



Investment Review and Strategy Summer, 2010

Summary

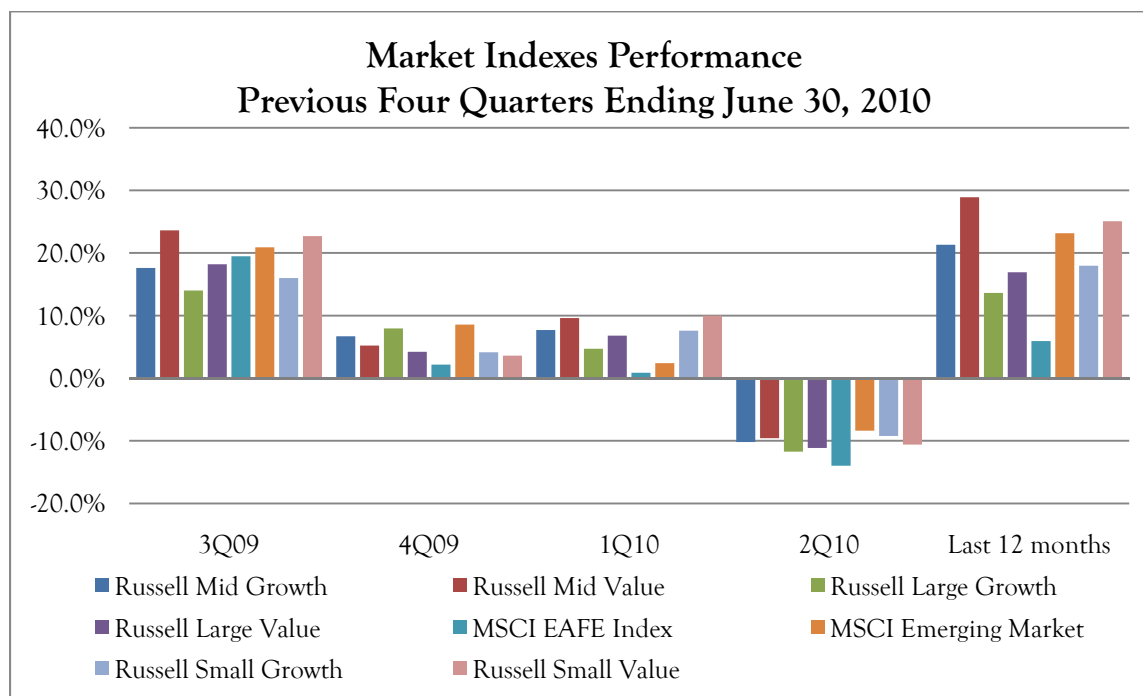
- ◆ **Stock market** was KOed by the European financial crisis and slowing U.S. economy. 2nd quarter returns were so bad, they took market indexes negative for the year. Corporate earnings remain surprisingly solid. Recent European bank stress tests indicate world is not coming to an end. Values are intriguing.
 - ◆ **Interest rates** are low, low, low as confirms limited future growth prospects for U.S. economy near term. Two-year Treasuries are at record low rates. Fed's monetary policy remains stimulative; Bernanke is considering further easing options. Fixed income investment strategy based on slow growth and prospects for disinflation. We will watch to lengthen bond portfolios to average maturities with focus on better value of corporate bonds versus government securities.
 - ◆ **The Economy** will not double-dip but will be one of longer recession recoveries. Could be a bumpy recovery with mid-recovery pause instead of usual "V" economic recovery. Jobs, housing and consumer spending are dragging. 2nd quarter GDP is expected at 3.2% versus 1st quarter's 2.7%, then slower growth for the rest of the year.
 - ◆ **Government** increased involvement in businesses. Fiscal stimulus is not having powerful effect. Financial industry reforms and other new legislation will affect everyone on some level. Federal deficit is growing problem with no resolution in site.
 - ◆ **Taxes** on capital gains and qualified dividends are likely to increase in 2011, especially for higher income earners who make up about 30% of consumer spending. Corporations are unsure of future taxes and so unwilling to make major investments, creating new jobs. States and local municipalities will need to increase taxes to cover basic services. Major changes will alter the attractiveness of some investment strategies.
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HSA's Diversified Portfolio Market Style Tactical Allocation

Market Style Sectors	Commentary
Large Cap Growth	Increased weighting as Large Cap companies are at historically low valuations with solid earnings; slight bias toward Growth.
Large Cap Value	Increased weighting as Large Cap companies are at historically low valuations with oodles of cash.
Mid Cap Growth	Decreased weighting due to outperformance; continue to prefer growth over value companies.
Mid Cap Value	Maintained Weighting.
Small Cap Growth	Decreased weighting; performed well recently and now appears overvalued versus the Large Cap area.
Small Cap Value	Maintained; overpriced relative to other categories.
Emerging International Markets	Maintained; source of highest fundamental growth.
Established International Markets	Increased as Europe appears oversold; addressing financial problems increases attractiveness.
Cash	Maintained; fully invested in equities.

