



*November 2010*

## Monthly Investment Commentary

The fourth quarter got off to a positive start with gains across all equity asset classes. Large-cap domestic stocks, as represented by the S&P 500 Index, returned nearly 4% in October, with mid- and small-cap benchmarks generating similar gains. Turning abroad, the MSCI EAFE Index was up 3.6% for the month and the MSCI Emerging Markets Index rose 3%.

As is often the case in periods with strong equity gains, fixed-income returns for October were more subdued. The Lehman Brothers U.S. Aggregate Index returned 0.4% for October, while municipal bonds, as measured by Lehman Brothers 7-Year Municipal Bond Index, were slightly negative (-0.1%). Fixed-income returns overseas were stronger, with the J.P. Morgan Global Government Bond Index 1.4% and our emerging-markets proxy, the JPMorgan GBI-EM Global Diversified Index, gaining 1.3% for the month.

All asset classes we follow are well into positive territory for the year to date.

**Profit Drivers: What Do They Mean for the Global Economy Over the Next Decade?**

**A discussion with David Levy, chairman of the Jerome Levy Forecasting Center**

*David Levy, chairman of the [Jerome Levy Forecasting Center](#), and his team currently have a sobering view of the U.S. economy and have for many decades utilized the “profits perspective” to analyze U.S. economic cycles, with considerable success. The profits perspective focuses on the sources of profits or sectors of the economy—domestic and foreign—that add to or subtract from profits. This allows Levy and team to estimate the total volume of profits in an economy (as opposed to just S&P 500 profits) and where they might be trending. Below, we share excerpts from a recent discussion we had with Levy on the U.S. economy and equity markets. This Q&A is a useful input to our own overall scenario analysis and is, we think, an interesting read for anyone charged with making longer-term investment allocation decisions.*

David A. Levy is the third generation family member to head the independent economic consulting firm, Jerome Levy Forecasting Center. He is an expert in applying the profits perspective to economic analysis, with over 30 years of professional forecasting experience. Levy has given briefings, consultations, and testimony to members of Congress, administration officials, and Federal Reserve governors, and he is frequently quoted in the press. He holds a bachelor’s degree from Williams College and a masters from Columbia University.

**Please summarize the key elements of your framework, the “profits perspective.” How do you use it to assess the economy and the financial markets?**



The profits equation is a statement that lets us see how much of the wealth that is being created in the economy is flowing to the business sector. It is an accounting identity, derived from the Saving = Investment equation. Aggregate profits (the combined profits of all firms) have major implications for the larger economy, but they are broadly ignored in conventional economic models. Production, employment, and capital spending for the economy as a whole are strongly influenced by aggregate profitability. Therefore, understanding the determinants of aggregate profits leads to powerful insights into these activities and other economic phenomena, including inflation, unemployment, and business cycles.

The wealth that the business sector accumulates is a reflection of how much new wealth is created in the economy less the wealth captured by others in the non-business sectors—households, governments, and the rest of the world. This is different than the equation for the profits of a single firm.

### **Could you elaborate on the key sources of profits that make up the profit equation?**

The primary source of wealth creation in the economy is investment. That includes the three parts of fixed investment: 1) business purchases of structures, 2) business purchases of equipment and software, and 3) residential investment.

We also have inventory investment. If we are accumulating a lot of goods, we're actually accumulating wealth. If we decide the wealth isn't worth as much, we have to write down the inventories, and inventories are sold off and liquidated, and that's a negative for profits.

Moving on, there's another term, "government." The federal deficit is a source of profits. The federal surplus is what we call a negative source of profits. Personal savings is another negative source of profits. Finally, there is the foreign sector: a current account deficit is another negative source of profits.

If you use the profits equation and take a look at what happens as balance sheets change, we realize that all of the determinants of profits—what we call the profit sources—are tied to balance sheet expansion.

If we leave out the government for a moment, we can say that if private-sector balance sheets don't expand, the economy cannot produce profits. Period. Now that doesn't mean there won't be some firm that makes a profit. But then another one must have a loss.

So we really have an enormously different take on what's going on in this period than if we sit back and say, Oh, the economy's been growing, and some financial things simply got ahead of themselves and caused problems, now we have a headwind.

We have a much more powerful statement that says, We went through a period of enormous



balance sheet expansion. It generated unusually large profits, even when certain activities that normally create profits, such as business investment, had been weakening over the last 20 years or so. Now we have gotten to the point where, as things have broken down, private balance sheets are contracting, and the economy simply cannot function. The only reason it is functioning to some degree is because of that profit source—government savings.

