



4th Quarter Commentary

December 31, 2010

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

Dear Investor,

2010 was a very good year. There is something about the dawn of a new decade that lends itself to optimism. The markets, both domestically and abroad, responded to investor enthusiasm as they surged in the final quarter of the year. The price of practically every asset class rose in 2010 with the exception of home prices. In fact, despite several bumps in the road; including the "Flash Crash" on May 6, the Greek debt crisis and continued high unemployment; the Dow Industrials finished the year up 14%. Since 1925, this has happened only twice.

We should note, however, that the return for the third year following both prior instances averaged just 1.6%.

Rather than attempt to predict the future or comment on the past, I feel it would be more useful to answer several investor questions that seemed to come up frequently throughout the year.

Q: How do you feel the STAR™ II and III strategies¹ would hold up if we undergo another market correction in 2011?

A: Perhaps the best response is to see how they fared during previous market corrections, especially last year's April – June drop in which the S&P 500 fell over 15%.

In STAR II, we have a significant allocation to alternative assets², along with high-yield and foreign bonds. These tend to hold up well during a market decline, and that was the case this year as well.

¹ 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.

² 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.

ETF	4th Qtr	YTD	ETF	4th Qtr	YTD
S&P 500 (SPY)	10.79%	15.08%	Energy (XLE)	22.28%	21.78%
Russell 2000 (IWM)	16.47%	27.28%	Gold (GLD)	29.27%	8.45%
Emerging Markets (EEM)	16.46%	7.25%	Gold Miners (GDX)	33.92%	10.64%
Emerging Europe (RSX)	22.18%	17.11%	Basic Materials (XME)	34.13%	28.93%
U.S REITs (IYR)	26.57%	6.96%	Volatility Index (VIX)	-25.10%	-18.12%
Treasury Bonds (TLT)	-9.54%	9.07%	U.S. Bonds (AGG)	-1.35%	6.36%

As the table below shows, even though the S&P 500 fell and rose by roughly the same amount in the 2nd and 3rd quarter, it ended the 6-month period lower than it began. However, our three STAR II strategies with the largest equity allocations fell less and finished higher than the broad market.

Period	S&P 500	Moderate	Growth	Aggressive
Q210	-11.35%	-5.87%	-8.21%	-9.07%
Q310	11.15%	9.30%	9.00%	10.63%
Net	-1.47%	2.88%	0.05%	0.60%

In STAR III, the *Alpha* strategy has the lowest correlation to the market, and in fact actually rose when the market fell in the 2nd quarter. As the market declined, levels of uncertainty increased, which had the unexpected but beneficial effect of buoying the price of the long-term calls the strategy holds. Furthermore, investors continued to purchase Treasury Bonds, resulting in an increase in the price of the Treasury ETF. VEGA dipped initially, but fell only a fraction of the broader market's 15% decline. Those accounts in the VEGA Enhanced strategy fared even better, with several finishing the quarter with a net positive return.

Q: What if inflation and interest rates rise in 2011? Or the dollar declines? How might that affect returns?

A: I find that worries about inflation translate into a fear of rising interest rates/ falling dollar and how that might impact portfolios. Bottom line: some inflation is good for equities because it indicates corporations have the ability to raise prices, and their debt (in terms of present value) becomes cheaper.

In the case of bonds, longer-term bonds (those with maturities of 10 t 30 years) respond to inflation *expectations* whether real or imaginary, and therefore should not be impacted as much by actual inflation. And the premiums we collect on the Treasury ETF (TLT) **more than make up the impact on the price of the TLT from rising rates.**

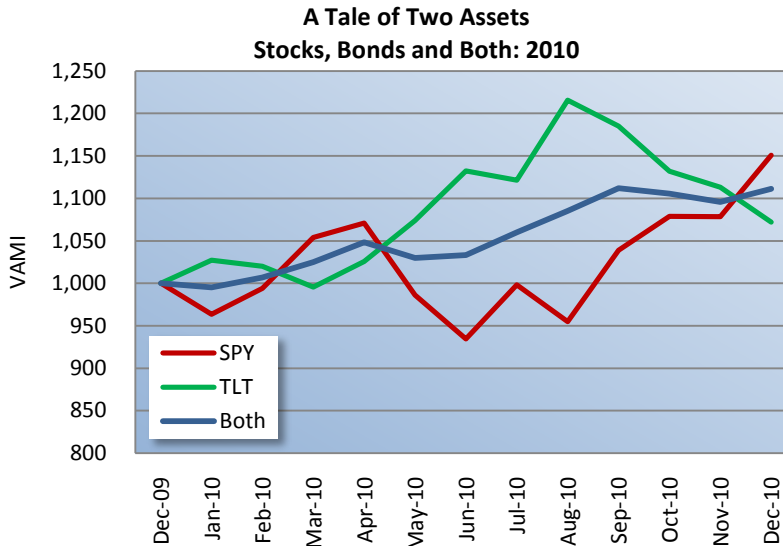
Finally, a weaker dollar is good for gold, and we own that in both STAR II and III portfolios.³

³ In STAR II, several of the funds own either gold or gold-related equities. The percentage allocation will vary depending on the model selected and the current fund management allocations.

Q: What are the pros and cons of an Absolute Return strategy?

A: Investment strategies generally fall into one of several categories. Our acronym for absolute return investing, “STAR™ III” stands for “Structured Target Returns” Simply stated, we believe that by structuring an investment outcome, we are more likely to achieve it. While there will be periods in which the market outperforms our STAR™ III approach, we feel that by minimizing the downside while participating in appreciation, we are better off. The cost of an absolute return strategy is an opportunity cost: we will not always outperform the broader indices. However, the benefits of protecting the gains we do achieve, and the consistency of those returns, far outweigh the upside we periodically pass up.

Perhaps the chart below, showing the returns of the S&P 500 and Treasury Bonds in 2010 best illustrates the value of holding both.



Q: How do you select the funds you use in your strategies? How do you decide how much to allocate to each?

A: In both STAR II and III, we hold “core” investments that are designed to capture the returns of the global stock and bond markets. In STAR II the allocation to stocks/ bonds will vary depending on the risk model selected, but each core holding is equally weighted. In STAR III VEGA the process is straightforward: depending on an account’s size, we’ll invest in anywhere from 5 to 10 ETFs, also equally weighted.

The rationale for the equal-weighting is also straightforward. By allocating equally across the core holdings, we are not curve-fitting or optimizing a strategy by using past performance. This makes it “robust” as no market-timing or other discretionary criteria are required. The net result is a built in “buy low/ sell high” methodology that is determined by market (not manager) conditions.

Sincerely,

A handwritten signature in blue ink, consisting of a large, stylized loop followed by a horizontal line with a small flourish at the end.

James Herrell, CFA

This client letter is published by Partnervest Advisory Services LLC and is provided free of charge. Any stated or implied recommendations herein are of a general nature and clients should consult with their investment advisor representative for advice concerning their particular situation. Information from third party sources is deemed but not guaranteed to be reliable. Due to varying needs and circumstances, allocations and performance of individual accounts may differ from their corresponding STAR model. Past performance is not indicative of future returns.

Indices do not reflect actual portfolios or trading and the stated returns do not include investment management fees, transaction fees, dividends and other earnings and the timing of investment decisions, thus, they are not necessarily indicative of the allocation or returns that an actual managed account in the future will or would have achieved. Investment management services provided through Partnervest Advisory Services LLC.

