July
2010

Monthly Investment Commentary

Commonwealth
Bank & Trust Company

4350 Brownsboro Rd.
Suite 210
Louisville, KY 40207

p (502) 259-2500
f (502) 259-1501
www.cbandt.com

Stocks continued their slide in June, ending the first half of 2010 with losses in every segment of the equity market. The large-cap Vanguard 500 Index lost 11.5% for the quarter, and is down 6.7% year to date. The small-cap iShares Russell 2000 and iShares Russell Midcap both lost 10% in the second quarter, though thanks to a strong first-quarter, both benchmarks are down just 2% year to date.

Turning abroad, the story was similarly painful. The Vanguard Total International Stock Index dropped 13.3% in the second quarter, bringing its year-to-date loss to 12%. The Vanguard Emerging Market Stock Index lost over 9% for the quarter and nearly 7% year to date.

Most of the positive news for the first six months of the year was in fixed income. The Vanguard Total Bond Market Index Fund, a proxy for high-quality, intermediate-term bonds, gained 3.6% over the second quarter, and is up 5.3% for the year through June.

Foreign bonds were mixed. The Citigroup World Government Bond index was flat in the second quarter, but still down 1% year to date, and although the JPMorgan GBI-EM Global Diversified Index lost 2% for the quarter, it returned a positive 3.4% for the year through June.

Investment Themes and Strategies

As noted in the performance review above, the first six months of 2010 have been a bit of a roller coaster—stocks were up early in the year, then down 5% by early February, then up almost 10% for the year by late April, then down over 5% for the year by early June. The S&P 500 ended June down 6.7% for the year-to-date.

Financial markets remain in a tug of war between cyclically improving economic and company fundamentals on the one side, and structural concerns about debt-related stress points and the longer-term strength of the economic recovery on the other. The tension between these opposing forces has left investors uncertain and the stock market stuck in a trading range. We think that unusually high uncertainty could be with us for years to come because the economic challenges we face are serious and will not be resolved quickly. Here are some of the investment themes that will remain for the next few years:

Investment Themes

Deflation vs. inflation: Ever since the Asian crisis in the 1990's and the bursting of the tech bubble at the beginning of the last decade, deflation rather than inflation has been the dominant threat to the world economy. This is likely to remain the case near-term. However, longer-term, we suspect inflation may be the bigger issue.

Still in a Side-ways market: We are 10 years into a flat stock market period and we think it will be many years until the stock market reaches new highs. The bright-side is we can still see decent returns (mid to high single digits) over those years because the decline in '07-'08 was so steep.

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Investors pay a premium for nominal growth: Growth in the developed world is likely to remain challenged for several years, leading investors to seek out markets and investments with higher growth potential. Investors are likely to pay a premium for this better growth, which may benefit the emerging markets and stocks that can consistently grow in this environment.

Competitive currency devaluations: In a world of zero interest rates, foreign exchange-rates become the key lever to regulate the economy. In a low nominal growth world with deflationary tendencies, we expect many countries to pursue "beggar thy neighbor" policies and competitively devalue their currencies.

Elevated volatility: In a low growth world with zero interest rates and fiscal policies that are hamstrung by large deficits and debt levels, we expect volatility to remain at high levels. With low rates and high debt, policy makers and governments will have less ability to "smooth-out" the business cycle, leading to higher volatility.

Bond yields and stock markets to remain positively correlated: Through-out the 80's and 90's there was mostly a negative correlation between bond yields and the stock market, in other words, as the yield on bonds came down, the stock market went higher. In our current deflationary (or very low inflation) world, bond yields have tended to converge with real economic growth. Therefore higher bond yields have tended to be consistent with higher economic growth, which then leads to higher stocks prices (vice versa).

In order to successfully navigate the volatile financial markets and the themes mentioned above, we have been utilizing the following investment strategies in portfolios. The magnitude of each investment theme used in portfolios depends on each investor's own personalized risk objectives and goals.

Investment Strategies

- **Buy Large Cap Quality Stocks –** The valuation of high vs. low quality stocks is the most attractive it has been in a long time; we like quality for the long-term
- **All-Weather Stocks –** We are focused on buying well-managed companies with strong competitive advantages that are able to gain relative strength in the challenging times and will excel in recoveries
- **Buy Pricing Power –** With the potential for deflation and tepid end market demand, we like companies that have the ability to raise prices
- **Tech stocks remain attractive –** Corporations have underinvested for several years-secular themes we like are moves toward the mobile internet & cloud computing
- **Investment income strategies –** With interest rates very low, we like investments that can produce and grow solid yields

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- **Emerging markets are growing faster than the U.S. (especially Asia) –** We recommend exposure to these markets directly and via companies that export to them (they are a buy on corrections)
- **Large-cap** is priced to outperform small-cap over the next few years
- The **corporate credit** (investment grade & high-yield) rally should continue; however it is probably on its last leg- investment grade bonds look fully valued
- Treasury yields are likely to stay constrained. Because the level of debt is so high, there is a natural "choke-point" for the economy if yields rise too high… risks for yields are to the upside- we anticipate bonds entering a low-grade bear over the next couple of years
- We are recommending some **alternative asset funds** that have the potential to improve risk-adjusted returns in this market – we are favorable on the vehicles we have identified and continue to recommend them, particularly for conservative accounts
- **Municipals** are attractive relative to taxable fixed income alternatives

We will continue to communicate our ideas and strategies that we are using to navigate these challenging markets. We take our responsibility seriously and look forward to guiding you through the complexity of the financial markets and helping you to achieve your personal financial goals. Please let us know if you have any questions or comments on this commentary or your own financial needs.

—CB&T Investment Team (7/10)