



Financial Alternatives

Integrated
Wealth
Management

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Year to Date 2011

Stock markets around the world were generally positive for the first half of the year. The S&P 500 ended up 6.02%. International equity markets as measured by the EAFE international index increased 4.98%. Domestic Real Estate Investment Trusts (REITs) led the way with returns of 9.74%. Domestic utility stocks were also strong performers in the first half of the year. The Vanguard utility exchange traded fund (VPU) increased 9.27%.

Emerging market stocks on average underperformed developed country stock markets. The MSCI Emerging Markets Index earned only 0.88% in the first half of the year. We would not be surprised to see a reversal of this trend in the near term.

Bond investments were positive year to date. See the graph below for additional investment performance detail. In summary, stock and bond markets continued their recovery from the March 2009 lows.

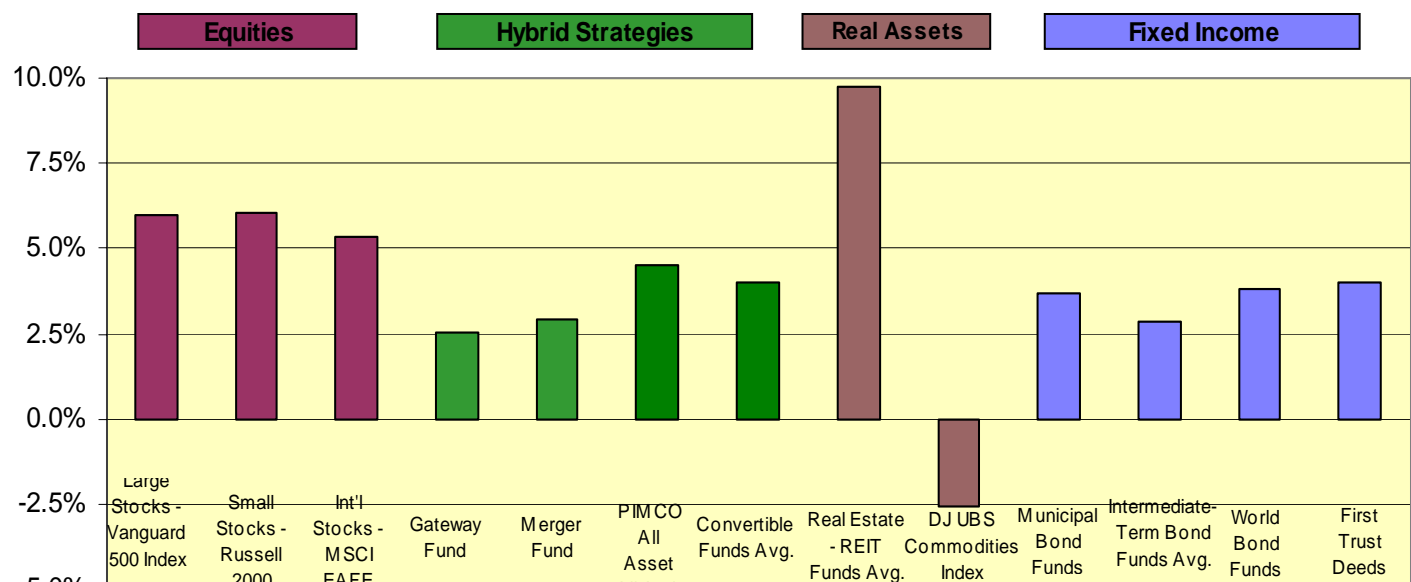
In this mid-year newsletter we'll revisit last year's discussion of Jeremy Grantham's Economic Scenario Probability Tree to see which of the three scenarios came closest to describing what happened in the economy and stock markets this past year.

Executive Summary

- Stock and bond markets around the world were generally positive for the first half of the year.
- Grantham's 7-year return forecasts for stocks are below the historical long-term averages.
- The Shiller 10-Year Normalized P/E Ratio also shows that stocks appear to be more on the expensive side historically.
- These historical valuation measures tell us nothing about what might happen in the short term.
- Some investment professionals we respect have a more bullish view on stock market valuations.
- We will view a continue rally on the S&P 500 up to the 1,500 – 1,600 levels as an opportunity to rebalance portfolios and take profits in stocks and move these funds into more conservative investments.
- We will continue to take a prudent approach to managing our client's portfolios in an effort to strike the proper balance between income and safety of principle versus long-term growth.

