

**2nd Quarter Commentary**  
July 1, 2010

“We cannot direct the wind, but we can adjust the sails.” Bertha Calloway

Dear Investor,

In late April the market took an abrupt turn downward after posting gains since the previous March. There were plenty of events to test investor enthusiasm, ranging from the debt crisis in Greece, to the “Flash Crash” on May 6, and fears of a double-dip recession. While all these events merit our serious consideration, in the end, the dip in equity markets, while unpleasant, was entirely within the bounds of a normal market correction. In fact, we just experienced the highest weekly return in over a year to start the 3<sup>rd</sup> quarter.

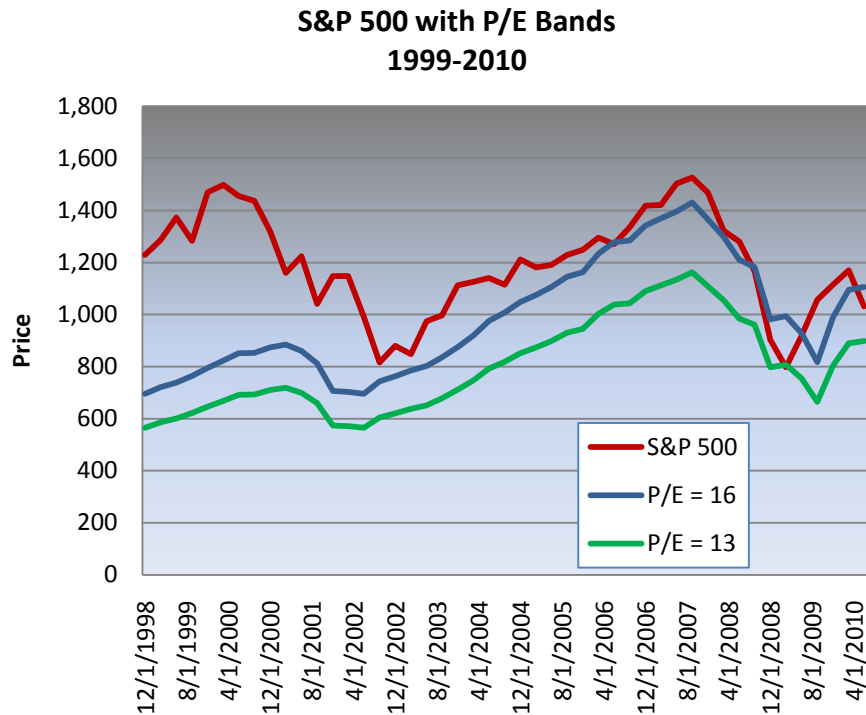
Furthermore, diversification worked as intended during the second quarter. The S&P 500 lost 11.4%, and foreign stocks were down 13.3%, but Treasury bonds gained 12.1% and Gold advanced 11.7%. One of the primary benefits of a drop in equity prices is that it affords us the chance to purchase stocks at more reasonable valuations, while reducing other investments, such as bonds, at higher prices.

If we use the S&P 500 Index to compare several key metrics from today vs. 1999, we find that stocks are far more attractive today than they were back then.

<u>Metric</u>	<u>1999</u>	<u>2010</u>	<u>Difference</u>
Price	1310.17 (03/29/99)	1030.71 (06/30/10)	- 21 %
12 M dividend	\$14.20	\$21.10	+49 %
Yield	1.09%	2.04%	+87 %
Earnings	\$45.00	\$69.00	+53 %
Price/Earnings	29	14.95	- 48%
10 Y Bond Yield	5.20%	2.93%	- 44%

Given that consensus earnings on the S&P 500 over the next 12 months are estimated to be around \$82, we get a forward Price/ Earnings (P/E) ratio of 12.5. As the chart below illustrates, this is significantly below the long-term average of 16, and is closer to

