

**Burt Associates, Incorporated**  
 FEE ONLY FINANCIAL ADVISORS AND MONEY MANAGERS  
 6010 Executive Boulevard, Suite 900  
 Rockville, Maryland 20852  
 (301) 770-9880  
 FAX (301) 770-9885

## Quarterly Investment Commentary

Date: July 20, 2011

To: All Clients

From: Burt Associates, Incorporated

Re: Q2 Investment Commentary & Portfolio Positioning

*We would like to announce that Burt Associates, Inc. will be undergoing a “facelift.” While nothing has truly changed at the firm, in the coming months you will notice we have updated our corporate logo, website, and marketing & educational materials.*

### One Step Forward...Half a Step Back

Momentum that carried stocks higher through the first four months of the year fizzled in May as investors became increasingly concerned about a slowing economy. These fears were exacerbated by supply chain disruptions stemming from the earthquake and nuclear incident in Japan and fears that a Greek default would spread contagion to other weak EU members and rattle the European and global financial systems. Those concerns, particularly relating to Greece, intensified as the second quarter progressed, and a modest retreat in May worsened in June before we saw a late-month rebound as it became increasingly likely that the EU and IMF would manage to kick Greece’s debt can down the road at least one more time.

### Market Performance

When the dust settled, stocks wound up roughly flat for the second quarter of 2011. The large-cap S&P 500 was barely positive while small-cap stocks, measured by the Russell 2000, lost 1.61%. Growth outperformed value across the market cap spectrum. Despite a temporary lull in the second quarter, the domestic equity markets are posting positive gains YTD, with mid-cap growth stocks leading the way. Developed-market foreign stocks, measured by the MSCI EAFE, were up 1.56% for the quarter, but trail the U.S. equity

Total Returns for Select Indexes for the second quarter 2011 and YTD

U.S. Stock Indexes			Non-U.S. Stock Indexes		
	2Q	YTD		2Q	YTD
S&P 500	0.1	6.02	MSCIEAFE	1.56	4.98
S&P MidCap 400	-0.73	8.56	MSCI Europe	2.44	9.05
S&P SmallCap 600	-0.16	7.54	MSCI Japan	0.18	-4.76
Russell 3000	-0.03	6.35	MSCIEM	-1.15	0.88
Russell 3000 Growth	0.64	6.98			
Russell 3000 Value	-0.68	5.74			
Russell 2000	-1.61	6.21			
Russell 2000 Growth	-0.59	8.59			
Russell 2000 Value	-2.65	3.77			
Russell 1000	0.12	6.37			
Russell 1000 Growth	0.76	6.83			
Russell 1000 Value	-0.5	5.92			
Russell Mid Cap	0.42	8.08			
Russell Mid Cap Growth	1.61	9.59			
Russell Mid Cap Value	-0.69	6.69			
			U.S. Bond Indexes		
				2Q	YTD
			Barclays Capital US Agg Bond	2.29	2.72
			Barclays Capital GNMA	2.88	3.52
			Barclays Capital US Govt 1-3 Yr	0.81	0.88
			Barclays Capital US Treasury Long	3.36	2.32
			Barclays Capital US Treas. Bill 1-3 Mo	0.02	0.06
			Other Indexes		
				2Q	YTD
			DJ UBS Commodity	-6.73	-2.58
			DJ US Select REIT	3.97	10.93

Source: Morningstar (total return in US \$)

market YTD. Despite ongoing sovereign debt concerns within the Eurozone, the MSCI Europe index was up 2.44% for the quarter, and 9.05% YTD. Emerging markets struggled for the quarter as the MSCI Emerging Markets Index posted a 1.15% loss.

Domestic high-quality, intermediate-term bonds, measured by the Barclays Capital U.S. Aggregate Bond Index, gained a 2.29% gain for the second quarter, following a relatively flat first quarter. Unlike the first quarter, long term issues outperformed shorter maturities.

While we made several moves in the first quarter to tactically position our portfolios, we maintained our positioning throughout the second quarter. While we have been pleased with the changes we've made, we continue to evaluate other opportunities within the capital markets given the domestic and international economic climate.

