



The first quarter of 2010 was a good one, with U.S. stocks enjoying healthy gains and bonds earning at least small positive returns.

We have been expending a huge amount of research effort to thoroughly understand the overall environment and the various ways macro trends could play out. The main story is that the need to reduce spending now, in order to reduce the massive debt built up in previous years, suggests the strong possibility of a sluggish economy for many years to come.

We believe that risk assets like stocks are not priced attractively enough to fully compensate investors for the risks we see, and therefore we are under-allocated to equities in our balanced strategies. However, periodic market declines in the years ahead could give us opportunities to improve returns by adding risk assets when we expect to be paid better for taking it on, and this will require patience.

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Quarterly Investment Commentary April 2010

Looking Down From 30,000 Feet, the Landscape is Dominated by Mountains of Debt

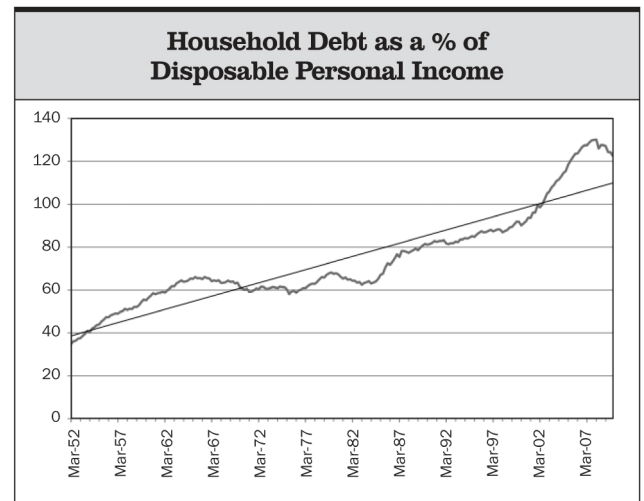
A year ago the stock market had just started its rebound from the depths of the worst bear market in over 70 years. The powerful rally in “risk” assets over the past year is certainly comforting.

While we take some satisfaction in the returns we’ve achieved for our clients since that time, we remain quite concerned, and our assessment of the key macro issues and risks that the global economy must deal with in coming months and years has not changed.

Though the worst case of a great depression has been avoided, the global economy continues to struggle in the aftermath of massive wealth destruction and a hard stop to the decades-long trend of expanding indebtedness.

More so than in past periods, the investment climate in the years ahead will be highly influenced by how the key macro components of this environment unfold. We’ve seen massive growth in debt throughout society, reaching binge levels in the last decade. Think of all that debt as a form of borrowing against future consumption – now we must pay it back in the form of less spending. This suggests a sluggish economy, possibly for many years to come.

Government spending has kept the economy from falling off a cliff, but at a longer-term cost of massive deficits that will be difficult to fix without causing more damage – including the possibility that shifting gears to cut budget deficits too early



Debt is coming down, but is historically very high relative to income. Source: Federal Reserve.

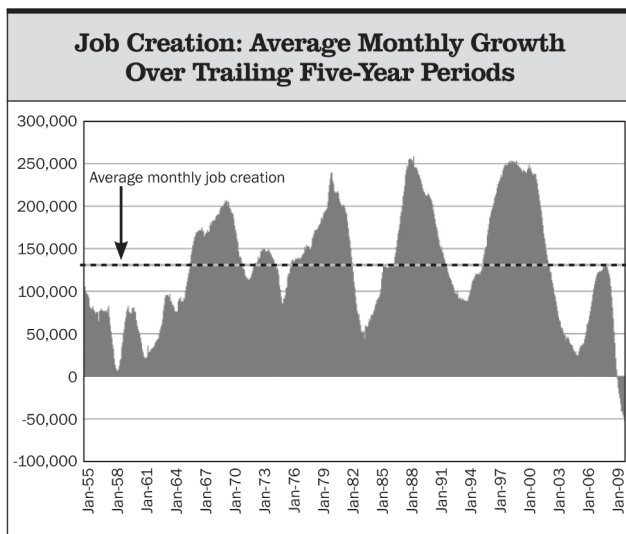


could throw the economy into a significant and ugly decline.