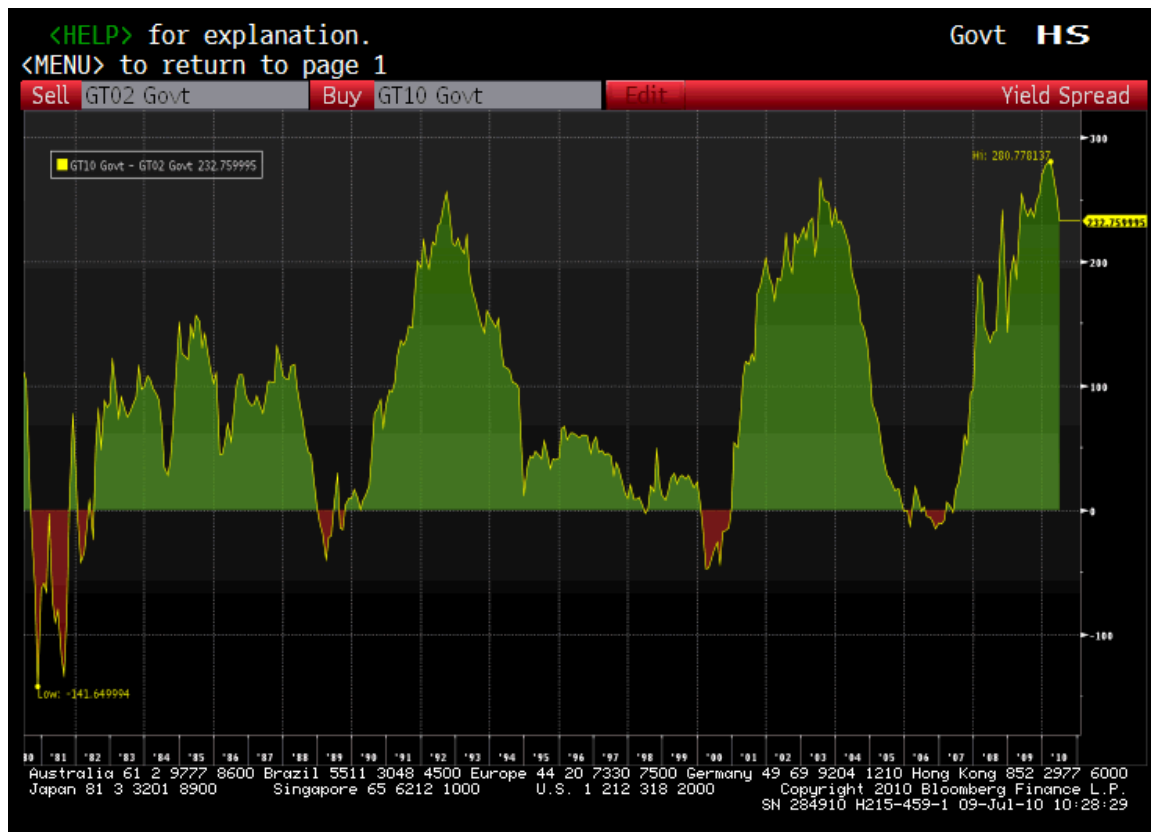
the low-end of historical valuations. In fact, were the S&P were to trade at its long-term average P/E of 16 over the next year, it would rise over 25% from current levels to around 1,300.



While it can be argued that equity valuations were above average back in 1999, what has the return from dividends alone been since then? The S&P 500 has paid out \$250 in dividends over the last 11 years. That comes out to a 19% return from dividend income. Furthermore, growth in dividends has been close to 50%. Looking ahead to the next 10 years, we can expect a return of around \$500, or almost 50% from dividends alone in the S&P 500. By comparison, at 3%, the return on 10 Year Treasury bonds will be 30%. The conclusion being, even with zero price appreciation, equities seem to be the better choice at this juncture based on income alone.

### The Economy

It may seem counterintuitive, but one of the key determinants of the future direction of the U.S. economy is not the level of interest rates, but the slope of the yield curve. At the moment, the yield curve is very steep, meaning long-term rates are significantly higher than short-term rates. As shown in the chart below, the current spread between the 2 and 10 Year Treasury Notes is near historic highs. This suggests GDP growth won't slow to less than 1% in the next year.



The high points were on 12/84, 8/92, 6/03 and most recently in March of this year. In the previous three instances when the yield curve was this steep, The S&P 500 gained 44.80%, 12.00% and 32.8% respectively over the ensuing 12 months. While not predictive, it lends confidence to a forecast of a stronger economy and positive equity returns.

## The Market

The rally that began in March of 2009 ended in late April of this year. After gaining over 80% from its lows, the S&P 500 dropped 15% by the end of the quarter. While this may appear worrisome, such corrections can be healthy in terms of restoring valuations to more sensible levels. Even after the drop, the market is still up more than 50% from its lows!