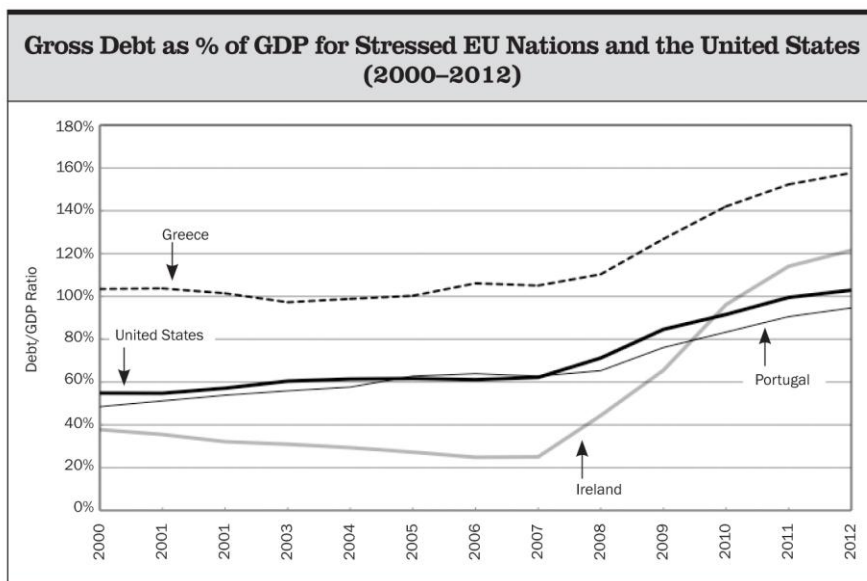
## The Big Picture

Our view of the economic and investment landscape did not materially change over the past quarter, but, towards the end of the period, market volatility increased in response to disappointing economic data and renewed fears of a European sovereign debt crisis. Our assessment of these and other factors and their impact on portfolio risk and return expectations is ongoing. Given the fluidity of the situation we may make portfolio changes at any time.

The following are some of the key issues we are currently focusing on, as well as a recap of the broader U.S. economic situation.

### Greek Debt Crisis Fears (Again)

It appears that the European Union, the European Central Bank, and the International Monetary Fund will once again provide Greece with additional financial assistance in return for Greek promises of more fiscal austerity. The aim is to buy more time with the hope that Greece will ultimately be able to get its fiscal house in order and pay back the debt. However, we, and most other investors, believe some type of Greek default, “restructuring,” or “reprofiling”—in which the debt repayment schedule is extended but the principal value is not marked down—is inevitable given the severity of their situation.



Given the very high likelihood of some form of default, the key questions for us as portfolio managers are the timing and, most importantly, the impact on the global economy and financial and credit markets. Unfortunately, the answers to these questions remain highly uncertain at this point.

Since the financial crisis in 2008 we have worried about the risks and repercussions stemming from excessive debt levels in the developed world. Greece is but one facet of this risk. By itself, a Greek default is probably manageable for the global financial system without causing a crisis—

although even that is not certain given the interconnectedness of the global financial system (i.e., countries and banks owning large amounts of each others' debt) and exposures among financial institutions, including those in the United States. However, the big risk is that a Greek default could spiral into a broader European debt

“contagion” spreading to other heavily indebted European countries, such as Ireland and Portugal, and possibly even Spain or Italy. Given the size of the latter economies, if that happened there is universal agreement that the financial/economic system would be overwhelmed. Even if these other countries don’t want to default, there could be a crisis of confidence that basically forces default in a self-fulfilling prophecy. Essentially, the market would refuse to lend to these countries and they would be unable to roll over their debt. Default would be the only option without the support of central banks and/or the IMF which would help to restore investor confidence.

While at this time we are not planning any portfolio changes based on the recent developments in Greece, this remains a rapidly evolving situation. We continue to analyze the potential outcomes in terms of their likelihood and magnitude of impact on the asset classes in which we invest. Should there be a crisis in the near-term related to Greek debt, we’d expect “risk assets,” such as stocks and emerging-market currencies, to fall. Despite the United States’ own debt problems, Treasury bonds would likely be perceived as a “safe haven” asset class.

