Opis Advisors, Inc.®

September 2010

Investment Commentary

The first six months of 2010 have been a bit of a roller coaster—domestic 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 nearly 7% for the year by the end of June.

Our commentary examines the economic "tug of war" being reflected in the stock market, with improving economic and company fundamentals on the one side, and concerns about debt-related stress points and the longer-term strength of the economic recovery on the other.

Our view of the big-picture environment we face in the next few years remains unchanged. The recovery continues but it is not inspiring, and we see above-average risk in spite of being early in a recovery cycle.

Stocks continued their slide in June, ending the first half of 2010 with losses in every segment of the equity market. The S&P 500 Index lost 11.5% for the quarter, and is down 6.7% year to date. The Russell 2000 index and The Russell MidCap™ Index 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 MSCI EAFE Index dropped 13.3% in the second quarter, bringing its year to date loss to 12%. MSCI Emerging Markets 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 Lehman Brothers U.S. Aggregate Index, 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 J.P. Morgan Global 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.

In our balanced portfolios, the largest contributor to performance was our tactical allocation to emerging-markets local-currency bonds (ELB). Other tactical positions, such as our new investments in arbitrage strategies and our overweight to investment-grade bonds versus U.S. equities, also helped performance. We talk more about our current views and future performance expectations in the commentary below:

Investment Outlook

As noted in the performance review above, the first six months of 2010 have been a bit of a roller coaster—domestic 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 nearly 7% for the year by the end of June. This reflects what we see as an economic "tug of war" in the stock market, with improving economic and company fundamentals on the one side, and 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 markets stuck in a trading range (i.e., bouncing around within a range with noclear trend). 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.

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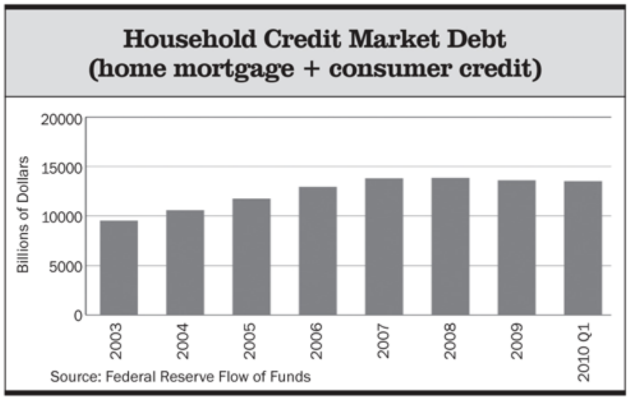
Though we won't forget the market freefall of 2008, now that there has been a strong stock market rebound from the bottom, it's interesting to compare market levels today to three years ago. Despite the rebound they continue to reflect a level of economic stress:



Credit is contracting but it's been a drop in the bucket in terms of total debt outstanding (shown here) and also relative to household income (not shown).

As long-term investors, our views tend to evolve gradually rather than change suddenly based on new information (the fall of 2008 being a notable exception). That's certainly been true in recent quarters with our assessment of the big picture unchanged.

The Challenges We Face

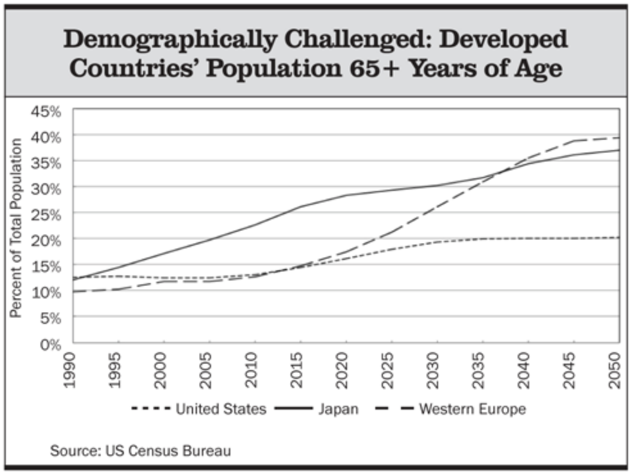
It's no secret that there is too much debt in most of the developed world—the United States, Europe, and Japan. We've written about it ad nauseam. That the problem is identified doesn't lessen the challenge. In coming years the developed world must walk a tightrope as it deals with the pressing need to slow and ultimately reverse debt growth without also seriously harming economic growth rates.