Stock Market Review

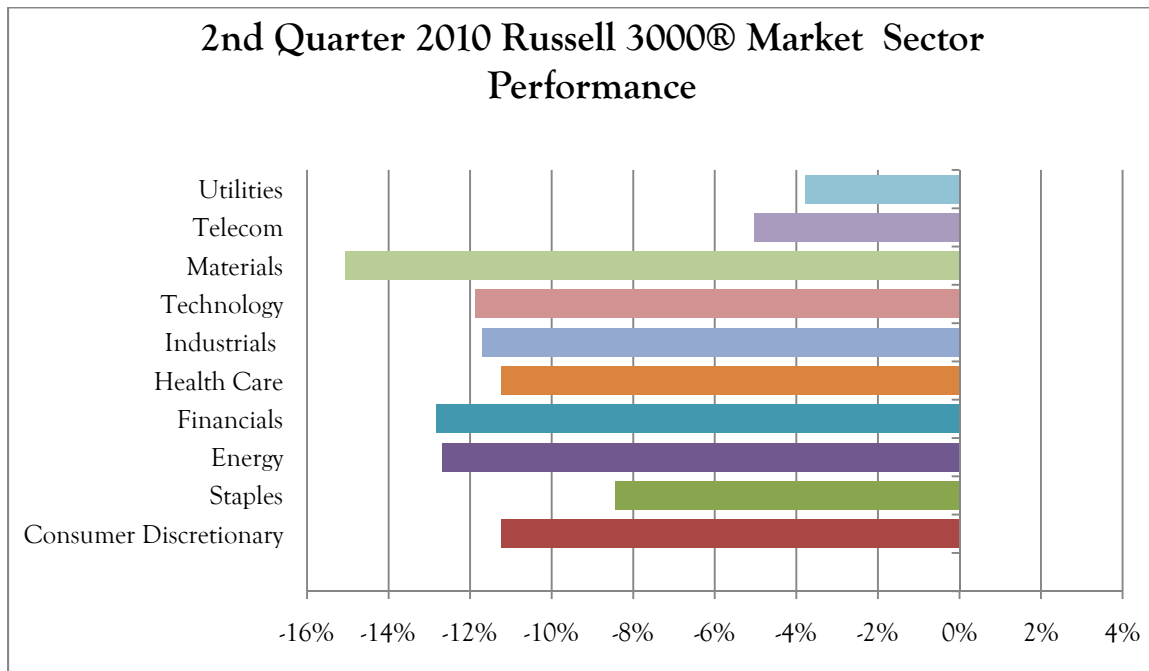
The U.S. stock market went from the best 1st quarter since 1998 to the worst 2nd quarter performance since 2002. The 2nd quarter dropped steeply enough to take out the hard earned returns of the first quarter. Declines were broad based as there were no beneficial hiding areas during the quarter. The various market styles, as shown in the chart below, illustrate the depressing results with quarterly declines between 9-12%.



The emerging markets as measured by the MSCI Emerging Market index were the best performing, dropping 8.4%. This loss compares favorably to the developed markets throughout Europe and Japan as represented by the MSCI International Index. It fell almost 14% for the quarter and is the worst performing index during the last 12 months with only a 6% rise.

Given the concerns that the world markets worked through during the 2nd quarter and into the 3rd quarter, the market's performance isn't surprising. Europe is staggering through their own financial crisis, starting with Greece and its overpowering debt load. Resolutions to Greece's problems seemed to be in hand with financial backing from the European Union and International Monetary Fund but the markets didn't buy it. Other European countries (Spain, Portugal, Ireland, and Italy) suffered from increased sovereign credit problems. Because this is the first major crisis for the European Union, new methods and coordination are needed. In the latest attempt at coordination and transparency, the European Union conducted a stress test of 91 of their major banks, hoping to assure the world that their crisis is controllable. The European Union hopes to see similar improvements as the U.S. saw after performing stress tests on its major banks last year. The good news is that only 7 of the 91 banks didn't pass the test; the bad news includes concerns that the tests were "too easy."