We will show his firm's 7-year return forecast for various asset classes, use this information to illustrate that equity markets are somewhat expensive relative

2011 Short-term Returns (January 1 - June 30)



Source: Morningstar

to historical valuations, and explain that caution is in order.

In addition, we will revisit the Shiller 10-Year Normalized P/E Ratio which also shows that stocks appear to be more on the expensive side historically.

Revisiting Grantham's Economic Scenarios

Exactly one year ago we presented and discussed the Economic Scenario Probability Tree shown below. Here is a look back to see which of the scenarios turned out to be closest to what happened over the past year.

Scenario #1 was that the economy would have a strong and sustained recovery, interest rates would rise and the stock market would fall. Grantham assigned this scenario a 30% probability and it clearly did not happen over the last year. The stock market didn't fall, interest rates didn't rise and the economic recovery was not particularly strong.

Scenario #3 was that the economy would bump along, interest rates would stay low and some poor economic data or crisis would emerge to break the animal spirits of the stock market; thus causing it to fall and avoid a longer-term major market bubble. This scenario was assigned a 21% probability.

At this time last year it looked like scenario #3 might unfold because the S&P 500 was down -6.65% through June 30th. But it clearly did not materialize as the S&P 500 quickly ended its downturn and rose from

a level of 1,031 on 6/30/10 to 1,321 on 6/30/11, with a total return of 30.69% during this time period.

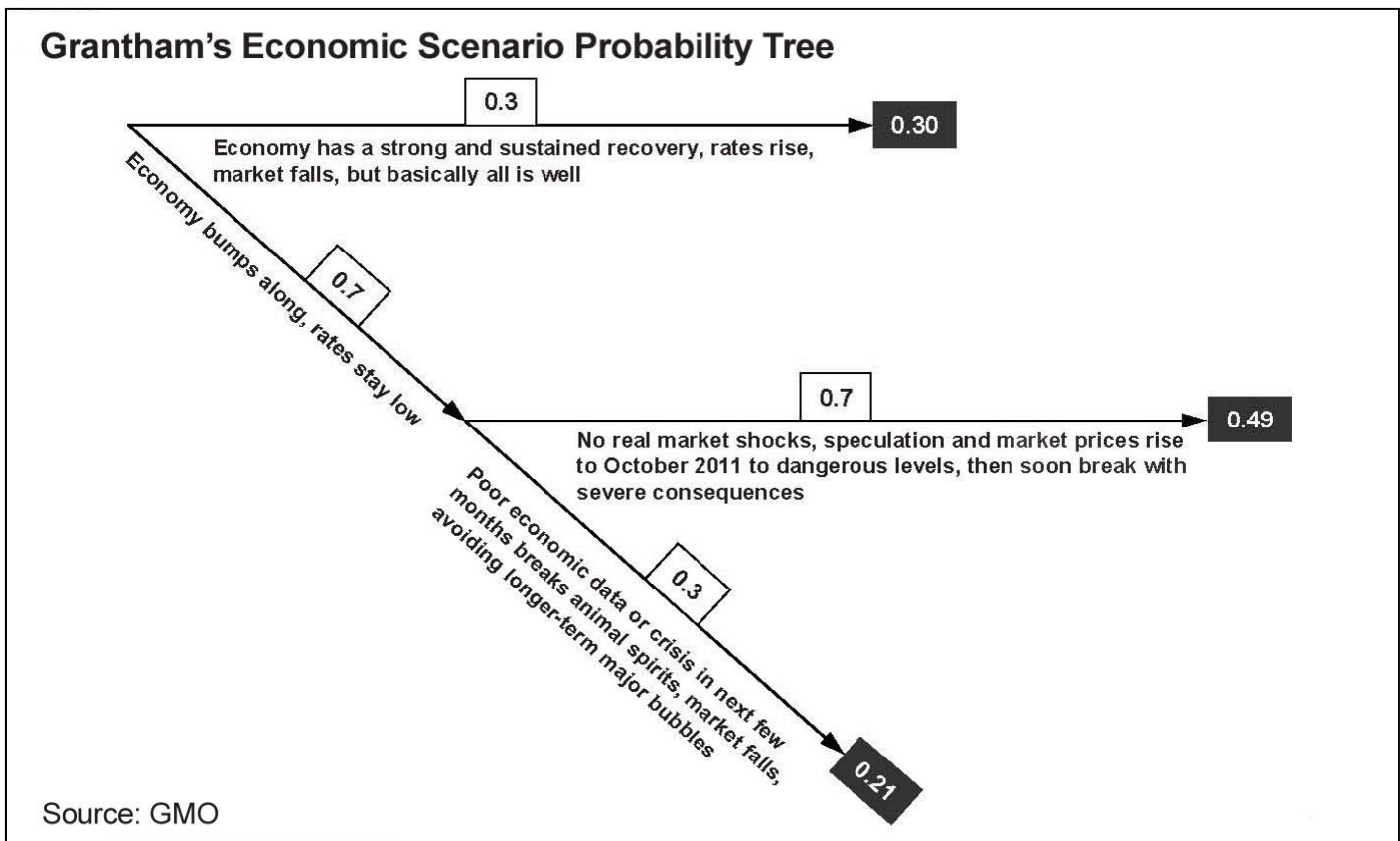
Scenario #2 was that the economy would bump along, interest rates would stay low, there would be no real market shocks, speculation and market prices would rise through October 2011 to dangerous levels (1,500 to 1,600 on the S&P 500) and then soon break with severe consequences. This scenario was assigned a 49% probability.

