

Monthly Investment Commentary



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Stocks tacked small gains in June on to big gains in April and May, and closed the second quarter with their biggest three-month gain in more than 10 years. The large-cap Vanguard 500 Index Fund gained 16% for the quarter, and is now up 3.2% for the first half of 2009. The small-cap iShares Russell 2000 surged by almost 21% in the second quarter, but still trails year-to-date with a gain of 2.7%. Growth and value performed similarly in the second quarter, but for the first half of the year, growth is significantly ahead thanks to a much stronger (less bad) first quarter. The Vanguard Total International Stock Index soared 27.3%, bringing its year-to-date gain to 10.7%. Despite a 2.3% loss in June, Vanguard Emerging Market Stock Index did even better in the second quarter, gaining 34.2%, which is also its six-month return. High-yield bonds (based on the Merrill Lynch U.S. High Yield benchmark) padded their already big year-to-date returns with a 3% gain in June. So far in 2009 the asset class is up 29%. The extreme volatility we've noted in REITs is exemplified by the performance of Vanguard REIT Index; it lost 3.3% in June, finishing the second quarter with a 30% gain, but is down almost 12% year-to-date. The Vanguard Total Bond Market Index Fund, a proxy for high-quality, intermediate-term bonds, gained 1.8% over the second quarter, and is up 2.1% for the year through June.

As we look back on a tumultuous first half of the year, we are struck by the degree to which conflicting signals characterize the investment and economic environment. After a horrendous 2008 and a dismal first quarter in 2009, the second quarter saw robust gains – stocks in fact had their best quarter in more than 10 years. The conflicting signals on the economy include several positives that helped drive the market's rebound from its March low. The prospect of a meltdown of the financial system appears past; the government has demonstrated it will do whatever is necessary to avoid a disaster of this scale. And though economic activity continues to worsen, it is doing so at a slower rate, which suggests that we are getting closer to an economic bottom. However, the global economy remains in a fragile state as the effects of massive wealth destruction and the unwinding of a huge debt bubble continue to play out. The ultimate result will likely be lower spending by both consumers and businesses in the years ahead, as the economy in effect resets to the level where it might have been without the artificial boost of the credit bubble. While they probably allowed us to avoid a depression, the massive bailout and stimulus spending (along with longer-term demographic factors such as spiraling health care and other entitlement spending) are causing the federal deficit to balloon, which could lead to dollar weakness and inflation down the road.

Other conflicts are at play that will influence how the environment unfolds in the years ahead. One of these is housing, which started the cycle of damage we are now in. There have re-

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cently been a few positive signs including stronger demand and historically high levels of affordability. But a wave of new supply from foreclosures over the next two years suggests the market will continue to struggle. (There is more than a trillion dollars in adjustable mortgages that are underwater and that have yet to reset to higher payments, and high unemployment will make things worse by pushing more of these homeowners over the edge.) Broadly speaking, these conflicts create a very wide range of possible outcomes. We recognize that no amount of analysis will allow them to determine exactly how the coming years will unfold, therefore we direct our analytical effort toward thinking carefully about what could happen across a range of possible outcomes.

In our base case, we believe returns from stocks and bonds over the next five years will be in a range of the mid to high-single-digits. Fortunately, as we invest for our clients we are not limited to just what the broad stock and bond markets provides, and this is a source of optimism for us. Because we have been in an environment in which many stocks and bonds have traded at prices below what their fundamentals suggest they are worth, we believe that our investment selections can add a lot of value over their market benchmarks. While some of the lowest-hanging fruit may have been taken, pricing disconnects remain that we think will continue to give our security selection a tailwind in the years to come.

Pricing disconnects exist at the asset class level as well, and we expect to see more opportunities if markets experience further periods of high volatility. Below is a recap of our expectations for some of the asset classes we follow:

Broad domestic equity returns are projected to be in a single digit range the next few years based on most scenarios we've reviewed. More encouraging is that the recent market dysfunction has created enough valuation discrepancies that we believe we can add value to that forecast with good stock picking. Given the fragility of the economy and the extensive government intervention, it is likely that we will experience more periods of market volatility over the next year or two that could also provide us with compelling opportunities to buy quality stocks. We still believe that another powerful leg down in the stock market is possible. However, it's more likely that, the systemic meltdown risk has passed and there are enough positive developments so that we believe the odds of retesting the March lows have gone down.

Emerging markets have had a strong rebound from their October trough and may be a little ahead of themselves in the short-run. However, our analysis suggests that a diversified emerging-markets portfolio has higher expected returns the next few years than developed-

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country stock markets, including the United States. This does not mean the emerging markets will necessarily perform better in the short run. We also recognize that emerging markets have more potential downside risk in a market selloff. However, over a multi-year time horizon we expect emerging markets to deliver higher returns than the rest of the world's equity markets.

High-yield bonds were extremely depressed late last year as valuations were priced at depression levels. Since then, high-yield bonds have rallied sharply, up 29% for the year and 38.8% since the end of last November. However, with junk-bond yields still in the low teens, the asset class still offers mid single-digit to low double-digit returns over five years in most scenarios. This takes into account an expectation of extremely high default levels.

Investment-grade bonds continue to be characterized by a U.S. Treasury market that is very unattractive over a five-year horizon, while other sectors are more attractive. The valuation discrepancies between Treasuries and other sectors of the market have given active bond managers an opportunity to add enormous value in recent months. We believe good potential remains, though the opportunities are not as compelling as they were a few months back. Investors will not get rich from their bond investments, but decent returns are still likely over the next few years. However, as we look further out into our time horizon, inflation risk is a threat to bond returns.

Treasury inflation-protected securities (TIPS) provide an excellent hedge against higher inflation and remain a good "diversifier" for most portfolios. TIPS are designed to protect investors from inflation by adjusting the outstanding principal by the inflation rate. A recommendation of TIPS is not driven exclusively based on their current valuation. Rather, our longer-term concerns about inflation suggest it may be prudent to seek out some inflation protection in portfolios with large fixed-income weightings. These are likely to be longstanding positions in a bond-heavy portfolio.

Overall, we believe that some prudence is called for given the current high level of uncertainty in the economy and financial markets, but that good investment opportunities do exist. We will continue to work hard to identify and take advantage of these opportunities.

As always, we appreciate your confidence, and welcome your questions.

- CB&T Investment Team 7/2009

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