

QUARTERLY NEWSLETTER

July 6, 2011

Market Commentary:

Appreciation of world equity markets, as measured by the FTSE All-World Index, has slowed during the 2nd quarter of 2011 providing a year-to-date (YTD) total return of 4.85% as of June 30, 2011 versus a YTD return of 4.46% as of March 31, 2011. This slowing is not unusual given the stunning rally since the market's March 2009 low point which posted gains of over 70% from March 31, 2009 through December 31, 2010. Reversion to the mean simply continues to rule long term market returns and further pullback in the near future is quite likely.

During June 2011, the Federal Reserve lowered its expectations for economic growth, but maintains a positive outlook as exhibited in its decision to halt QE2 (discussed later) as planned. The Federal Reserve has also decided to maintain the Fed Funds target rate at the historically low range of 0.00%-0.25% which has remained unchanged since December 2008.

What does all this mean for future market returns? I believe the answers lay in current valuations, future interest rates, future inflation, and strength of currencies.

When measured on a fundamental basis, equities appear to be trading within acceptable ranges. That is, equities appear to be trading at valuation levels largely supported by earnings and asset valuations. By no means does the market appear to be trading cheaply, but instead appears to be fairly priced on a historical level.

Measuring fundamental price levels in a vacuum would be foolish, though. Given current interest rate levels, the steepening of the yield curve, and levels of government debt which exist in the United States and much of the developed world, interest rate risk, inflation risk, and currency risk are becoming increasing more important factors to consider.

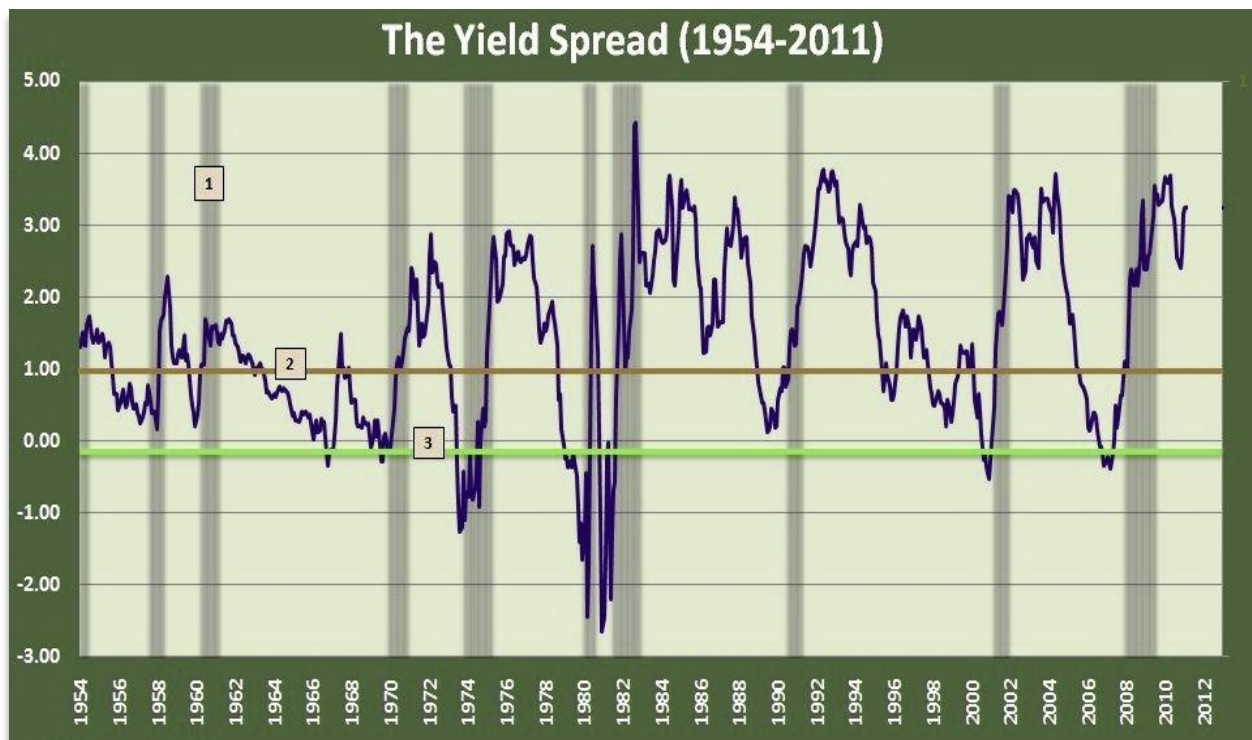
Interest Rate Risk:

Interest rate risk is the risk interest rates will rise in the future thereby causing the value of your investments (especially bonds) to decrease.