What transpired last year was closest to scenario #2. The economy did bump along, interest rates stayed low and the S&P 500 increased.

Will the S&P 500 continue to rise to the 1,500 – 1,600 level by October and then begin to fall with dangerous consequences? That remains to be seen. We doubt it will happen; but if it did, we would view such a rally as an opportunity to rebalance portfolios, take profits in stocks and move these funds into more conservative investments.

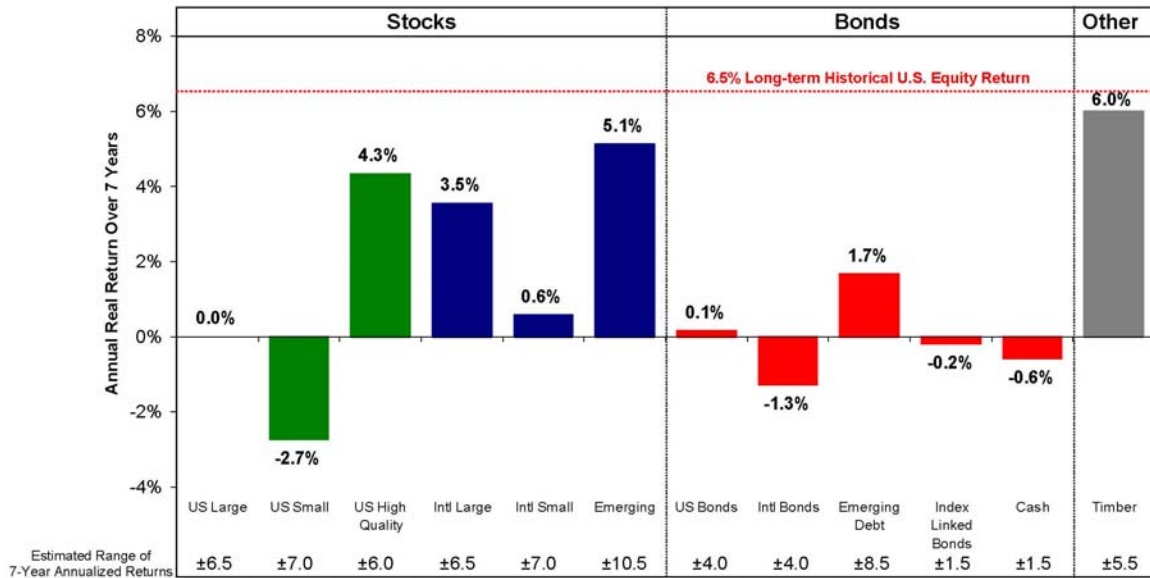
Even if the market does not reach these lofty levels, the 30.69% rise from a year ago has by some measures caused the equity markets to appear to be fairly expensive historically.