The recent economic strength stems mostly from this stimulus spending and smaller inventory drawdowns (companies are still drawing down inventories – selling more than they are producing so that inventories decline – but the drawdown has slowed). The problem is that both of these factors are temporary.

There is still a lot of government spending that will roll out this year but unless there is a new round of stimulus, which is quite possible, it will dissipate in coming quarters. Inventories will be a positive growth driver for a while as they are gradually rebuilt, but this too will pass as the year progresses. Other sectors of the economy are strengthening—manufacturing in particular has been impressive but it is still far below its prior peak and overall, the economy is on fragile footing. What we don't yet know is whether the economy will be on solid enough footing to stand on its own as government supports are withdrawn and inventories stabilize, or whether it will stumble and possibly contract again.

In normal cycles the consumer is the key to sustained growth. The weakness in this critically important sector suggests to us that a sluggish recovery is the most likely outcome over the next couple of years and that there is still risk of a return to recession if government policies are not skillfully managed.



According to Ned Davis, if job growth averages 150,000 a month over 10 years, unemployment won't fall below 6% until 2019, or below 7% until 2018. It would break below 10% in 2013. Average monthly job growth since 1950 has been 120,000. The last 20 years, excluding the impact of the recession, job growth has averaged 137,000 per month. Source: Bureau of Labor Statistics.

There are several important variables to a strong and sustainable economic rebound, but jobs are the most important. The big question is not whether the job picture will improve, but how much it will improve and how quickly. But while the labor market remains very weak, monthly job losses likely peaked some time ago, and we appear to be entering a period of net job creation.

A strong snapback in job creation at some point would not be shocking. With over eight million jobs lost, there was probably some overreaction on the part of businesses that will be reversed. However, we also believe that businesses are adjusting to a



smaller workforce in the face of continued concern about economic growth in coming years. We don't know how this will play out, but the weight of the evidence suggests to us that even with a strong temporary snapback, we shouldn't be optimistic about a return to a strong labor market for several years.

Other big problems include huge amounts of commercial real estate debt coming due, continued strains in the housing market, and possible high inflation down the road from deficit spending.

There are some positives that could contribute to a better outcome, including continued strength from emerging economies. Domestically, we could see stimulus spending, low rates, and inventory rebuilding create a virtuous circle in which businesses with strong balance sheets add jobs, and consumer and business confidence builds and feeds on itself.

Our Investment Outlook in This Time of Great Uncertainty

Our scenario analysis forces us to think about a variety of different macro outcomes over our five-year decision horizon. We then assess the return potential for each asset class in each macro scenario. Our valuation work is a major driver of the return analysis, though the macro factors are also important. It would not be shocking to find bargain valuations in some asset classes when the outlook is poor—often times risk is more than fully priced into financial assets in negative environments. Unfortunately, that is not the case today—generally speaking, return potential over the next five years is not compelling. However, that does not mean that returns couldn't be decent over the near term.

Global Stock Outlook: We think mid-single-digit returns or worse are more likely for stocks than higher returns over the next five years. Our outlook for developed market foreign equities is similar and for emerging-markets equities is slightly higher across all scenarios. We believe risks are relatively high, but we can't predict timing. We can easily imagine good returns in 2010 if the economy continues to grow, low rates encourage risk taking, and there is no catalyst to cause risk aversion.

We never want to be complacent in our assumptions. We constantly test and challenge our own thinking, and look for new ways to analyze issues. One example is our work to approach the all-important question of what corporate earnings growth will be by analyzing historical sales and margin data. The results are slightly more favorable than



our more conventional earnings growth analysis, which is based on a much longer history.