Sector Strategy



All ten of the economic sectors within the broad based Russell 3000® index, comprised of the 3000 largest companies in the U.S., suffered negative returns during the 2nd quarter. The following table indicates Holt-Smith Advisors opinions regarding these sectors using macro "top down" assessments. These opinions are used to focus our stock selection on those areas that have the best opportunity in the current market environment.

Stock Market Sector	Focus for HSA Portfolios	Commentary
Utilities	Underweight	Best performing sector of the 2 nd quarter with 3.8% decline, thanks to dividends; few interesting opportunities; maintain underweight
Telecom	Overweight*	Second best performing sector, down 5% for the quarter; small percentage of Russell 3000® index but there are a few intriguing small to mid-sized stocks available in this area; increased our weighting.
Materials	Neutral*	Worst returns for the quarter, dropped 15%. Hurt by expectations of a global slowdown; lowered our weighting.
Technology	Overweight	Company valuations getting more attractive; new computer cycle, cloud computing and smart phones create areas of interest; generating strong earnings and huge cash flows; maintain our overweight.
Industrials	Neutral*	Concerns increase as economy pauses; inventory rebuild mostly completed; lowered our weighting.
Health Care	Neutral	Participated in broad market deterioration contrary to its traditional outperformance in difficult market environments; concerns as health care reform effects still to come; maintain a neutral exposure.
Financials	Neutral	Second worst performance in 2 nd quarter; fundamentals are being rebuilt quickly with the stronger financial firms; concerns about small banks and commercial real estate loans expands; FDIC closing banks on weekly basis; maintain neutral exposure.
Energy	Neutral	Sector declines over 12% in quarter with stable oil prices but major issues created by the BP Gulf of Mexico environmental disaster; drilling moratorium hurts many companies; maintain neutral exposure.
Consumer Staples	Neutral	2 nd quarter performance is better than average, -8%; many companies are international with meaningful exposure to Europe; fundamentals solid but growth potential expected to slow; maintain neutral weighting.
Consumer Discretionary	Underweight	Consumer spending remains suspect with the high unemployment and housing issues; too soon to add more here; maintain underweight.
*Indicates a change in strategy for the 3rd quarter, 2010.		

Fixed Income Strategy

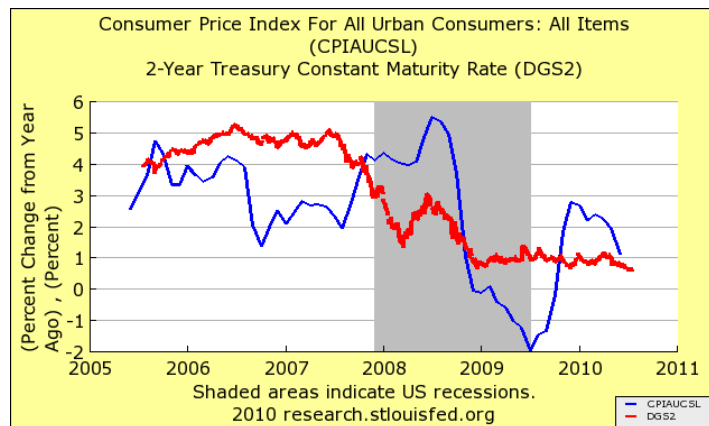
Expectations for increasing interest rates have been pushed back for several quarters. With the U.S. economy and European worries, the Federal Reserve tightening of monetary policy is not likely until sometime in 2011 despite the surging level of debt. Inflation remains low with little on the horizon to push it higher soon.

Bond Market Indexes as of 06/30/10	2nd Quarter	1 year	3 year	5 year	10 year
Barclays 7-10 year U.S. Treasury Index	+7.7%	+9.7%	+10.1%	+6.3%	+7.1%
Barclays Government/Credit Index	+3.9%	+9.7%	+7.4%	+5.3%	+6.5%
Barclays U.S. Aggregate Index	+3.5%	+9.5%	+7.6%	+5.5%	+6.5%
Barclays U.S. Credit Index	+3.3%	+14.7%	+7.4%	+5.3%	+6.9%
Barclays Intermediate Gov/Credit	+3.0%	+8.3%	+7.0%	+5.3%	+6.1%
Barclays Intermediate U.S. Credit Index	+2.4%	+13.0%	+7.2%	+5.4%	+6.6%
S&P Municipal Bond Index	+2.2%	+9.7%	n/a	n/a	n/a
Barclays 1-3 U.S. Treasury Index	+1.2%	+2.7%	+4.8%	+4.3%	+4.4%
JP Morgan Emerging Market Bond Index	+1.2%	+18.7%	n/a	n/a	n/a
iBoxx \$ Liquid High Yield Index	-0.1%	+22.2%	+4.4%	n/a	n/a
S&P/Citicorp Int'l Treasury, ex U.S. Index	-4.3%	-1.4%	n/a	n/a	n/a