Interest rate risk (cont'd)

The chart below shows the interest rate spread between 10-year and 2-year debt issued by United States. The labels on the chart are explained as follows:

1. Grey bars: Recession
2. Brown line – Historical average spread
3. Green line – Effective spread of zero. When the purple line drops beneath this line, long term bonds are yielding less than short term bonds. This creates what is known as an inverted yield curve.



Source: Federal Reserve Bank of St. Louis

This chart tells us quite a lot. First of all, you will notice that each gray bar is preceded by a contraction in the yield spread. This suggests that market participants are expecting a downturn, thus demand less compensation for maintaining "safe" positions in long-term government debt.

As spreads widen, however, the market is demanding more compensation for holding long term bonds since either their inflation expectations are higher, their anticipated returns in other markets are higher, or both.

What we also know from this historical data is the current yield spread appears to be reaching its upper limit which will undoubtedly lead to

Interest rate risk (cont'd)

contraction in the yield spread in the future. This contraction can happen either by inflation fears subsiding, the Federal Reserve lifting its targeted short term interest rate, or some of each. What we do know is that short term interest rates are historically very low (the Fed can't go any lower), thus I would suspect a rise in short term rates will be much of the cause of future spread contraction and less from a drop in anticipated future inflation.

The Federal Reserve is walking a tight rope. Their missions of maintaining both low inflation and low unemployment are often at odds as they are now. To carry out these missions, the Federal Reserve uses both interest rate targets and monetary policy. Short term interest rates are set to either encourage savings (i.e., slow the economy) or discourage saving (i.e., stimulate the economy). I will discuss monetary policy in more detail within the next section, but keeping short term interest rates low while increasing the money supply does have the potential of creating inflationary pressures if the economy does not grow enough to absorb the additional supply. If this were to occur, the Fed might have to increase interest rates as it did in the late 1970's and early 1980's when stagflation (a period when the economy is sluggish and inflation is high) was occurring.

One especially interesting observation worth noting is the spread between Treasury Inflation Protected Securities (TIPS) and non-TIPS with similar duration. This spread is generally seen as a good indicator of anticipated inflation. That is, the higher the spread the higher anticipated inflation. Though the spread has recently increased to 2.25% (for 30-year Treasuries), this spread is still lower than the historic average inflation rate of approximately 3%, therefore I continue to view TIPS as attractively priced and a good inflation hedge. It would seem stated long term rates for both TIPS and non-TIPS bonds are rising at approximately the same rate, with the stated rate of non-TIPS rising slightly more.

Inflation Risk:

Inflation risk would seem to be low due to the current high unemployment rate. There simply aren't a lot of people out spending money to drive prices up. This isn't the only way inflation occurs, however. The Federal Reserve has assumed aggressive quantitative easing since the 3rd quarter of 2008 which can itself cause inflationary pressures.