When the government spends a whole lot more than it takes away in taxes, it is injecting wealth at its own expense into the economy?

When the government spends a whole lot more than it takes away in taxes, it is injecting wealth at its own expense into the economy. The federal deficit currently more than fully accounts for all of the profits in the domestic economy. The dismal outlook for the private profit sources over the next few years as balance sheets contract, along with political pressure to keep the federal deficit from continuing to expand from its current level, will make it hard for profits to continue rising.

**You say balance sheets are contracting and profits cannot rise because of that; can you tell us more about why you believe that will happen?**

First of all, we need to look at where the profits are now. At this point, we have a very large and growing fraction of earnings that are coming from abroad. If we could take that out, we would see that the recovery in domestic profits (which are a better reflection of conditions in the domestic economy) has not been nearly as good. For total corporate profits, we're just a little below the peak of 2006. If we look at just domestic profits, it's a double-digit percentage below that point.

One of the reasons that profits in the whole economy are not as strong as those reported for the S&P 500 companies has to do with what's not included in that measure. Large businesses have been doing much better than medium and small businesses. A lot of this has to do with access to both equity capital and credit. Banks and other institutional lenders have tended to be very reluctant. Only in the last quarter or two have we seen some of the Fed's surveys showing a little bit of backing off of the very, very tight standards and defensive postures of banks.

But on the other hand, investors in the bond market have been much more aggressive. So companies with access to the bond market have had an advantage.

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One of the nice things about using the profits equation is that we can look back at history and see



what was responsible for an increase in profits or a decrease in profits. What's striking about the current situation is that the dominant influence on rising profits has been the massive expansion of the federal deficit.

Now the federal deficit is plateauing, more or less, and it's one of the reasons why the economy is not continuing to pick up. Meanwhile, the rebound in inventory investment is probably near its end, the outlook for fixed investment is poor, and there are significant pressures on households to continue increasing their saving rate. The profit sources that drove the recovery in aggregate profits have, by and large, run out of gas. By the fourth quarter, we estimate that we're going to see some disappointment that will become greater in the early part of 2011.

**Do you think it's helpful to look at long-term historical trends to see how earnings grew during different economic environments?**

I think the tricky part is that we're dealing with some changes in the economy that do not have a precedent. We have exited an era of rapid private balance sheet growth, which lasted for the past few decades. Now we are in a contained depression, and the economy will operate very differently as a result.

We got a little taste of the kind of downward spiral that can occur in the economy and in the financial system during the last down episode. The problem is we're still dealing with a lot of deep financial problems that we see as headwinds now, but there is the potential—in fact, I would argue there's a high probability—of them becoming something considerably worse.

For example, I think we dealt with the worst of the mortgage-backed derivatives crisis. What we haven't dealt with is the worst of the mortgage crisis. A lot of people are in houses they can't afford, and they certainly won't be able to afford them if they don't get jobs. Households have way more debt than they can manage. Asset prices became way above what can be justified by the returns they can produce. And whether it's the financial sector or the corporate sector or the household sector, balance sheets have to contract. That means the economy simply will not be able to sustain any kind of growth or expansion or even stability without very large government-deficit spending.

This is a time where we're going through adjustments. We don't want to do what the Japanese did and delay the adjustments. We want to move those adjustments along and we want debt to be written down. But during that period, we have to put on a lot more public debt. It's better than having a complete collapse of the economy.

**To clarify the term “contained depression,” you're saying that other than the government, almost every sector in the economy is going through a balance sheet correction. If the government were not stepping up to do fiscal stimulus, we would be in a “great depression.” Correct?**



Yes. The fact that the government is actively passing some bills that enlarged the deficit somewhat has added a little bit of extra cushioning. The most important feature is the automatic stabilizer: when the economy gets weak in a recession or depression, the deficit automatically widens as revenue falls off and social outlays pick up a bit.

The other thing that we haven't touched on that's just as critical is having an effective lender-of-last-resort that prevents a downward spiral of defaults and failures in the financial sector. I don't think it's hard to imagine what would have happened in 2008-2009 if we hadn't rescued Citibank and Merrill and AIG, etc. The eurodollar market and the international financial system would have collapsed.