The United States and other countries with excessive household sector debt are in the early stages of what is likely to be a long process of deleveraging. Though it is dropping, household debt relative to income remains excessively high. Most of these countries must also dramatically reduce public sector (government) debt growth and in some cases they will need to reduce the absolute amount of debt. This huge challenge has not yet begun.

The timing and aggressiveness with which public sector debt and deficits are attacked will be extremely tricky to get right given current economic headwinds. On the one hand, too much austerity coming from very tight fiscal policy can be counterproductive because it risks smothering already weak growth, which reduces tax revenues, increases social safety net spending, and could weaken the political will that is needed to follow through on spending discipline.

But waiting too long to tackle rising debt levels digs a deeper hole and risks a lenders' strike, which could result in government borrowers (and all others too) being forced to pay a much higher interest rate to finance their debt. At the extreme, as we are seeing with Greece, debt levels become unmanageable as borrowing costs become untenable, resulting in a crippling crisis for the country and a ripple effect that in a global economy has reached far beyond Greece's borders. A critical unknown is whether enough countries, including the United States, can thread the economic needle so that the recovery has time to gain steam while maintaining lender confidence that the deficit/debt problems will be addressed over time. Slowing and ultimately reversing the growth of debt is further complicated by aging populations—a reality that most of the developing world faces to different degrees.

An aging population presents several challenges. It means that savings rates will face downward pressure as more of the population moves from working and saving to retiring and depleting savings, and paying fewer taxes given lower income. More retirees also mean more government retirement and health care expenses (Social Security and Medicare in the United States). This is fine if pensions and health care are fully funded. But that is not the case.



A large portion of Japan's poplulation is over 65 and the percentage will move sharply higher in coming decades. Europe's demographics are not too bad at present but are set to get sharply worse over the next 30 years. The U.S. population is also aging and though the 65+ age group will be a much large percentage of the total population in 25 years, we will be much better off than Japan.

While the private sector gradually de-levers, and we wait for the public sector to later do the same, at least the United States is experiencing an economic recovery, albeit a tepid one. There has been clear improvement from the depths of the recession. The economic cycle is, for now, a plus, but the big problems have not been resolved.

Three variables critical to improvement in private-sector consumption and a normal recovery—the labor markets, credit growth, and housing—remain weak. We are still down about eight million jobs from the peak and in the private sector job growth is barely positive – though that is an improvement from last year. Credit market debt is contracting as it has been for about two years, which removes an important driver of consumer spending. And the housing outlook, which is critical to household financial strength and the banking sector, remains cloudy and appears to be slipping backward with an expiration of the homebuyer tax credit.

The rest of the developed world looks worse. Europe is experiencing very slow growth, southern Europe is uncompetitive and has many countries in various stages of sovereign debt crisis, and economic policy is a challenge given a single monetary policy in the eurozone, but no political union and differing economic situations.

Fortunately, key parts of the developing world are in much better shape with stronger balance sheets, higher growth rates, younger populations, and slowly emerging consumer sectors. Their strength is an important source of support for the global recovery. And there are other positives that help to mitigate the negatives. The continued impact of massive federal stimulus (though this will wane later this year in the United States), healthy corporate balance sheets and cash flow (after huge cuts to expenses), and a natural rebound in economic activity after a huge decline are also sources of strength in the U.S. and global economy.

Thus, our view of the big-picture environment we face in the next few years remains unchanged. The recovery continues but is not inspiring, and we see above-average risk in spite of being early in a recovery cycle.

Capturing Returns and Protecting Capital—Our Investment Posture

In assessing potential returns, our scenario analysis approach has been invaluable, and we believe, a superior approach to traditional valuation analysis. This approach allows us to be forward-looking so that we can factor in a number of possibilities that impact potential returns over our decision horizon, and it gives us the advantage of considering a range of outcomes when we make investment decisions, rather than requiring us to correctly identify one specific forecast.

Stocks: After a huge stock rebound from the market depths of March 2009, our equity scenario analysis continues to suggest that developed stock markets offer only low to mid-single-digit return potential over the next five years. On the positive side, we continue to have some optimism that the low-return environment we think is likely may be a good one for highly skilled active managers to add value over their benchmarks.