A look at Grantham's GMO 7-Year Asset Class Return Forecasts as of May 2011 and October 2008 on the following page can shed light on the historical valuation of stocks and their long term expected returns.



GMO 7-Year Asset Class Return Forecasts*

As of May 31, 2011



*The chart represents real return forecasts¹ for several asset classes. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Actual results may differ materially from the forecasts above.
¹ Long-term inflation assumption: 2.5% per year.

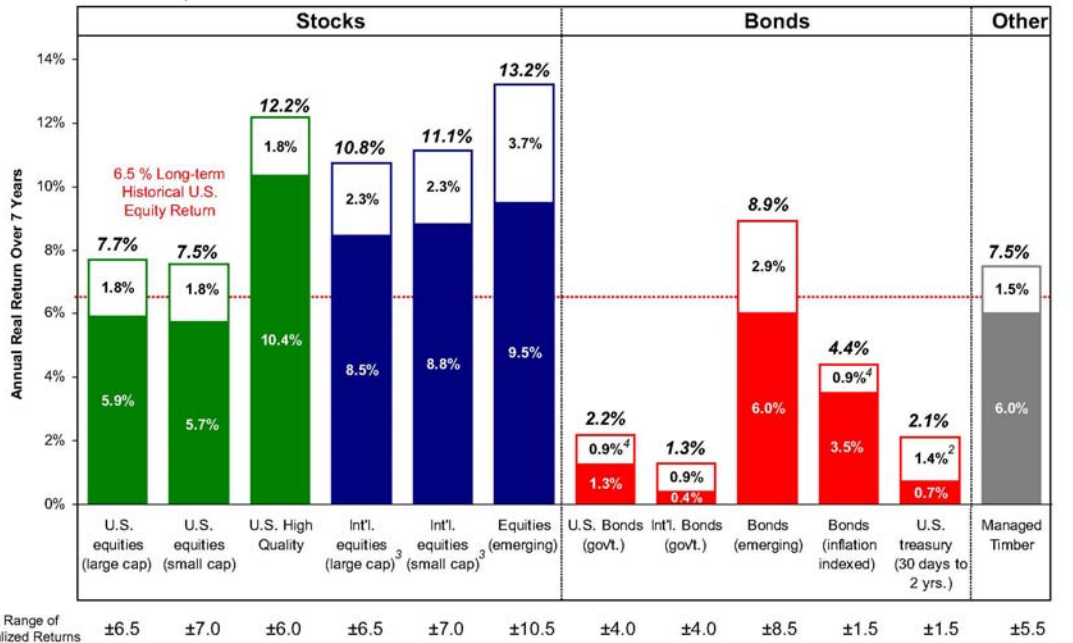
GMO

Source: GMO

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GMO 7-Year Asset Class Return Forecasts*

As of October 31, 2008



*The chart represents real return forecasts¹ for several asset classes and an estimate of value expected to be added from active management. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Actual results may differ materially from the forecasts above.

¹ Long-term inflation assumption: 2.5% per year.

³ Return forecasts for international equities are ex-Japan.

² Alpha transported from management of global equities.

⁴ Alpha transported from management of global bonds.

GMO

Source: GMO 1

GMO 7-Year Asset Class Return Forecasts

Both graphs on page 3 illustrate the average historical real return of the US stock market (6.5%) as a red horizontal line. It's important to point out that GMO forecasts "real return" which is simply the rate of return after deducting inflation. A footnote at the bottom of the graph indicates that they assume a long-term inflation rate of 2.5% per year.

