CAPITAL MARKETS UPDATE

After a strong first quarter, equity markets were negative for the quarter ending June 30th. For the second quarter, the Dow dropped (1.85%), the S&P 500 slid (2.75%) and the Russell 2000 lost (3.47%).

Despite the weak second quarter, the three major U.S. stock indexes wrapped up the first half of the year with decent gains: the Dow was up 6.83%, the S&P 500 was up 9.49% and the Russell 2000 was up 8.53%.

In similar fashion, international equities were down (7.13%) for the quarter and up 2.96% year to date. Emerging market equities were down (8.89%) for the quarter and up 3.93% year to date.

Fixed income securities generated positive returns for the quarter and year to date, while commodities were negative for both time periods.

INVESTMENT ENVIRONMENT

As usual, investors seem focused on short-term issues: *What will happen in Greece and the European Southern Peripherals? Will they choose austerity? Will the US go red or blue in November? What will happen with the Affordable Healthcare law?*

But seasoned observers—such as Bill Gross at PIMCO—remind us that these issues are relatively unimportant for the longer term. The *30-thousand-foot question* which most impacts investment decisions over the coming decade is ***what will happen with the massive Global debt that countries, corporations and individuals are facing world-wide?***

The US has continued to be considered less risky than many other markets but like Europe and Asia, we're looking at significant challenges ahead.

Chart 1 shows gross US federal government debt to GDP—currently at 100%. But projecting this

Chart 1: US Gross Federal Government Debt to GDP

Source: Haver Analytics, as of Q1 2012

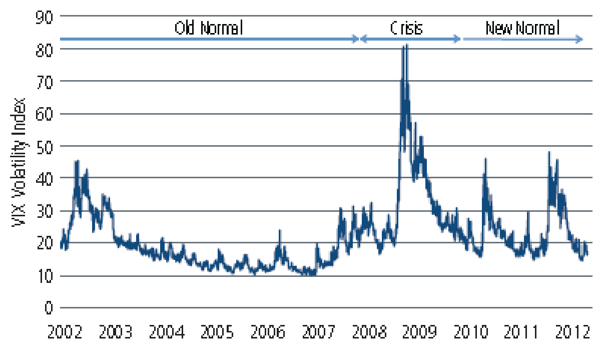
trend into future years, and adding liabilities for Social Security, Medicare, Medicaid plus unfunded liabilities of state and local governments, we're looking at the possibility of **800% debt-to-GDP ratio in less than ten years**.

If our highly partisan political atmosphere continues and we cannot muster the political will to apply the necessary fiscal repairs, there are only two ways that this will play out—**default** or **printing money**. Neither of these outcomes is pleasant to think about as investors. Both stocks and bonds would have difficulty in either of these. A more likely scenario is that there will be a combination of outcomes…**some** steps toward deficit reduction, **some** downgrading of sovereign debt, and **some** increase in inflation.

Unfortunately, the final end-state for the global economy following this debt-induced crisis is unclear and this uncertainty continues to impact the markets. Chart 2 shows the VIX or volatility index of the S&P 500 for the past ten years. After the financial collapse in 2008, we continue to see aftershocks in market volatility due to the cloudy outlook. As the economy slows, corporate earnings growth is likely to decelerate.

How should investors proceed under this environment of uncertainty? It is tempting to make a case for a single outcome and invest accordingly. But making big investment bets in this environment is extremely risky. To embrace

Chart 2: S&P 500 Volatility



Source: Bloomberg. Data through 31 May 2012.

one scenario and heavily tilt the investment mix based on this forecast can result in large losses quickly.

We believe this is a time for **caution** and **prudence** and suggest proceeding under four investment principles:

- **Manage Expectations.** Volatility is likely to continue and returns will be lower while uncertainty persists and debt overhangs are resolved. The double digit average stock returns we experienced in the last half of the 20th century will be difficult to replicate in the foreseeable future.

- **Hedge Your Bets.** Diversification has never been more critical. Utilize multiple asset classes, including alternative assets and commodities. Trim equity positions in favor of hedging strategies and absolute return funds.

- **Review Fixed Income Assets.** Consider tilting toward short term bonds, floating rate securities and diversifying globally. Today's long term yields provide small marginal returns and do not warrant the risk of rising rates and inflation.

- **Rebalance.** Market volatility provides an opportunity to rebalance to long term targets. This ongoing discipline will lead us to trim assets that have led and add to those which have lagged.

NEW INVESTMENT TAX?

Now that the Supreme Court has upheld the Affordable Health Care Act, there's one provision which will impact investment income. Passed by Congress in 2010, the Act includes a 3.8% surtax on investment income which would go into effect starting January 1, 2013.

The tax applies to **net** investment income of most joint filers with adjusted gross income of more than $250,000 ($200,000 for single filers). Starting January 1st, the tax rates on long-term gains and dividends for these earners will jump from their current historic low of 15% to 18.8%--assuming Congress extends the current tax rates.

Of course, it's an election year and what will be in effect at the end of the year is unknown. But if this provision stands, it would make sense for investors who are considering selling assets to accelerate investment income by taking gains in 2012.