In our modern economy, there would've been a greater depression. Let's face it—I don't know about you, but I'm not as likely as some people were in the '30s to go grow vegetables in the backyard and do handicrafts that we could barter with. We're in a modern and highly complex, highly specialized economy. Without our financial system working, we're cooked.

**The federal government was able to stop the debt deleveraging in the early '90s and then again in early 2000. Why do you think they can't stop it again now?**

That's a great question. We saw elements of balance sheet overexpansion in the 1990s, and that's when we first coined the term, "contained depression," as an effort to try to describe what we saw happening.

We had too much capacity. We had a whole string of financial problems at failing institutions. No one wanted to expand.

However, what we did not accurately judge at the time was the ability of lower interest rates to help the economy escape from that contained depression.

We're in a modern and highly complex, highly specialized economy. Without our financial system working, we're cooked.

Lower interest rates created an enormous revaluation in any asset price that hadn't just collapsed—especially stocks. The effect of that—the wealth effects—not only for individuals but for new tech companies that suddenly had so much cash coming in . . . it was very easy for them to start expanding. Then when things broke down—when the stock market plunged in the next downturn, 10 years later—it turned out that the drop in interest rates this time was able to channel into this enormous amount of money coming out of real estate. That stabilized the economy and offset the negative wealth effects. It soon created even greater wealth effects of its own.



What made a difference this time is, we ran out of room to drop interest rates.

Everybody that could refinance and pay their debt [did so] when the fed funds were 1% and the Treasuries had dropped down to around 3% in 2003.

There wasn't a whole lot of room to go lower in the next expansion. Remember, every time the Fed dropped rates—from 1982 on, when the rates were extremely high—rates fell to a level that was substantially lower than anything anybody had seen for years. So each time there was a huge refinancing opportunity and a huge excuse to push up the valuations of . . . the next hot asset class if not multiple classes.

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If there's some way somebody can figure out how to create the financial circumstances to greatly expand balance sheets again—enough to generate enough profits to lift us out of this link to the federal government—we could get lifted out of this contained depression.

I think that's going to be tough to achieve. First, we have these deep problems with mortgage loans. We have people who have been beat up both in the stock market and in the real estate markets. They're not sure what to do now. There's just no place that I can see where we're going to get a new bubble in the economy.

Where we are getting [a bubble], of course, is in some other parts of the world. It's not Europe. Not Japan. Some in China. Some in East Asia, ex-China, and Japan. Some in India. Some in Australia. Some in Canada.

The problem is, these parts of the world are not big enough to carry Europe, Japan, the United States.

### **Could quantitative easing help?**

One of the questions that comes up a lot these days when we talk to our clients is QE [quantitative easing]. Our view is, QE can do a little, but it can't do much.

QE was very important in 2008 and 2009 as a major mechanism for the Fed's lender of last resort function. If the Fed is going to intervene in the Treasury market and just go out further on the yield curve and try to drive down yields, we suspect they will have some effect. The market will certainly jump ahead. Maybe we've seen some of that already.



But the benefit to the economy and financial conditions won't be huge. In the residential real estate market, the people who are refinancing as a result of lower mortgage rates are mostly the ones who keep refinancing. There is a huge number of people who are not going to be bailed out by saving another 127 bps on their mortgage payments. The people who are in trouble are in trouble, period. In some cases, we may even have people paying down equity. Or paying down debt. So in essence, it's a cash-in rather than a cash-out refinancing.

Meanwhile, commercial real estate is always—to a large extent—mostly finance driven, rather than necessarily demand driven. There's no demand for space right now. I think as a result, with the deflation of the assets, we might see some spurts of purchasing in certain areas as people try to bottom-fish and take advantage of low financing to do it. But we're not going to get the kind of investment that's going to turn commercial property prices upward overall or lead to new construction to any significant degree.

**You assign more than 50% probability of a downturn or a double-dip or another recession in the next year or so. Why do you believe that?**

The conclusion comes from our analysis of profit sources.

Let's start by looking at the private sector profit sources. We have fixed investment in equipment and software. That's the one area that we see some bounce happening.

However, we think this is largely pent-up demand for equipment and purchases that were delayed during the crisis and recession. The other part of it is, of course, we're having a lot of companies that I think had put off going to the next generation of whatever kind of technology they're using.

Those things, I think, will tend to run their course for a few quarters. But we do not see signs of business as looking to do major expansion. Again and again, the sentiment comes back that we just want to keep overhead down. The reason is that it's a period where there's extremely little growth in top-line and widespread overcapacity.

