July 2012

Quarterly Letter

By Martin Weil

"To buy when others are despondently selling and sell when others are greedily buying requires the greatest fortitude and pays the greatest reward."

~ Sir John Templeton

During May, equity markets surrendered their considerable first quarter gains, only to claw back a good measure of those gains in June. The S&P 500 index ended the second quarter down 2.8% but remains 9.4% higher for the year, when dividends are included. Foreign stocks declined nearly 8% for the quarter, but are 4% higher for 2012. Bonds gained 2% during the quarter.

Model Portfolio Performance[i]

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6/30/2012

	Risk Benchmark	2nd Qtr	Year to Date	Cumulative Since Inception	Annualized Since Inception
All Equity	100% Stocks	-4.6%	8.4%	97.4%	5.2%
Growth	80% Stocks/20% Fixed Income	-3.3%	6.5%	94.2%	5.0%
Balanced	65% Stocks/35% Fixed Income	-1.9%	5.7%	106.7%	5.5%
Conservative	40% Stocks/60% Fixed Income	-0.5%	4.9%	103.2%	5.4%
S&P		-2.8%	9.4%	39.9%	2.6%

Returns for our four portfolio models ranged from a negative 0.5% for our Conservative model to a negative 4.6% for our All Equity model. For the first six months of 2012, our four model portfolios have gained between 4.9% and 8.4%, results in line with our benchmarks.

Foreign stock funds were the largest detractor from returns during the quarter. The specific bond funds we own all outperformed their benchmarks, with PIMCO Total Return earning nearly a 3% return both this quarter and last, Bill Gross apparently going all out to make up for his miserable 2011.

Portfolio Updates

Following the basic research and recommendations we employ from Litman Gregory, we are increasing our allocations to foreign equities, taking advantage of a massive sell-off in the sector. In the face of near-universal fear of a Eurozone collapse, this is a decidedly contrarian move. While we do not discount the possibility of a total meltdown in Europe, markets both in the Eurozone and the Emerging Markets are now priced for a severe economic downturn. Even were this to occur, at these prices, we believe investors will be well rewarded over a five-year horizon. Our intent is to opportunistically acquire an overweight to both Europe and EM markets during the coming months.

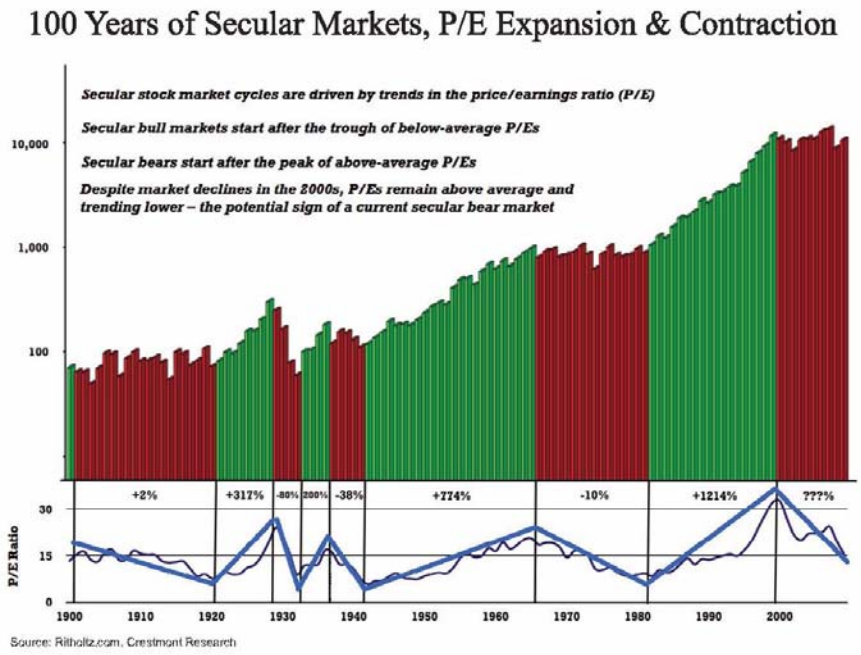
Even with this increase in risk exposure, we remain underweight stocks in general in all but our All Equity model. Within this equity underweight, our holdings are strongly tilted to those funds investing in

large cap, well capitalized, market leading, brand name stocks. This approach reflects our core belief that we are in a multi-year range bound market, with the likelihood of sub-par returns ahead, but nonetheless, a market with substantially heightened risks.

Why We Are Still on Defense

The quandary facing asset managers today is how to navigate equity markets that continue to offer sub-par longer-term returns, but have exhibited heightened volatility and risk. Some managers have elected to proceed as if ongoing excessive valuations and debt levels in the global financial system are beyond any individual's ability to manage. There is much to be said for this "steady as she goes" approach for longer-term investors. One thinks of Warren Buffett in this regard, the ultimate long-termer, who has famously quipped that his preferred holding period is "forever." If your investment horizon is forever and you own good investments, what happens this year or this decade truly is of no consequence.

Unfortunately, for a good percentage of us, the reality is that our time horizons are not forever. Whether five years or twenty-five, there is a point at which almost every one of my clients envisages that day when they, or their heirs, will begin to spend some of their accumulated savings. The earlier you plan to start, the shorter your investment horizon and the more damage can be caused by short-term volatility.



