Memo to Advisors
July 28, 2011

Dear Advisor,

As we approach the weekend with no clear resolution to raise the U.S. Debt Ceiling by next Tuesday, the day Treasury Secretary Timothy Geithner has stated is the point at which the U.S. Government will begin defaulting on its Treasury obligations, there is clearly a need to put the whole situation in perspective. I have been receiving an increasing volume of calls and emails from Advisors asking what my thoughts are on the Debt Ceiling issue and what the likely impact will be on their client's portfolios should Congress and the President fail to arrive at an agreement by Aug. 2.

First, let's review the Debt Ceiling issue itself. Increasing the borrowing limitation is nothing new. Congress has raised the debt ceiling 72 times since 1962, including 10 times in the last decade. Up until last year the House of Representatives had the authority to do so automatically. In January of this year, however, the House repealed this rule, leading to the current stalemate. The Republicans do not want to raise the debt ceiling high enough to carry it beyond the 2012 presidential election, whereas the Democrats do. No surprises there. Whether a smaller increase passes before next Tuesday or whether the issue drags on a bit longer remains to be seen. However, the chances of an actual default appear to be slim. First, the U.S. Government can reduce spending to prevent a default - although doing so comes with its own consequences as this would shave an estimated ½ - 1% from GDP each quarter. Second, when up against the wall of a possible collapse of the entire financial system on September 29, 2008, recall that the TARP bill was initially defeated in the House. But when the market reacted by falling 9% the following day, lawmakers overwhelmingly passed the law on October 3. Third, the market is not pricing in a high probability of an actual default. Current Credit Default Swap rates are indicating a less than 2% chance of a default over the next year.

In my opinion, the real issue is whether U.S. Treasuries lose their AAA credit rating. S&P has stated that the chance of a downgrade within the next 3 months is 50%. This same probability is echoed by PIMCO, Blackrock, Franklin Templeton, Western Asset Management, and others. So let's examine the potential impact of a downgrade on both the stock and bond markets, and, perhaps more importantly, our investment portfolios.

The effects of a U.S. default or downgrade are hard to predict, since neither occurred before in the U.S. The market reaction to a possible downgrade so far has been relatively muted. Since July 1st, when the political wrangling began to heat up in earnest, the S&P 500 has declined 1.7%, while the Treasury Bond ETF (TLT) has gained 2.72%, and Gold has shot up 8.31%. Should the ratings agencies proceed with a downgrade, it would be logical to expect a reactionary drop in equity prices, although how long and how far is hard to predict. Here it is important to keep in mind that our STAR II and III portfolios are designed to withstand market uncertainty and, in fact, even potentially benefit from an increase in volatility.

In Alpha, we hold Call Spreads on both the SPY and GLD. As we've seen so far in July, the issues surrounding the debt ceiling deadline have been positive for the price of gold as both a dollar hedge and a flight to quality investment, and slightly negative for equity prices. By holding both in equal proportions, we achieve a balanced portfolio where a drop in the price of one asset may be accompanied by a rise in the price of the other. Furthermore, TLT has actually gone up in price, which seems counter-intuitive given the specter of a possible downgrade. The reasons for this are varied and complex, but simply stated it boils down to the following equation. Any downgrade, while it may ultimately have consequences in terms of higher yields and an increase in borrowing costs to the U.S Government, will most likely have a muted effect on the yields of longer-term bonds. Consider Japan, which has credit rating of AA- and a 10 year yield of 1.1%. Japan has been mired in a deflationary economic cycle for over a decade. As we all know, if the economy remains weak, rates remain low.

We construct our STAR II and III portfolios to be as balanced as possible, given the size of a client account. While each strategy contains an equity component, we balance both U.S. and foreign stocks. Furthermore, we add in other assets, such as real estate, energy, basic materials, gold and Treasuries with the goal of lowering correlations and reducing portfolio volatility. Our VEGA strategy directly benefits from higher levels of expected volatility in the form of higher option premiums. One needs only to go back to the 4th quarter of 2008, when we first launched the strategy, to see its expected return in a volatile environment. In addition, since it launched, we've added several elections to the strategy, which we dub VEGA Enhanced. These are all intended to further buffer downside risk and provide the opportunity to reinvest accumulated premiums at the most opportune time - when volatility is spiking.

Whether we encounter a spike in volatility in the ensuing week is still anyone's guess. But I feel that the potential opportunity costs of selling one's investments and going to cash far outweigh any short-term drop in the price of one or more ETFs. Remember, the decision to exit the market is a two-part process. One still needs to determine when to get back in. In STAR III we've structured our portfolios to prevent a client, or their Advisor, from having to make those choices. This is not meant to imply we are complacent – far from it. A default or downgrade of U.S Treasuries could result in fundamental changes in the investing landscape. We are monitoring the situation closely, and rest-assured, should we feel a change or modification in our investment approach is warranted, we will not hesitate to act. In the interim, please feel free to contact us with any questions or concerns you have and we will do our best to respond.

Very Truly Yours,

James Herrell, CFA