The top graph presents 7-year forecasted returns as of May 31, 2011. It shows that they do not expect any of the asset classes listed to exceed the long-term stock return of 6.5% - and it illustrates notably low returns for bonds.

GMO's methodology for calculating these forecasts is not difficult to grasp. It assumes that stocks will return to their long-term historical valuation levels at the end of the 7-year period. So if stocks are currently above their long-term historical valuation levels, the forecasted returns will be below average. And if stocks are currently below their long-term historical valuation levels, the forecasted returns will be above average.

As of May, the 7-year forecasted stock returns are below average, which tells us that the stock market's current valuation is above average. It is important to remember that these forecasts tell us nothing about what will happen in the short term. However, when we consider shifting clients among conservative and aggressive positions, the forecasts can serve as a helpful indicator.

Part of what gave us the confidence to rebalance

(and generally buy stocks) during the late 2008 downturn were the exceptionally high 7-year forecasted returns shown on the October 31, 2008 graph (found at the bottom of page 3).

This graph told us nothing about what would happen in the short term, and in fact the market continued to drop before bottoming out in March of 2009. Still, we were convinced that due to the market being much cheaper, future returns would be favorable in the long-term.

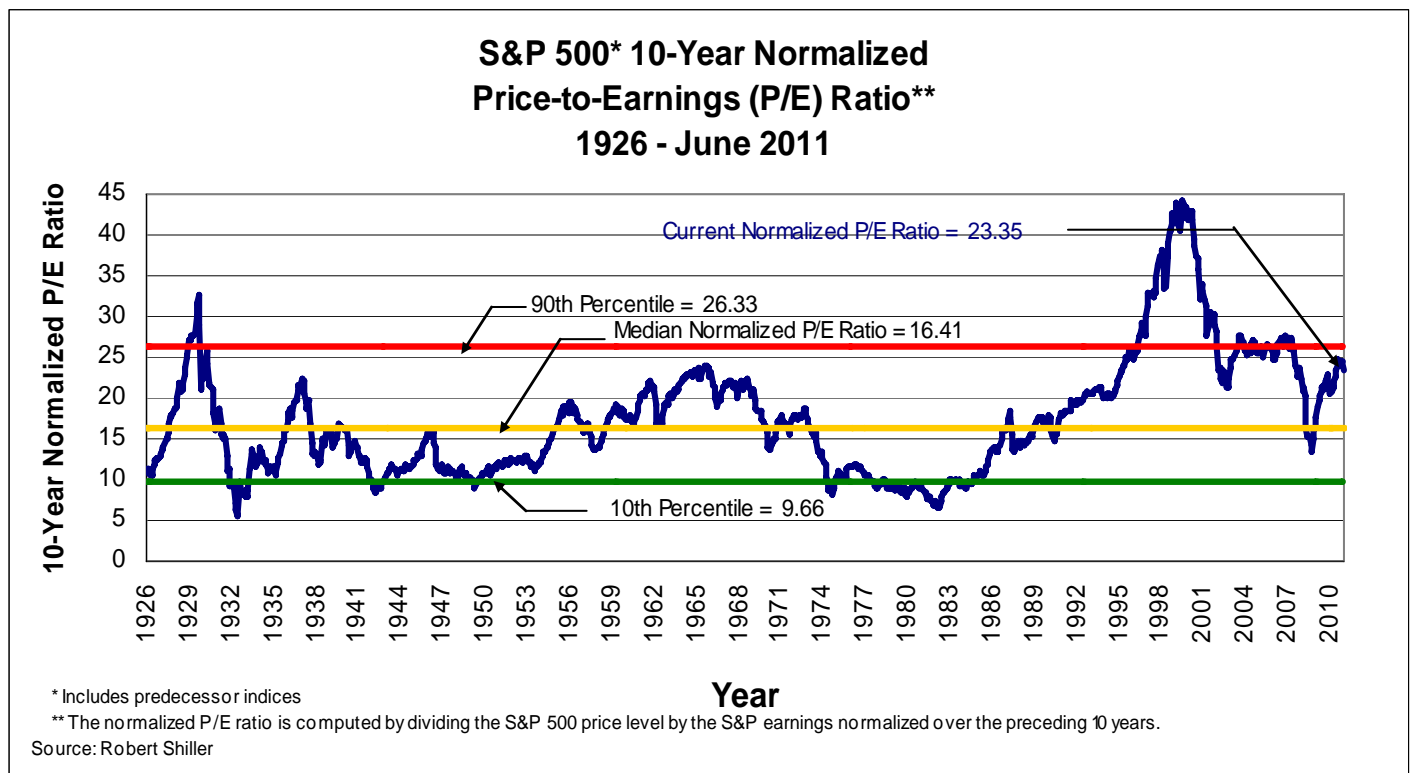
A look below at the 10-Year Normalized P/E Ratios provides a similar view on stock market valuations.