### **China Hard Landing**

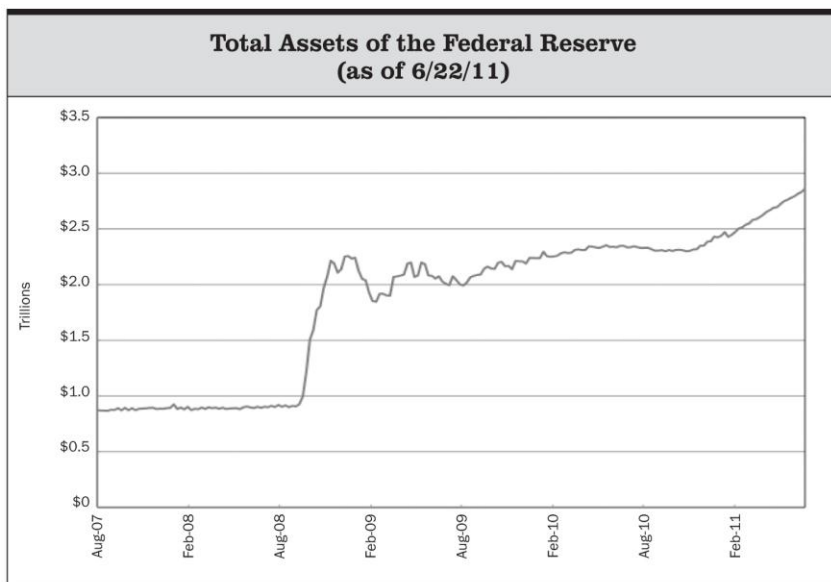
Another risk that we have highlighted recently and is growing in importance is a potential “hard landing” for the Chinese economy, as opposed to a smooth manageable slowdown, and the global ripple effect that could potentially result. Many experts believe there is a bubble in at least some segments of China’s property market. The general consensus, however, is that this bubble is not widespread and can be managed by the Chinese government, as it has been in the past. There is a risk, however, that the bubble may have already grown very big and, if pricked, will result in a sharp contraction for China. A hard landing will be negative for equities, commodities, and emerging-markets bonds. This issue is especially hard to assess given of the lack of reliable information from China.

### **The U.S. Economy and Debt Ceiling Debate**

The U.S. Treasury estimates that without further borrowing, the government will run out of money around August 2, 2011, and has given this date as a deadline for Congress to raise the debt ceiling. This is a newer source of short-term uncertainty for the markets. As with the Greece situation, we think the most likely outcome is a political agreement that avoids a near-term market upheaval. But the longer-term structural problem with our debt and deficit will likely remain unresolved, and possibly won’t be seriously addressed until after the 2012 presidential election. There is also a chance the two sides don’t reach an agreement and the debt ceiling is not raised by August 2. If this happens, we’d expect a temporary sharp negative market reaction until an agreement is reached.

### **The End of QE2**

The Federal Reserve monetary stimulus policy known as QE2 ended in June. While there is uncertainty about how the end of QE2 will affect Treasury rates (since the program was a huge source of demand for Treasuries), we expect it to be a nonevent (at least in the near term) because the Fed has telegraphed its plans well in advance, and so the market should have digested and discounted it by now. In addition, the Fed will continue to reinvest the maturing debt on its books into Treasuries, thereby maintaining the size of its balance sheet for the time being—it just will no longer be expanding its balance sheet as it was under QE1 and QE2. The Fed’s balance sheet has



more than tripled since the financial crisis and now stands at a whopping \$2.8 trillion, reflecting the huge amount of liquidity the Fed has pumped into the financial system.

The Fed has also made it clear that it will be maintaining its Fed funds interest rate at an “exceptionally low” level (0%–0.25%) for “an extended period.” Providing further clarity, at his June 22, 2011, press conference Fed chairman Ben Bernanke said:

The thrust of “extended period” is that we believe we’re at least two or three [Fed Open Market Committee] meetings away from taking any further action. And I emphasize “at least.” But depending on how the economy evolves, and inflation and unemployment, it could be significantly longer.

So while there are no concrete signs the Fed is gearing up for “QE3,” they are clearly signaling they have no plans to start tightening monetary policy either. This reflects their recognition and concern that economic weakness is likely to persist for some time.

### **There Are Signs the Economy is Slowing**

Recent U.S. economic news has been somewhat disappointing, with sluggish GDP growth and continued weakness in employment and housing, which are important drivers of consumer confidence, income, and spending. In the first quarter, real GDP grew at only a 1.9% annual rate compared to 3.1% in Q4 2010. Despite massive fiscal and monetary stimulus, in the seven quarters since the recession officially ended in June 2009, real GDP growth has averaged only 2.8%. This compares to an average growth rate of 5.3% for the same period after the prior 10 recessions.

