



Aurum Quarterly Newsletter *2nd Quarter 2010*

Summary

- **Double dip recession fears overblown, for now. Secular debt issues increasing long-term risks.**
- **US Equities somewhat overvalued within an uptrend. International and emerging markets closer to fair value.**
- **Fixed income remains attractive despite interest rate volatility with opportunities globally and across credit sectors.**
- **Alternative investments should benefit from long and short security mispricings along with volatility.**

Economy

Fears of a double dip recession seem overblown at this point in the cycle and with the lack of confirmatory data pointing to another contraction. Though many leading economic indicators began rolling over, most indicate continued expansion, albeit at a much slower pace. Much of the fiscal stimulus package remains to be spent the rest of 2010 and in 2011. An increase in withholding taxes indicates rising incomes along with lower data on job layoffs. After six consecutive months of growth since October, retail sales turned negative on a month over month basis in May and June and consumer sentiment surveys still sit in the doldrums, so the cyclical issues are waving a yellow flag. Nevertheless, a recovery on the asset side of the consumer's balance sheet should help restore confidence.

Despite these positive factors, there are certainly many larger secular trends that need addressed. Housing led us into the crisis, it continues to flat-line with an increasing number of delinquencies and huge inventory, even with record low mortgage rates. Unemployment dropped, but remains stubbornly high at 9.5% and the broader measure of unemployment, U-6 stands at 16.5%, which accounts for people working part time that would like full-time work and those that gave up the job search. A jobless recovery similar to the 1990 and 2001 recessions impeding growth for many years seems likely. The deleveraging of households continues as credit contracted in 15 of the last 16 months. Small businesses, accounting for 60% of gross job creation, also borrowed relatively less than two years ago. The government addressed many of these issues with unprecedented monetary and fiscal stimulus. This has the affect of transferring debt from the private sector to the public sector for growth, which provides only a temporary solution. The point where the government withdraws stimulus to allow the private sector to take over for true economic growth walks a very fine line.

An overhang of sovereign debt burdens many developed nations. Greece was the first of many countries under stress. Japan is the classic example of the long-term impact of a boom in credit followed by asset deflation and below average growth as it experienced over the past two decades. Many emerging market nations did not experience a technical recession (two consecutive quarters of contraction) during the financial crisis. These countries have strong balance sheets and a growing middle class that can eventually support domestic consumption, and hence the respective economy. In addition, many natural resource rich countries look set to benefit to from the longer-term inflation affects.

Equities

During the past quarter, global equities experienced a 17% correction from mid-April to the end of June, ending the quarter down 14%. US equity valuations remain stretched to the upper quartile of historical valuations. Valuations prove a poor indicator of inflection points, though, as equities remained overvalued for well over the past decade, other than early 2009. Cyclical trends remain strong, near-term earnings expectations seem moderate, and medium-term technicals look favorable. Most attractive now are quality stocks with high dividends, which lagged the broad market rally and maintain high earnings power and cash flow generation.

International market valuations look closer to fair value. However, many currencies may be vulnerable relative to the dollar, especially given the problems in the Eurozone. It's not that the US economy or dollar is in great shape, but it could



be the best looking house in a bad neighborhood in the developed market. The risk appetite for emerging market (EM) is ripe with flows into EM at a record pace. The scorching growth pace and giddiness of investors have our managers underweight more popular countries such as China.

Aurum's Asset Allocation Frameworks remain equal-weight equities with an overweight within the asset class to emerging markets. Looking at 19 secular bear markets, Morgan Stanley Research found that the typical rebound rally is 17 months, followed by a correction lasting on average 13 months. This rebound rally lasted 13 months, from March 2009 to April 2010, but the current correction lasted only a little over two months. Sentiment remains very bearish though, which is a contrarian indicator. The medium-term framework seems favorable with the historically strong third-year of a presidential term upcoming. The twelve-month period from October of year two to September of year three of presidential terms returns an average of 27% (with 19 observances) with the worst return a positive 6%, though there are no guarantees it will come to fruition this time. [1]

Fixed Income

With all of the worry about interest rates rising at the beginning of the year, the 10-year Treasury started April at 3.86% and fell steadily to 2.95% at the end of June. Investment grade corporate and high yield fixed income dropped, while non-agency mortgages were a very bright spot, providing positive returns. Global bonds fell on a broad basis as the dollar rallied against most major and minor currencies.