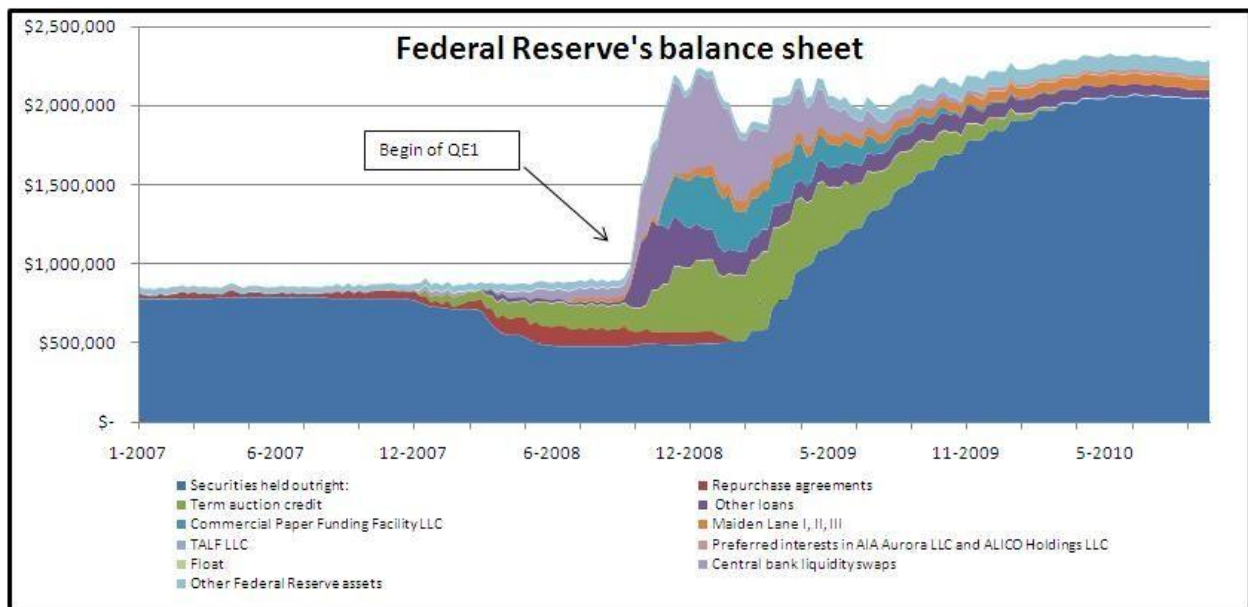
Quantitative easing (QE) is basically increasing the money supply. QE is often done to unfreeze credit markets, increase spending, increase inflation, or some of each. The first round of QE which was started 3Q2008 was basically to unfreeze credit markets. You will recall the Federal Reserve acted as the lender of last resort to banks and insurance companies deemed

Inflation risk (cont'd)

too big to fail. This allowed companies seen as critical to the US's financial markets and economy to continue to operate.

The level of QE1 Fed action can be seen on the chart below. When the Fed bailed out banks and insurance companies it essentially created a wash of money supply which will ultimately place downward pressure on the value of the dollar. However, it's thought that the current high unemployment will stave off any such devaluation which would ultimately cause inflation, but only time will tell.

(Side note: QE1 was unprecedented as it was the first time the Fed effectively created new money without the approval of Congress, but that's another story altogether.)



Source: Board of Governors of the Federal Reserve System, chart stated in millions

Other than lending money to big banks and insurance companies, the Federal Reserve can also accomplish quantitative easing by repurchasing Treasuries on the open market. This is the traditional route of QE which the Fed had taken until QE1. The Fed's institution of QE2 followed the more traditional route of increasing the money supply through open market purchases.

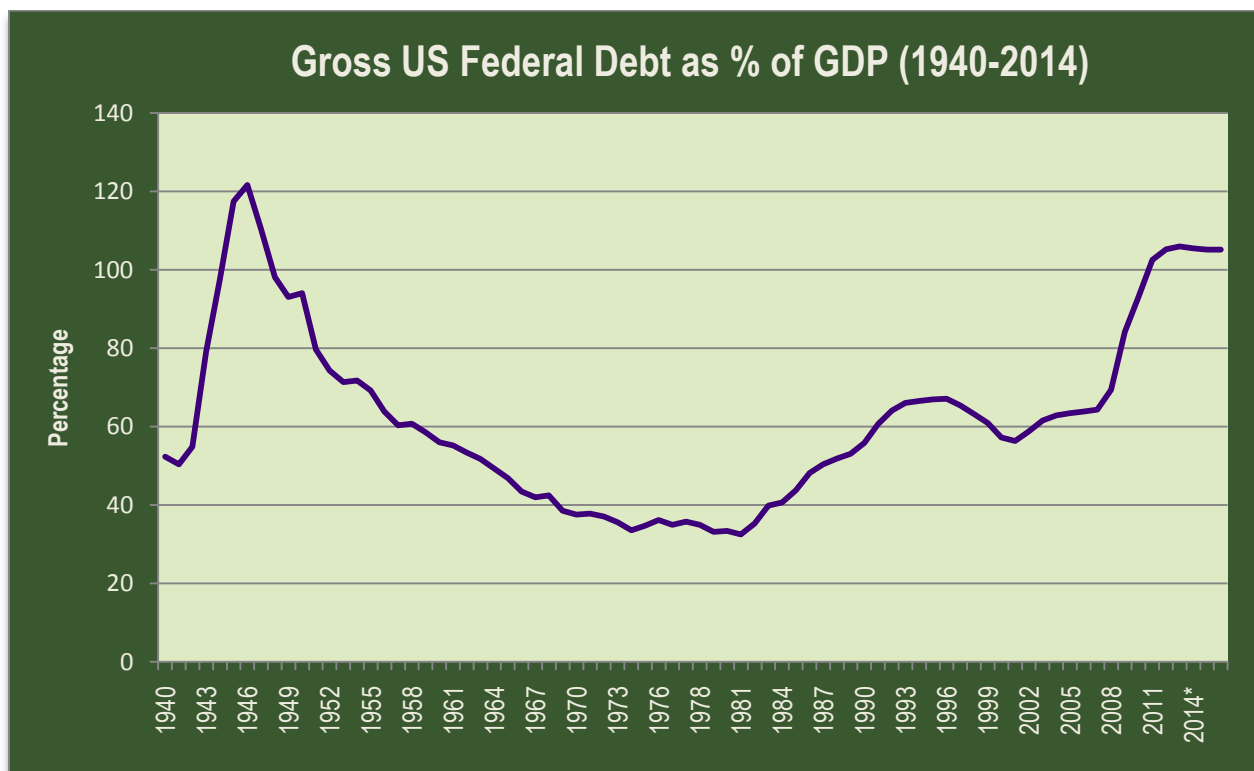
As mentioned previously, the Fed just announced it will continue targeting low interest rates, but will discontinue QE2 as planned. Doing so will allow the effects of QE2 to make its way through the economy, thereby allowing the Fed time to measure those effects. The upside to this approach is