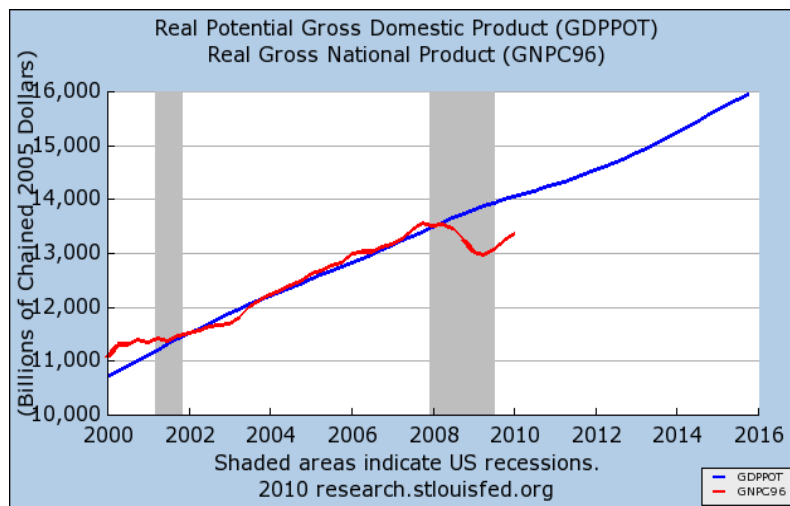
Treasury indexes in the 7-10 year maturities were the best performing area during the 2nd quarter of 2010. At the same time, indexes of sovereign debt of mostly European countries produced the worst performance for the quarter and the last twelve months. High yield or junk bonds booked in the second worst results, but even with a slightly negative quarter, provided the highest returns for the last twelve months. The High Yield index is expected to be one of the riskiest areas of the multitude of bond market choices due to a higher than average probability of default. In the meantime, the European Union has stated that no sovereign debt within the union would be allowed to default.

Investors' cash has been flowing into bond funds, pushing bond prices higher and interest rates lower. For the year-to-date through May, 2010, as measured by the Investment Company Institute, bond mutual funds have seen \$135 billion of new money. The Institute estimates that another \$34 billion has moved into bond funds in the last 7 weeks. This contrasts sharply with U.S. stock funds losing an estimated \$26 billion since the beginning of the year. Mutual fund flows are often used as contrary indicators as investors tend to move cash around based on emotions rather than fundamentals.

This extreme flow investing in fixed income securities have helped push Treasuries and other fixed income securities to low rate levels. On one hand, this helps to stimulate the economy as those businesses and individuals that still have solid credit scores can borrow at very



low rates. Thirty year mortgages are currently offered at 4.5%. The two-year treasury has plunged to a record low of 0.55%. Given the level of inflation of about 1%, the real rate of return on this investment is actually negative—a level that doesn't make sense for a long term investor and part of the reason why stocks are looking more attractive than bonds.



The U.S. Real GDP has been growing and is expected to continue to grow in the months ahead. The red line on the chart on the left illustrates in real dollars that the economy peaked in late, 2007 and bottomed in 2009. The blue line shows the Real Potential GDP which is the amount the economy can produce if we were at

full employment and with little inflation. The gap between the two is fairly wide, indicating in the U.S. we have a long way to go to get back on track.

Second quarter 2010 GDP results will be announced soon. According to the Blue Chip Forecast, a reliable survey of 50 leading economists averaged together, we should see an improved growth rate of 3.2% versus the 2.7% earned in the 1st quarter. The rest of 2010 will not be as exciting with growth estimated at 2.7%-2.8%. The unemployment rate is anticipated to remain high, at 9.5% by the 4th quarter of 2010, and maybe declining to 8.8% by the end of 2011. Job growth will pick up but not enough to overcome the expansion of our labor force. Even so, the likelihood of a double dip recession is small without any new major economic shock to the global economy.

Although Treasury rates could move somewhat higher now that some of the European debt issues are more transparent and given the subpar growth potential in the U.S. economy currently, it will likely be several quarters before we will see significantly higher interest rates.

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