in stock funds and purchased \$32 ½ billion in bond funds. **Since the start of 2008, investors have purchased \$900 billion in bond mutual funds**, while selling \$1.5 trillion

# STAR™ Asset Management

in equity funds. This appetite for bonds is not surprising in light of the nearly non-existent yields offered by money market funds, which stood at a paltry 0.04% at the end of the quarter.

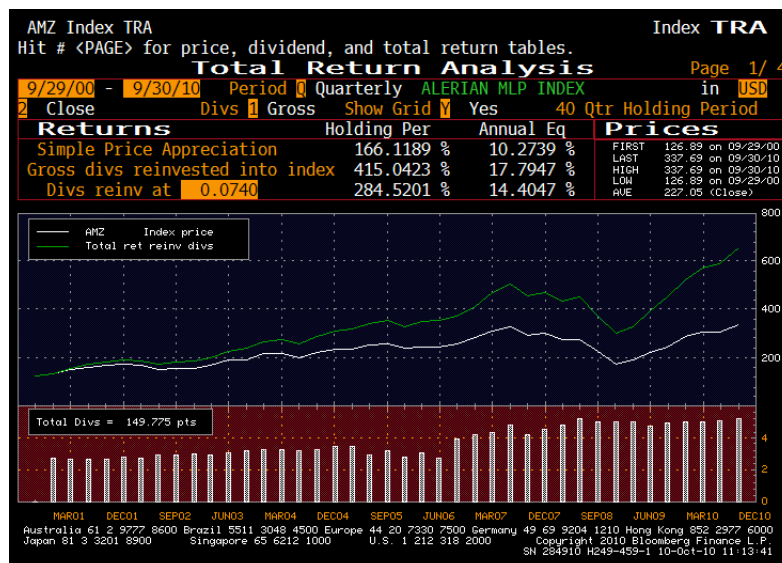
We manage interest-rate risk in a number of ways in our portfolios. In particular, we hold off buying longer-term bonds in a quest for higher yields. Our approach is best reflected in how we currently manage the iShares Barclays 20+ Year Treasury Bond Fund ETF (TLT) in our strategies. When the price of TLT is above \$100, our standard practice is to cease new purchases, and switch to selling cash-secured puts.\* The cash that would otherwise be invested in TLT is now used as collateral to repurchase the ETF at prices of \$100 and below. We get paid a premium for selling the puts, the same as when we sell covered calls, *regardless of whether the TLT actually closes below \$100 by expiration.*

*\*For additional information on cash-secured puts please consult your financial advisor.*

ETF	3rd Qtr	YTD	ETF	3rd Qtr	YTD
S&P 500 (SPY)	10.56%	3.87%	Energy (XLE)	12.84%	-0.41%
Russell 2000 (IWM)	10.46%	9.28%	Gold (GLD)	5.12%	19.19%
Emerging Markets (EEM)	19.96%	8.59%	Gold Miners (GDX)	7.64%	21.03%
Emerging Europe (RSX)	15.97%	4.32%	Basic Materials (XME)	17.26%	4.03%
U.S REITs (IYR)	12.01%	18.34%	Volatility Index (VIX)	-31.38%	9.31%
Treasury Bonds (TLT)	4.67%	20.57%	U.S. Bonds (AGG)	2.16%	7.82%

## STAR II™

We recently began adding the JP Morgan Alerian MLP Index (AMJ) ETF to STAR II accounts. As the chart below indicates, the MLP index has steadily raised its dividend over the last 10 years, even during the financial crisis.



Since September, 2000, the 50 companies comprising the Alerian MLP index have increased their annual dividends by \$9.57 or 89%, to \$20.27, bringing their total return to over 17 ½% per year. Furthermore, MLPs provide an alternate source of yield, other than fixed-income, and offer the potential for price appreciation as well.

### STAR III™

We capitalize on volatility in a myriad of ways in our STAR III strategies, primarily by collecting option premium on the underlying ETFs we hold. Starting in June, we began adding ETFs that own volatility outright to the VEGA strategy. These ETFs (VXX, VXZ) confer two advantages to the strategy. First, the premiums we collect are on the order of 2 – 3 times the percentage amount we receive for the S&P 500 (SPY) calls, and second, they are negatively correlated to the equity markets, meaning they will rise when markets fall. To be sure, they are not a free lunch. There can be a cost of carry when volatility is declining, which may erode the price of the ETFs, and they need to be actively managed according to sophisticated algorithms. But, used in the context of the VEGA framework, they lower overall portfolio volatility and increase the returns we collect from option premiums.

As a result of the steady advance the markets in general experienced throughout the third quarter, volatility declined, with the VIX ending the quarter near its long-term average of 20. In our Enhanced VEGA portfolios, we capitalize on low volatility by purchasing longer-dated out-of-the money put options on the SPY. When purchased in this manner, during periods of low or average volatility, the “Put Protection” enhancement is a relatively low-cost way to help offset any future price declines outside of the norm. Since we have yet to devise a way to predict future stock market movements with any degree of certainty, we liken the puts to an airbag in your car: you hope you never need it, but you certainly feel better knowing it’s there.

Sincerely,



James Herrell, CFA

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