It's clear that these are still historically quite low rates of return. So investors are concerned about the profits relative to their investment. When balance sheets have gotten big relative to the economy, you have very large total equity value relative to total sales. You end up with large profit margins, but yet not great return on equity. I think that is going to continue to dampen investment. So after this spurt of catch-up, I think it's going to level off.

Meanwhile, housing, after having a little bit of a boost—very little—from the tax credits, it's now going into a payback period. While we don't think that will last too long, basically housing is not going to grow. Residential construction as a source of profits will not grow. We also see further weakness and probably declines in commercial construction in the quarters ahead.



Inventories have been growing fairly rapidly. Our analysis is a little different from a lot of other people we see. Based on what we think of the business environment, and based on a number of the diagnostics we have about how businesses are experiencing delivery delays and such things. [ . . . ] Actually, businesses now are starting to overbuild inventories a little bit. They're not going to maintain these high rates of inventory investment. Then we have the state and local sector, which we haven't talked about yet. That's undergoing a severe set of financial stresses that are forcing it to contract. Like the federal government, if it runs deficits, it's actually a positive for the rest of the economy's profits. But if they're working like mad to try to reduce those deficits, they actually become a source of [profit] drag.

Then there's the household sector. We think the pressures on households to continue to reduce their debt and to cut back on their spending are very strong. The debt reductions in the household sector so far essentially reflect debt being written off. The people whose debt has been taken off the books are the people who are not going to be able to borrow again. There are plenty of people who lost jobs or lost parts of their incomes—going into tens of millions. They've been under enormous strain to support their living. They're losing the ability to [borrow] and they're going to have to consolidate further.

That basically leaves us with an economy that really doesn't have much potential for profits to grow. And the big question is, [ . . . ] what's the federal government going to do? If we knew the answer to that question, we would be talking a lot more about what we think would happen next year.

**This is your short-term view, that profits are trending down, and as such, you expect the economy to turn down. Could you talk about profit trends you see looking out longer-term?**

I think we're going to see overall dissatisfaction, with this tendency for margins to widen quite a bit during expansions without a whole lot of reaction to it. But in the downturns, and I don't know how many we'll have during the contained depression, earnings will drop.

The other thing is, the growth in profits is going to be stunted because the economy is not going to grow much. Sales aren't going to grow much.

That's before we even work in the outlook for pricing. We're not looking for a steady deflation, although it's possible. I think we're going to see some periods of deflation. Overall, it's likely we'll see minimal price increases over the next 10 years or however long this process of private balance-sheet repair takes.

**What about the rest of the world?**

I think even if we make the [reasonable] assumption that there are parts of the world that aren't



suffering from the kinds of problems that we have and still have a lot of growth potential—this would include countries like Brazil and China and India—they [nevertheless] have a great deal of vulnerability to the United State.

In particular, China and to some extent India—because of all of their service exports—are going to take some shots at some point from what happens to the rest of the world. Given the financial complications and so forth, I think that they're eventually going to get ahead of themselves and could correct, perhaps violently.

But that doesn't mean they have to go through the same kind of period of years and years of working off excesses. China's biggest problem is that it has built up this huge export sector that the rest of the world is not going to be able to support. And the rest of the world probably will not be tolerating it as well politically as time goes on.

**Are emerging markets big enough to really impact the U.S. economy-wide profits in a material way?**

I think the answer is no. The rest of the world does not have enough size yet and enough independent profit generation to act as a locomotive—to use the popular cliché.

In large part, China is a conduit through which the United States, via its trade deficit, is pumping profits to other countries.

**So to net everything out, what is your best-case scenario in terms of profit trends five years or so out?**

Modest growth trend with a lot of potential for downside volatility.

One of the things we do here is stand up and say when we just don't know something. I think the range of possibilities for earnings over the next five or eight years is very large.

I would say the best is going to be disappointing, below any kind of a trend that people have seen for any length of time since the '30s. There's the potential for overall declines, and certainly for some very sharp temporary declines.

There's a lot of room for governments to do some [obviously] disastrous things along the way. I'd think in a country like this we'll be able to recover from them, but again—as I said—we're not terribly worried about a Great Depression. But we are worried about making things considerably worse at some point than they are now.

I think the contained depression is going to take about a decade [to unwind]. We'll be lucky if it's a little bit less.