As we think about the equity markets, we also think about the potential for active managers to outperform, and we put some credence in the bottom-up views and analysis we hear from the stock pickers we respect. A number of relatively conservative value-driven stock managers appear to be quite bullish about the individual stock picking opportunities right now. Others are less so. However, they are still able to find good investments; and, since they run relatively concentrated portfolios they don't need to find a whole lot of them. There is some evidence that environments where overall stock returns are low but individual company returns vary widely are favorable for active managers; we believe we could see such an environment.

Emerging-Markets Local-Currency Bonds: Among other asset classes, emerging-markets local-currency bonds remain a compelling opportunity from a relative-return perspective versus the other major asset classes we track. We think it can generate mid-to high-single-digit returns in our most likely five-year scenarios—admittedly not spectacular returns but better than any other asset class. The returns are driven by the underlying bond yields plus an expectation of at least mild currency appreciation we expect given the stronger fiscal conditions in much of the developing world.

High-Yield Bonds: We did very intensive work on high-yield bonds in late 2008. Back then we viewed high-yield bonds as an asset class that had better potential than stocks in almost every scenario, and much less risk. High-yield has continued to do well in 2010, though the returns have been much more moderate. We no longer view the asset class as clearly superior to equities (both have low expected returns in most scenarios). High-yield could continue to generate decent returns in the short to intermediate term if the economy continues to gradually improve and interest rates remain low. But the huge increase in prices of high-yield bonds (now at or approaching par for most of the high-yield universe) means that our expectations for returns over our five-year investment horizon have fallen.

Flexible Fixed-Income Strategies: Eighteen months ago there were many table-pounding opportunities in the fixed-income market as everything outside of the government-backed market was in the bargain bin. Since that time every fixed-income sector except for government bonds has rung up big returns. Now, however, the opportunities are not so compelling, though on a five-year basis the return potential is higher in non-government bonds. So for the most part we hold funds that have a high



degree of flexibility. The focus of these funds varies—several will take some non-U.S. bond exposure, they will take some corporate bond and non-agency mortgage exposure, they may manage their duration (maturity strategy) more flexibly, or they may have expertise in a specific slice of the market. Overall we believe our fixed-income exposure will be subject to materially less inflation/rising interest rate risk than the overall bond market and has higher return potential—possibly as much as one to two percentage points (except in a period of extended deflation or near-zero inflation). It also gives us some defensive ballast, though less in the double-dip recession scenario than the overall bond market. That is the compromise, but we make up for that in other ways at the portfolio level.

The Value of Our Research is in the Decisions We Make With It

Investment decisions involve determining if you are being adequately compensated for risk. We think risk assets like stocks are not priced attractively enough to fully compensate investors for the risks we see. But periodic declines in the years ahead could give us opportunities to improve returns by adding risk when we expect to be paid better for taking it on—this requires patience.

The possibility that it may take years to complete the process of deleveraging is not uplifting. Skewing towards a positive view when the environment doesn't support it may feel better, but is not a path to generating better returns, so we are committed to working hard to understand the reality we live in and make decisions accordingly. That said, we think a volatile, challenging environment plays to our strengths. We have added significantly to our research capability in the past decade, and we think over the next decade this will help us ratchet down risk when it doesn't make sense to take it, and take advantage of opportunities when they are presented. If we can do this successfully then our own outlook is decidedly better than the mediocre outlook suggested by the big picture and current valuations. — *[Opis Advisors, Inc. Research Team, 4/9/2010]*

Stock and bond values fluctuate in price so that the value of an investment can go down depending on market conditions. Stock prices may fluctuate due to stock market volatility and market cycles, as well as circumstances specific to a company. The two main risks related to fixed income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. Investments in higher-yielding, lower-rated corporate bonds are subject to greater fluctuations in value and risk of loss of income and principal. Investments in foreign markets entail special risks such as currency fluctuations, political developments, economic and market instability. Investing in emerging markets involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size and lesser liquidity.



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