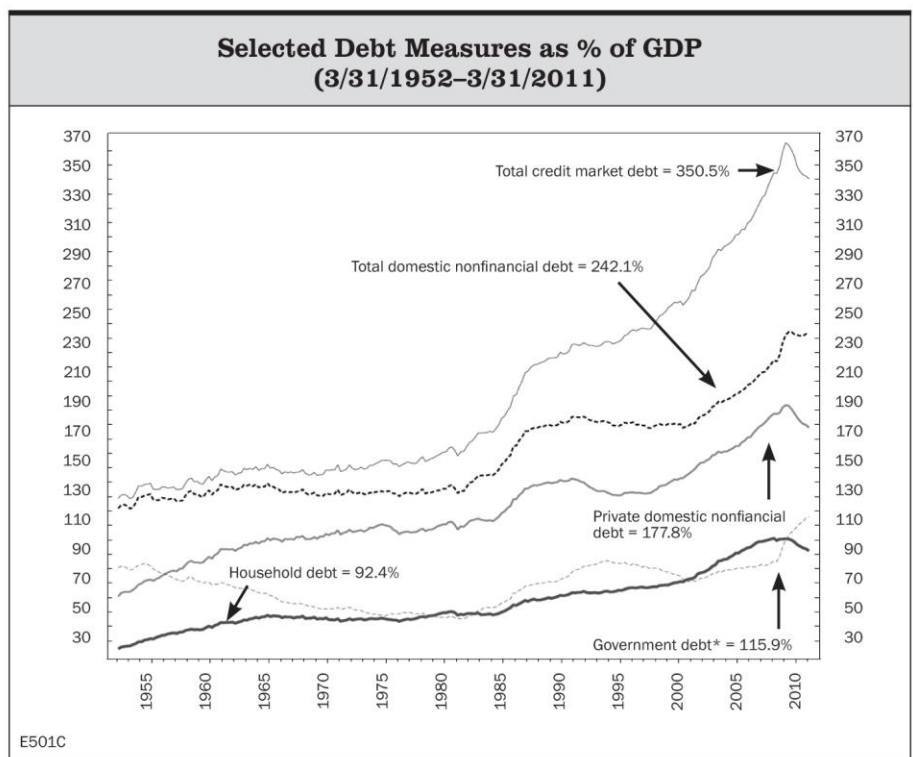
On the jobs front, the latest employment report for June showed the economy added only 18,000 net new jobs. This is the second straight month of dismal hiring, and well below the 220,000 monthly average increase in the prior three months. We have seen estimates (from various economists) that the economy must create anywhere between 100,000 and 200,000 net, new jobs each month just to absorb the natural flow of new entrants into the labor force and keep the unemployment rate flat. The unemployment rate in May ticked up to 9.1%.

Meanwhile, private and government economists have been cutting their growth forecasts for the year to below 2.5%–3% in most cases. The Federal Reserve also revised significantly downward their GDP and employment forecasts for 2011 and 2012 at their recent June meeting.

On the housing front, the widely followed S&P/Case-Shiller National Home Price Index fell 4.2% in the first quarter of 2011, following a 3.6% decline in the fourth quarter of 2010. The index is now 5.1% below its year-ago level, 34% below its peak in the second quarter of 2006, and down to a level last seen in 2002.

### **Debt Remains a Problem**

Finally, the ongoing headwind from very high debt levels in the United States has not materially lessened in aggregate. On the positive side, consumers have continued to reduce debt. For example, the ratio of



household debt to GDP fell to its lowest level in five years (See previous chart) and household debt as a percentage of disposable income has dropped to a near seven-year low. This is a medium- to long-term positive—necessary to get household balance sheets on a sustainable path that can support future consumption growth—but it is a headwind for near-term growth. On the negative side, as we all know, government debt continues to climb, so the overall U.S. debt picture has not improved much.

## **Portfolio Positioning - Building Portfolios in a Highly Uncertain World**

We did not make any meaningful changes to our model portfolio allocations for the second quarter. Therefore, we will use this opportunity to discuss where we stand today, including the changes we have made YTD.

**U.S. Equities:** For the year, the only change we have made to our domestic equity allocation was the replacement of the Vanguard Growth Index with the BlackRock Equity Dividend Fund. Our goal was to slowly shift our portfolio from an overweight in growth to a more balanced style. Historically, growth has tended to outperform value during most post-recessionary economic periods, and has outperformed value on an annualized basis for nearly 8 years. However, the macro economic backdrop we have detailed above has made historical comparisons difficult to say the least. Since the National Bureau of Economic Research officially noted an end to the recession in June 2009, there has been little in the way of style outperformance (measured by the Russell 3000 Growth and Value Indices). While growth outperformed value during the second quarter, we are pleased to note the BlackRock Equity Dividend fund has outpaced the S&P 500 by over 2% since we added it to our model allocations. On the large cap side, our performance was buoyed by our passive index investments, as some of our actively managed funds underperformed the market due to poor sector allocations and stock selection. We are actively researching potential alternatives within the large cap space. Our mid and small cap active managers delivered mixed performance over the period, and have remained competitive with their benchmarks and categories for the year. One particular highlight has been the Principal Mid Cap Blend Fund which has outpaced the Russell Mid Cap Index by over 4% YTD. Overall our domestic equity portfolio remains very broadly diversified by market cap, style and sector.