Another metric we find useful when assessing valuations is to compare the earnings yield on the S&P with the yield on the 10 Year Treasury note. As noted above, consensus earnings for the S&P 500 are estimated to be \$82 for the next 12 months, giving the index an earnings yield of 8% ( $\$82 / 1030$ ). By comparison, the current yield on the 10 year Treasury is just 3%.

ETF	YTD	ETF	YTD
S&P 500 (SPY)	-6.55%	U.S. REITs (IYR)	4.72%
Russell 2000 (IWM)	-1.65%	Russia (RSX)	-10.00%
Emerging Mkts (EEM)	-9.50%	Oil (USO)	-13.54%
Gold (GLD)	13.40%	Gold Mining (GDX)	12.44%
10 Yr Treasury (Yield)	2.95%	Volatility (VIX) Index	34.50

## STAR II

STAR II has performed noticeably better than the broad market so far this year. This is due to both the broad diversification within the models and our allocation to alternative assets. Both approaches lower the volatility of the portfolios as a whole, and potentially raise the overall returns.

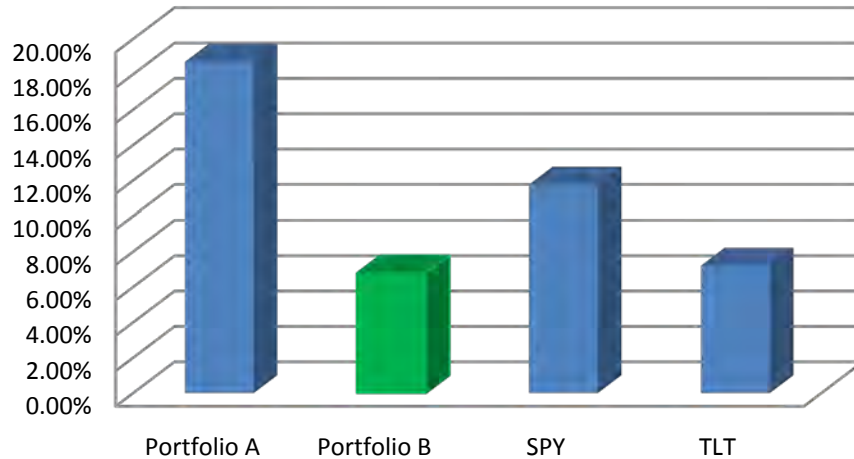
One fund we've used in our larger alternative assets allocations that we are considering for use in a broader context going forward is the Hussman Strategic Growth Fund (HSGFX). The fund's objective is long-term capital appreciation, with added emphasis on capital preservation in unfavorable market conditions. John Hussman is an experienced investor, with an impressive track record to support his investment approach. His fund is up 5.25% through the first half of 2010, and has beaten the S&P 500 by 30% over the last three years. I feel HSGFX will compliment the other alternative assets nicely.

## STAR III

In STAR III, we added a new security to VEGA during the quarter, the Barclays iPath VIX Short-Term futures index (VXX) that holds short-term 1 and 2 month futures on the CBOE Volatility Index (VIX). The VXX was launched some time ago, but it wasn't until the end of May that CBOE only began trading listed options on the VXX. This allows us to capture the volatility of volatility, and thus increase the return potential of our VEGA strategy significantly.

To illustrate how adding the VXX to VEGA can improve the strategy, consider the following example: Portfolio A consisting of the following ETFs: the S&P 500 (SPY), diversified emerging markets (EEM), Real Estate (IYR), Oil (USO) and Gold (GLD) in equal amounts. Portfolio B adds the VXX.

**Quarterly Standard Deviation of Returns  
2007 - 2010**



Over the last 3 years, on a quarterly basis, Portfolio A had a standard deviation (risk) of 18.69%. By comparison the S&P 500 had a quarterly standard deviation of 11.75%. Adding the VXX in Portfolio B lowers the quarterly standard deviation to 6.77%, lower than Treasury bonds. Furthermore, the VXX typically exhibits twice the volatility of the SPY, resulting in higher income from option premiums as well.

As always, we thank you for your continued support and encourage you to contact your financial advisor with any questions or comments.

Sincerely,

James Herrell, CFA



### **Important Disclosures**

*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 and there is always a possibility of the loss of principal. Model returns do not reflect actual returns on market circumstances that existed at the time and other circumstances and are thus of limited value in determining how an actual investor would have done during the time period. 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.*

---