Inflation risk (cont'd)

limiting inflationary pressures which would increase the longer such a program is in place.

The question then becomes whether the Federal Reserve can keep the money supply cheap and easy to stimulate the economy while maintaining low rates of inflation over the long term.

Most developed nations around the world find themselves with very high levels of debt. The United States is no exception. The chart below shows US debt as a percentage of Gross Domestic Product from 1940-2014. (2011-2014 are projections provided by the Budget of the US Government).



Source: Budget of the United States Government, Fiscal Year 2011, Historical Table 7.1
* 2011-2016 are provided estimates

As you can see from the chart, the US hasn't been in a debt situation like the current one since WWII. The main difference between then and now is that coming out of WWII the US had a world devastated by war which to help rebuild. This enabled the US to effectively produce its way out of debt. This time around the US may have to find a more traditional way out of its debt: inflation.

Inflation risk (cont'd)

The history of markets is riddled with countries that found themselves with too much debt. In virtually all of those instances the currency of those countries became worth less thereby causing inflationary pressures in the home country. Those instances were different, though, in that they tended to be more isolated. Now the question tends to be: Which countries are less in trouble than others?

Most of Europe is currently adopting austerity measures which slow government spending. The US, however, has yet to adopt such policy. One theory states that decreasing spending is the wrong approach since what's needed to get stalled economies growing is stimulus. The competing theory is that too much debt will hinder economic growth over the long term, thus spending should be slowed sooner than later. Only time will tell which countries adopted the correct spending policies.

Currency risk:

Somewhat related to inflation risk is currency risk. When your home country's currency loses demand on a worldwide basis, it causes inflation within the home country since those dollars cannot buy as many foreign goods. On the other hand, when a foreign investor has assets denominated in another currency, that investor will realize profit or losses based on the relative strength of the foreign currency. These are instances of currency risk.

What we do know is the developed world will continue to have brilliant citizens solving difficult problems, therefore as a whole we would expect the net output of the developed world will be positive over the next several years. What we do not know is which individual countries will be winners and which will not be. There will, in fact, be winners and losers. The US itself will be one of either, but we simply have no way of knowing which.

An examination of the fundamentals of foreign developed markets reveals those markets are trading at somewhat better valuations than those in the US (though overall earnings abroad seem to be shrinking). Additionally, China has indicated their desire to move away from using US currency as their own currency's sole benchmark; and have exhibited action to that end. I too believe that a prudent investor should hedge currency risk by investing in many different countries, especially developed ones.

Emerging market economies have historically been quite volatile. This stems from many things including political turmoil, war, and inadequate banking regulations. Among other things, emerging markets do help hedge currency

Currency risk (cont'd)

risk, but given historical volatility, extraordinarily high returns over the past decade, and current inflationary pressures one should use caution when investing in these countries.

Take away:

Short term interest rates are at historic lows while the interest rate spread between long and short term bonds is historically high. Either inflation and/or increases in the short term rate will cause the interest rate spread to return to its historic norm. To hedge against risk of rising interest rates, investors should maintain bond allocations with effective duration of less than five years. If the investor believes overall rates will rise dramatically in the near term, the effective duration should be shortened further still.