We continue to believe that we are in a long-term range bound market that began with the 2000 dot-com collapse, a cycle that will likely persist until Price/Earnings ratios[1] drop once again to the lower end of their typical range. This graph by Ed Easterling of Crestmont Research provides an exact picture of our longer-term view and conveys a remarkable amount of important information. Looking at the US stock market over the last one hundred years, the alternating 10-20 year periods of steadily rising prices (green) and generally trendless periods (red)

[1] *We prefer, as does Easterlng, Robert Shiller's 10-year smoothed cyclically adjusted price-earnings (CAPE) ratio.*

are obvious. These longer cycles coincide rather neatly with rising, or falling, price/earnings ratios, as shown in the lower panel. A closer look at the top panel also shows that the red periods, with declining P/Es, are more volatile and exhibit more upside and downside annual market swings than the green periods. We are in a red cycle now.

Before we can get to a new bull market, that "rising tide that lifts all boats," this research and that of others has shown that P/E ratios must decline further from today's average levels. There are only two ways this can happen; 1) Earnings (E) grow faster than the market (P) for a number of years, or 2) the market falls to a considerably lower level relative to earnings. Obviously, the first option would be preferable, but the second would provide some outstanding re-entry points for additional risk positions.

We do not believe the financial system will collapse but we do not dismiss the potential for more serious disruption of the global markets. For this reason, we continue to err on the conservative side of the risk equation, especially for our clients who are drawing down, or close to drawing down their portfolios. This is not to suggest that our portfolios will completely avoid losses in the event of a severe market downturn, it is just that we believe these losses will be less than they might be were we more typically invested.

In Short

The financial crisis is now some four years in the rear view mirror and yet even today, many of the underlying problems of excess debt and lax regulatory oversight remain. Our thesis has been that we entered a multi-year sideways market with the dot com collapse in March 2000 and that it would take a decade or more to digest the excesses of the 1990s. Twelve years into that "decade," research suggests we may still be only about half way through the adjustment period.

We would prefer to report a happier forecast for the future, one filled with double-digit portfolio gains for years to come. But that is not the hand we are being dealt. As a responsible fiduciary and investment manager, my job is to do everything I can to keep my clients on the path towards achieving their long-term goals. This requires investment returns to be sure. However, it also means investing with prudence, and minimizing the risks of a catastrophic loss that can significantly impair a client's financial plan.

Tax Law Changes May Be Ahead

- While there can be no certainty where Washington DC is concerned, we are advising clients to plan for the possible expiration of the "Bush" tax cuts. Specifically, to expect an increase in income, dividend and capital gains tax rates and perhaps a reduction in the $5M gift and estate tax exemption, if not by January 2013, then in the near future. Individuals should discuss their specific situation with their tax advisor sooner rather than later.

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[i]**Model Portfolio Performance Disclosures:**

a) Performance shown is for each portfolio model and is not a composite of the performance of actual client accounts. While our goal is that each client account will closely mirror the holdings and performance of our models, client account performance may, and does, vary according to several factors. Some of these are listed below. In addition, there have been periods, and may again be in the future, when our evaluation of major economic and/or market events leads us to manage client account allocations in a materially different manner than is shown in our models. At these times, client performance results will vary from that of our models.
b) All MWI managed client accounts are based on one of four diversified model portfolios, composed of no-load mutual funds, exchange-traded funds and other publicly traded securities. These four models are geared to different levels of investor risk tolerance. New accounts are invested following one of these models, typically using dollar-cost averaging over a period of months, not to exceed one year. Once an account is fully invested, it is expected to track the performance of its underlying model. Exceptions to this include accounts with restrictions such as: the client-directed retention of legacy holdings and/or excess cash, substantial withdrawals or additions. Accounts smaller than $100,000 are restricted by purchase minimums at certain mutual funds and as a result do not hold all the same positions. The performance of these accounts may differ somewhat from these models. Accounts employing municipal bond funds in place of the taxable bond funds used in models will slightly underperform on a pre-tax basis.
c) Benchmarks for each model are custom created following the neutral asset allocation for each portfolio. They are constructed from Vanguard's S&P 500 index fund, iShares Russell 2000 index, Vanguard Total International and Total Bond index funds. The S&P 500 index is calculated with dividends included.
d) Net of fees: The performance for MWI model portfolios is calculated net of our maximum annual management fee, and brokerage charges, if any. The returns of the portfolio benchmarks do not include any fees or charges other than those of the index vehicles employed in the benchmark. All returns assume dividends and income are reinvested.
e) Rebalancing: Model portfolios are routinely rebalanced every six to twelve months on the last day of a quarter. Actual client accounts may be rebalanced as needed. With tax-efficiency a part of our decision criteria, taxable accounts may be rebalanced less often and/or less completely than retirement and other accounts not subject to current taxation. This may result in performance discrepancies between taxable and non-taxable accounts managed following the same portfolio model.
f) Model allocation changes: Changes to model allocations are infrequent but can and do occur at any time. When a model is changed, allocations to client accounts are changed as soon as is practical. However, changes to the model portfolios are only recorded for performance purposes on the last day of any quarter.
g) Closed funds: From time to time, mutual funds that form part of MWI model portfolios close to new investors. Clients already owning closed funds in their accounts will generally continue to hold and/or add to their positions. New client accounts will be invested in alternate funds. At year-end, MWI will substitute in its models for any funds that have closed during the year with the alternate funds available then to new clients. As a result, performance disparities may develop between older and newer client accounts, and between older client accounts and current model performance.
h) Historical performance is not a guarantee of future results. While the performance period since January 1999 includes both rising and falling stock markets, there can be no assurance that the portfolios will perform as well under future market conditions.