**If you think we are in this contained depression, how long do you think it will last? And, under what set of conditions might it end?**

I think the contained depression is going to take about a decade [to unwind]. We'll be lucky if it's a little bit less.

This is a multi-business-cycle adjustment. No matter how much the government blunders this way or that way and what they do that may hurt the economy . . . we [will eventually] have to stabilize it.

Eventually, we [will] have asset prices that are way down. We [will] have debt levels that have come down largely through write-offs and a lack of new borrowing. We will have physical capacity that has shrunk partly through shutting down, partly through obsolescence and partly through aging, because of a lack of new investments.

We [will] get to the point where the technology that's still in place is farther and farther behind the technology that's available and needed for the day. You're starting to build up enormous pressures for reinvestment.

While we're pessimistic about the outlook over the next year and certainly overall for the performance of the economy over the next six or seven years probably, we do have a very strong long-term optimism.

**You say the government needs to take on debt and spend to offset private-sector deleveraging. Why is the rise in public debt not a concern?**

First of all, it is healthy for the U.S. government to take on a lot of debt in this period. The U.S. government can take on far, far more debt than a lot of people think. It's a widely misunderstood issue.

Three countries that people worry about a lot —the United States, the United Kingdom, and Japan—all have characteristics that give them a very, very high capacity to carry debt. It's interesting to note that all of those countries have had over 100% debt-to-GDP ratios in the past without any of the negative inflation consequences. We were about 110% after World War II. The United Kingdom, since they started having a parliamentary government that issued its own debt rather than it being the king's debt, has had debt ratios over 250% of GDP, using the most-conservative estimates of GDP.

Periods of high debt accumulation in these countries reflect either depressions or wars. At the end of a depression or the end of a war, you have enormous private investment, which lifts the economy and brings debt ratios down.



Let's just talk about the United States. We have complete control of the currency in which our debt is denominated. We do not owe debt in euros or yen or others, to any significant degree. We also have deep Treasury-debt markets. We have an effective tax-collection system, which is critical, unlike the Greeks, who have a lot of trouble doing it.

**As the public sector takes on more debt, how does the contained depression come to an end given that overall debt levels may still be high?**

When it ends, I think we will see public debt levels come down very rapidly.

It's worth noting that the United States took its debt ratio from 109% debt-to-GDP in 1946, to 52% debt-to-GDP [10 years later].

This is just because of the power of having a booming economy. Even with low rates of inflation, you have tremendous growth after having these years of not investing very much.

Just as you have a vicious cycle when balance sheets are contracting, you get a virtuous cycle when it comes back.

If the United States had to go well over 200% public-debt-to-GDP in this period, we could handle it. We would not have to fall through. We would not have hyperinflation. We wouldn't have anything of the sort.

**Given your profits outlook, what's your view on U.S. equity markets?**

We are not positive toward them. I think it's going to get tougher as the earnings are disappointing. That makes me guarded about the short-term. I believe that valuations and the levels of profits are both going to come down sometime probably in the next year—substantially. If not, sometime in the next couple of years. Possibly they'll come down very, very steeply. This is a time to be keeping powder dry, and to be thinking about the opportunities that are coming up.

**What would be your guess of the level of annualized sales growth companies can generate in this contained depression?**

The answer is, not much. I have to give you the same kind of answer I gave to the profits question. That is, there are many possibilities. You have the possibility of having between now and 2020, overall, some deflation; perhaps we'll have an average of tiny positive inflation. We have the possibility of having a fairly sharp downturn and then a gradual recovery that picks up steam toward the end of that period, or perhaps a second downturn at that point. There are many possible scenarios. But overall, we expect disappointing average sales growth during the contained depression.



**To conclude, is there anything that we have not talked about that investors should be thinking about over the next three to five years or even longer from an investment standpoint?**

The number one thing right now is conservation of capital. We're so used to saying, We've got to find ways to get returns, what are we going to do this quarter? This year? The next two years?

I know that's not the kind of time frame you're emphasizing, or at least not the very short-term. But people still get that itch. But not losing money may be a wonderful performance over the next couple of years.

There are going to be some, in all likelihood, great buying opportunities due to the volatility that may come in this period.

The idea is that every year is not the same, and it's not just a cyclical problem. There are a lot of people that just want to hold their positions through the cycle and think, Don't worry, it'll all come out [okay]. We're dealing with something a little different here, and people will sleep a lot better and make a lot better decisions if they can have that in mind.

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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.

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