Inflation risk is the most insidious of all risks in that it's hard to feel and measure while it's happening. Only over long periods of time can its effects be felt and accurately measured. Inflation risk is quite real, though, so the prudent investor should do what he can to hedge against it. Over long periods of time history has shown us that equities, REITs, and TIPS act as good inflation hedges, while bonds succumb to it.

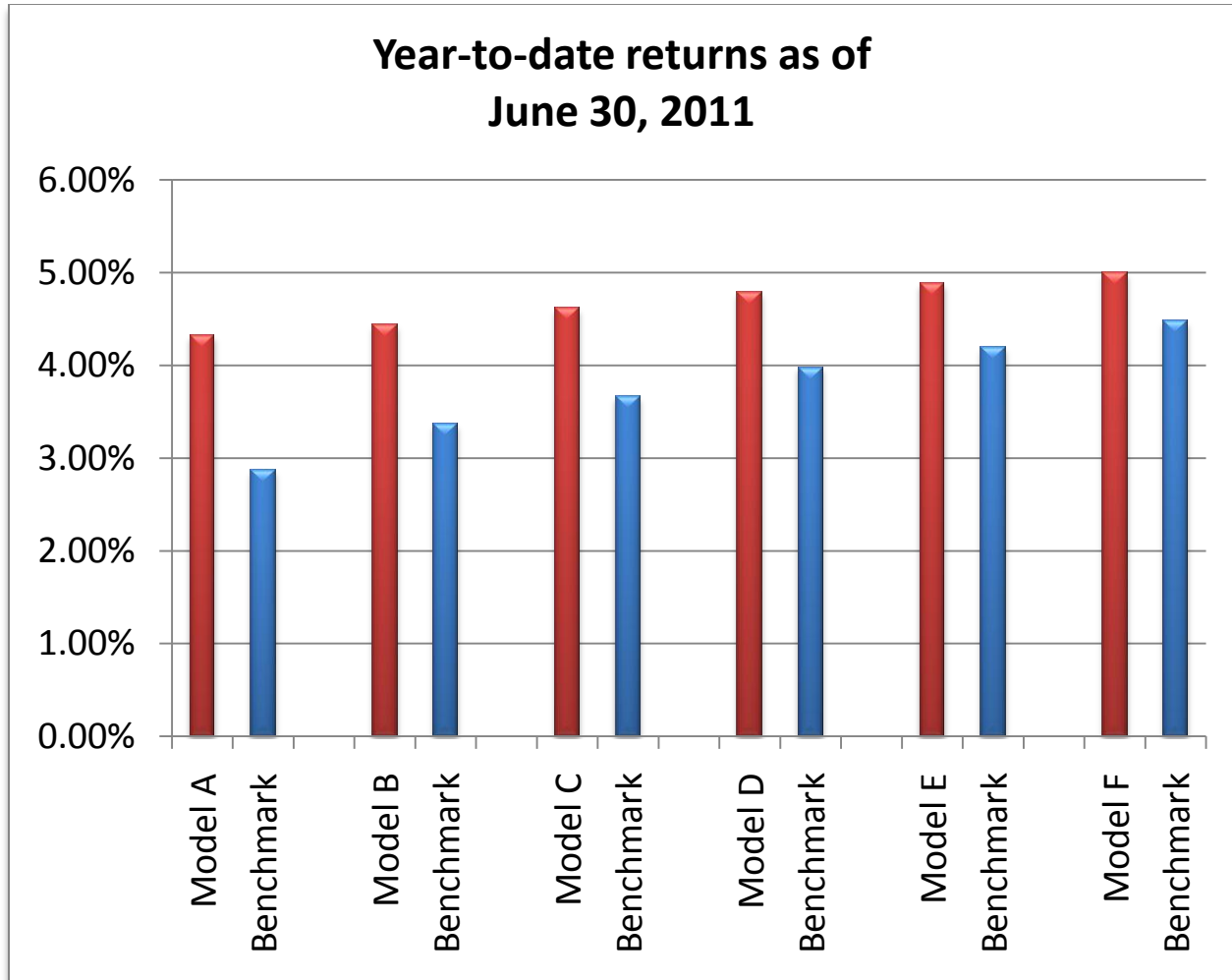
Somewhat related to inflation risk is currency risk. The prudent investor will invest around the globe to gain exposure to many different currencies while realizing emerging market economies bring their own special risks. The intelligent investor also knows that his country makes up only a portion of the globe's investible marketplace (US equities comprise 42% of the world's equity market), therefore will recognize potential home bias issues when formulating asset allocation targets and measuring portfolio performance.