10-Year Normalized P/E Ratios

We described Robert Shiller's 10-Year Normalized P/E Ratio graph in detail in our July 2009 newsletter. We encourage you to review this newsletter on our website for additional information. As you can see from the graph, the current ratio of 23.35 is well above the historic median of 16.41, and approaching the 90th percentile of 26.33.

The chart at the top of the next page shows the subsequent 10-year returns of the S&P 500 when starting with the Shiller P/E ratio at various levels. It illustrates that, in general, subsequent 10-year returns are much higher when starting P/E ratios are relatively low.

With today's P/E ratio currently over 23, we are near the higher end of historical valuations. All things



S&P 500 10-Year Normalized P/E Ratio & Subsequent 10-Year Compound Annual Return

10-Yr. Normalized P/E Ratio	Below 12	12 to 16	16 to 20	Above 20
Avg 10-Yr Compound Return	14.88%	12.91%	8.50%	4.68%
Range of Historical Outcomes:				
75th %	17.11%	16.50%	10.00%	7.74%
50th %	15.59%	13.11%	8.42%	4.41%
25th %	14.32%	9.33%	6.63%	2.20%
Number of 10-Yr. Periods	26	16	17	15
Average Equity Risk Premium*	8.25%	7.94%	4.14%	-0.79%

* For any given 10-year period, the Equity Risk Premium is the compound annual return on the S&P 500 (with dividends reinvested) minus the compound annual return on Long-Term Government Bonds. Calculated using data from Ibbotson Associates.

Data from 1926 to 2008

Source: Gibson Capital, LLC

being equal, this does not bode well for future stock returns. Although this really tells us nothing about the direction or extent of market movements in the short term, it has been a respectable indicator of what to expect over the longer term.

With current valuations, we should not expect above average returns. This is one major reason why we feel that now is the time to exercise caution, and not to chase a rising market if it indeed continues to rise. That said, there are investment managers who we respect that have a relatively bullish view of the stock markets around the world.

Summary and Company Update

In summary, stocks appear to be on the expensive side relative to long-term historical valuations. We believe caution is in order and we'll view a significant rise to 1,500 – 1,600 on the S&P 500 in the shorter term as a rebalancing opportunity.

Long term historical valuation measures tell us nothing about what may or may not happen in the short term but they can tell us when to be more cautious or aggressive as we position portfolios for the long term.

We will continue to take a prudent approach to managing our client's portfolios in an effort to strike the proper balance between income and safety of principle versus long-term growth.

In the last three years we have aggressively invested in our business by remodeling the office, installing a new state of the art trading platform and hiring another financial advisor, Ellen Li.

We are pleased with the steps we have taken to improve the service we provide to our clients and these efforts continue. We are currently creating a new website and also upgrading our computer systems both

of which will be completed by the end of August.

We are committed to continual improvement and look forward to serving you for many years to come. Please call us if you'd like to discuss this newsletter or your semi-annual reports in greater detail.

We hope the first half of the 2011 has treated you well and that you are enjoying your summer.

Past performance is no guarantee of future results. All content in this newsletter is intended as general information, not specific advice. Performance data listed is for illustrative purposes only. Portfolios are personalized and often consider many variables, including investment objectives, age, time horizon, risk tolerance, and tax variables. Information contained herein has been obtained from sources believed reliable, but not guaranteed.

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