**International Equities:** The heightened volatility within the international markets continues. While the turmoil in the Middle East no longer dominates the headlines, the growing sovereign debt crisis within the Eurozone has again peaked investor interest since it was highlighted nearly 21 months ago. We continue to monitor these issues, and to maintain a broadly diversified international allocation of companies located in both developed and emerging economies. Our portfolio managers are positioned to seek out geographic and sector opportunities that are less affected by the strains of the developed world. Corporate sector capital expenditures are likely to remain strong as is consumer spending in emerging markets (fueled by a continued growth in incomes that outstrip inflation). They continue to believe equities are still attractive relative to other major asset classes over the intermediate- to long-term, though returns are likely to fall below historic norms. In general, the corporate sector is in solid financial shape and generating strong free cash flows which should attract interest from investors seeking growth and protection from potential inflationary worries.

**Bonds:** The performance of our core fixed income holdings was good for the second quarter, with most positions outperforming their respective investment category. For the year, the only change we have made was to reduce our allocation to the Vanguard GNMA Fund and allocate assets to the Osterweis Strategic Income Fund. We believe that this allocation will benefit our portfolios in the long term as interest rates eventually move higher. The Osterweis Strategic Income Fund takes on additional credit risk at the expense of interest rate risk, and has performed very well during periods of rising interest rates. At the same time, a rising interest rate environment will likely be detrimental to GNMA securities. Rising interest rates slow homeowner re-financings and prepayments, thus lengthening a GNMA security's maturity and duration. Investors are then either forced to hold lower coupon securities, or face falling prices as newer securities offer more attractive rates. Although interest rates (measured by the 10yr Treasury) trended downward for the quarter, we believe this is prudent long term positioning. Relative to the Barclays Capital U.S. Aggregate Bond index, our core

portfolio is overweight the U.S. corporate, TIPs, and non-U.S. corporate, and non-U.S. government sectors. Sectors that are underweight include U.S. Treasuries, agencies, and mortgage securities. We are maintaining a short duration, or interest rate sensitivity, within our fixed income allocation. Our core holdings currently have a 3.48 year duration compared to a 4.61 year duration for the Barclays Capital U.S. Aggregate Bond Index. We have also recently been reviewing the U.S Treasury holdings within our core fixed income investments. While we believe that the debt ceiling will ultimately be raised without issue, we continue to monitor this situation and want to know where we are positioned.

**Alternative Investments:** We continue to evaluate the opportunities to add low correlation alternative investments to our model allocations. We had previously discussed reducing our allocation to the Hussman Strategic Growth Fund should we see a sell-off in the U.S. equity markets. Unfortunately, while the market fell over 8% from early May through mid-June, it was more a function of poor economic data rather than valuation concerns or profit taking. Based on these factors, we thought it would be prudent to maintain our current allocation. This is a period when our allocation to alternatives can truly benefit overall performance. While the S&P 500 fell 8% during this period, our alternatives allocation fell only 1%, significantly limiting downside losses.

### **A Concluding Reminder About Downside Risk**

It feels as though we have shared very little good news over the past several quarters. While the markets have rebounded strongly from their depths in 2008, the economy continues to grow at a sluggish pace. The headlines continue to tout high unemployment rates, a weak housing market, and global debt issues. Fortunately, financial markets and economies are cyclical in nature, yet we cannot be remiss when it comes to unexpected volatility. We believe the global markets and economies are likely to stabilize in the future, yet continue to maintain a conservative, risk conscious positioning. The good news for clients who are in the appropriate model for their risk tolerance and time horizon is that in the event of a significant market downturn, our positioning should enable us to redeploy capital from lower-risk investments higher-risk assets with much better return potential. If there is one thing we can be almost certain of, it is that there will be market shocks over the next few years and they will create investment opportunities for us to take advantage of. There may also be events that magnify risks that we will want to further protect against. In the long run, we are confident that this approach will benefit you.