Model Portfolio Performance Summary

On the following page are performance results from model portfolios and vehicles utilized during the first half of 2011. The RED bars reflect the returns associated with my recommendations for the 6 months measured, while the BLUE bars reflects those of the global marketplace as a whole. Each bar reflects a model portfolio consisting of a bond/stock allocation, with Model A being the least volatile and Model F the most.

Model Portfolio Performance Summary (cont'd)

You will notice that each of my recommended models outperformed the respective benchmarks, but as equity exposure increased the spread in outperformance narrowed. This is a result of US Large capitalization stocks outperforming during the period measured. Over the long term, however, I believe that small capitalization stocks will continue to outperform large cap stocks as they have historically.



You will recall from the previous newsletter that return is not the whole story, however. Instead, returns should be measured in relation to risk, which in the investment world is measured in terms of volatility. Six months is unfortunately too short of a time frame to measure volatility. Instead, this risk measure will be provided after a full twelve months.

In Closing

Though returns have been positive this year, it is important to stay focused on long term results. Historically, 1 in 3 years have provided negative returns. We are now overdue for such a year.

Remember: *Diversify utilizing a sound investment strategy and stay on target. You will be rewarded.*

If you need assistance developing an investment program and identifying appropriate investment vehicles, then seek the assistance of a fee-only NAPFA registered financial advisor who is also a CERTIFIED FINANCIAL PLANNER™ professional having the proper education and experience.



Troy Sapp, CFP®
Commencement Financial Planning LLC

Year-to-date Model Performance Discussion and Disclosure

Equity markets experienced decent performance during the first half of 2011, with large capitalization stocks in the United States leading the way. Commencement Financial Planning LLC (the "Advisor") believes that small capitalization stocks will outperform large capitalization stocks over the long term, thus tends to overweight them in its model portfolios when compared to the market as a whole. If large capitalization stocks had an even stronger performance during the first half of 2011 than small capitalization stocks, the models would not have performed as well compared to their benchmarks.

The Advisor's model investment portfolios for the period also utilized Treasury Inflation Protected Securities (TIPS) and below investment grade bonds as part of the bond sub-allocations. TIPS tend to outperform when actual inflation is higher than anticipated by the market and/or during times when the market is suddenly willing to pay a premium for inflation protection. Below investment grade bonds tend to perform better during periods when equities perform well. The Advisor believes below investment grade bonds are more attractive when risk premium yields equal or exceed the historic average of 4%, and will adjust its investment model portfolios accordingly. If TIPS and below investment grade bonds had not outperformed Treasuries, Agencies, Mortgage Pass-thru, and investment grade

Year-to-date Model Performance Discussion and Disclosure (cont'd)

bonds, the Advisor's model portfolio would not have performed as well compared to the benchmarks.

More information regarding the Advisor's investment strategies can be found within its most current Form ADV Part 2.

The stated returns include internal fund fees, but do not include fees charged by the Advisor, potential brokerage fees, or potential taxes. See the Advisor's most current Form ADV Part 2 for its fee schedule. Brokerage fees vary depending on the broker utilized. Taxes could result from income and/or capital gains distributed by the funds during the period as well as from the realization of capital gains due to fund share transactions as a result of portfolio rebalancing.

Performance results assume no contributions or withdrawals are made during the period, all fund distributions are reinvested, and all investment portfolio models/benchmarks are rebalanced to targets semi-annually.

Benchmark portfolios consist of the Vanguard Total World Index ETF (VT) which is designed to track the FTSE All-World Index; and the Vanguard Total Bond Market ETF (BND) which is designed to track the Barclays Capital U.S. Aggregate Float Adjusted Bond Index. The target allocation of stocks and bonds for each benchmark reflect the stock and bonds allocation targets of each respective investment portfolio model. The Advisor has adopted this method to provide what it believes to be the best performance measurement tool.

Investing provides the potential for both profit and loss. Past performance is not indicative of future results. Investment model portfolio performance provides hypothetical returns, does not represent actual trading, and has inherent limitations. Actual performance would have differed according to investment inflows or outflows; the timing of rebalancing; the taxability of income and gains; unique expense levels; and decisions particular to each investor.

The Advisor did change its recommended model portfolios and investment vehicles during the period measured. From time-to-time the Advisor will make such modifications to the investment model portfolios and/or investment vehicles.