Bonds: Within our bond allocation, while high quality investment-grade bonds only offer minimal return potential over our five-year horizon, they do offer a defensive investment that could perform well if the economy is very weak or falls back into recession. Additionally, the fixed-income vehicles we hold are more aggressive and potentially more volatile than a typical investment-grade bond portfolio, as we believe these fixed-income positions will capture materially higher returns and provide much better protection against unexpected inflation and in a rising rate environment.

Among the fixed-income asset classes, we still find emerging-markets local-currency bonds to be the most compelling from an expected risk/return standpoint, though we don't expect returns to be excitingly high. Potential ELB (Emerging Markets Local Currency Bond) return comes from the interest income and our expectation that the economic fundamentals (less debt and more growth) in many key developing economies are very likely to lead to currency appreciation (versus the dollar) over a multiyear time frame. In all but our most pessimistic scenario we expect returns from the ELB asset class to range from the mid- to high single-digits, possibly even into the low double-digits. Moreover we view this asset class as significantly less risky than equities. However, it is much more volatile over the short run than investment-grade bonds and we don't view it as a defensive asset class—rather, we view it as a hybrid when we assess its impact on our overall portfolio level risk.

Assessing five-year return expectations is a critical step in our investment process; however, so is our portfolio-level risk analysis. This step involves assessing how each portfolio is likely to perform in various one-year risk scenarios, then using this information to further calibrate the exposure to various asset classes. This process, along with our individual asset class analysis, has resulted in our portfolios being materially underweight to equities and therefore somewhat conservatively postured. We believe we are positioned to perform better than benchmarks in a bear market or a low-return market. However, if stocks have a strong upward move, our portfolios are almost certain to lag their benchmark returns.

Though we recognize a positive investment scenario is possible, as is a temporary period of strong market performance that could be driven by improving economic news and impatience with the near zero return offered by the money markets, we are clearly not placing a high probability on a bullish environment. For some time now, our view of the opportunities and risks for investors hasn’t been very encouraging. And while the story is what it is, it is also important to remember it won’t last forever—there will be better opportunities at some point. We hope that some of those opportunities will come soon and allow us to perform better than what the broader markets give us. But we’re prepared to be patient. In the meantime we are working hard to ensure that when opportunities do present themselves we are in a position to recognize and take advantage of them, while also being highly attuned to the potential risks in this uncertain environment.

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The S&P 500 Stock index is a widely recognized, unmanaged index of common stocks. Past performance is no guarantee of future results. Average annual returns assume the reinvestment of all distributions and/or dividends. Indices are unmanaged, statistical composites and their returns do not include payment of any sales charges or fees an investor would pay to purchase the securities they represent. Such costs would lower performance. It is not possible to invest directly in an index.

The Russell 2000 is an index comprised of 2000 smaller company stocks. Used as a measure of small cap stock performance. It is not possible to invest directly in an index.

The Russell MidCap™ Index is an unmanaged index generally representative of the US market for medium capitalization stocks. It is not possible to invest directly in an index.

The Morgan Stanley Capital International Europe, Australia and Far East Index (MSCI EAFE Index) is a widely recognized benchmark of non-U.S stock markets. It is an unmanaged index composed of a sample of companies representative of the market structure of 20 European and Pacific Basin countries and includes reinvestment of all dividends. Individuals cannot invest directly in an index.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. Individuals cannot invest directly in an index.

The MSCI US REIT Index represents approximately 85% of the US REIT universe. Individuals cannot invest directly in an index.

The Lehman Brothers U.S. Aggregate Index tracks investment-grade corporate and government bonds. Individuals cannot invest directly in an index.

J.P. Morgan Global Government Bond Index tracks government bonds in the U.S. and 12 international markets. Individuals cannot invest directly in an index.

The JPMorgan GBI-EM Global Diversified Index consists of the Government Bond Index-Emerging Markets span over 15 countries. Individuals cannot invest directly in an index.

Foreign Bonds – These are issued by governments or corporations located outside of one's domestic market and trade on foreign financial markets. Also, as one may expect, these bonds most often trade in the currencies of their domestic markets. A strong move by the U.S. dollar against the foreign currency would reduce the effective interest/principal payment you would receive after conversion. As such, it is important when investing in foreign bonds to understand this risk and evaluate the likely move of the relevant currencies before purchase. Default risk is of particular concern for foreign bonds that are issued in less industrialized countries or nations where there is considerable political strife. Under these conditions, interest rates and monetary policy can fluctuate more widely than in more established countries.

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