With the end of quantitative easing and flows starting to slow, the downward pressure on rates may be easing. There is a possibility for rates to expand out of the previous range if growth exceeds expectations. Nonetheless, a shift towards the perceived safety of fixed income securities by the baby boom generation should keep inflows steady. In addition, the secular headwinds of deleveraging could keep yields contained. As Reinhart & Rogoff studied in the 250 financial crises over the past 800 years, interest rates tend to trend downwards during deleveraging, balance sheet recessions. These two countervailing (cyclical and secular) forces acting on interest rates will have a key impact across asset classes.

Even with the interest rate volatility ahead, this does not mean the asset class cannot be profitable. It will be more challenging and managers with flexible mandates and strong credit research should provide value. In addition, many credit sectors and pockets of global fixed income securities remain attractive, in addition to the currency benefits of countries with strong balance sheets. In Aurum's Asset Allocation Frameworks, we remain tactically underweighted fixed income by 10% of the strategic weight given the asymmetric payoff of rates having little further to fall and much further to rise.

Alternative Investments

Diversified (risk-managed and uncorrelated) strategies performed in-line with expectations over the past quarter. The HFRI Fund of Funds index fell 2.8% on the quarter, beating out the double-digit losses across equities. Macro strategies showed positive gains, while long/short equities mostly fell in line with each manager's market exposure. Managed futures whipsawed with the change in rates and equity volatility trends in May. Diversified alternative strategies are the largest overweight within Aurum's Asset Allocation Frameworks due to the relative value of investment opportunities on both the long and short side.

Real Estate (REITs) outperformed the broader equity markets in the quarter. Still, an overhang of commercial debt is a concern over the next few years. Many banks holding this debt enacted the 'extend and pretend' playbook, hoping prices on properties will recover in the future rather than taking losses on the assets now. Many institutional investors continue to allocate to the opportunities within the private side which could provide a pricing floor. Based on Net Asset Values, REITs trade at premium to private real estate. Given the uncertainty surrounding valuations and overleveraged asset class, we prefer diversified alternative strategies over REITs for now.



With the flight to safety, Treasury Inflation Protected Securities rallied 3.8% during the second quarter, with a total return of 4.4%. Given the money creation by authorities to combat the financial crisis, long-term inflation remains a concern. The asset allocation frameworks remain equal weight TIPS.

Conclusion

Global markets remain in a precarious position. Most developed markets, including the U.S., burdened by the 25-year secular rise in credit, face a challenging environment. Record government stimulus provides a short-term punch to the economy that needs the private sector to take over for a sustainable recovery. US equities remain somewhat overvalued within a medium-term uptrend, with risks that the current correction may not be complete, though sentiment is very bearish. International and emerging markets look fairly valued with many country indices correcting to lows reached in June 2009. Fixed income faces the risk of rising interest rates longer term, but the flight to quality and deleveraging has the rate downtrend still in place. Opportunities remain across tax-free municipals and on the taxable side with corporate, non-agency mortgages, and global bonds offering yield advantages. Alternative investments remain attractive as long/short managers continue to exploit opportunities on both sides and we anticipate higher volatility, which our diversified strategies stand ready to combat.

Asset Allocation Frameworks

	Conservative Income		Conservative Balanced		Moderate Balanced		Aggressive Balanced	
	<i>Strategic</i>	<i>Tactical</i>	<i>Strategic</i>	<i>Tactical</i>	<i>Strategic</i>	<i>Tactical</i>	<i>Strategic</i>	<i>Tactical</i>
Equity	0%	0%	20%	20%	35%	35%	50%	50%
US Large-Cap Growth	0	0	4	4	7	7	10	10
US Large-Cap Value	0	0	4	4	7	7	10	10
US Mid/Small-Cap Growth	0	0	2	1.5	3	2.5	5	4.5
US Mid/Small-Cap Value	0	0	2	1.5	3	2.5	5	4.5
International - Developed Markets	0	0	6	6	12	12	16	16
International - Emerging Markets	0	0	2	3	3	4	4	5
Fixed Income	65%	59%	45%	40%	30%	27%	17%	15%
Investment Grade	57	48	40	29	24	21	12	10
Short-Term Investment Grade	5	5	5	5	3	3	2	2
High Yield	3	6	3	6	3	3	3	3
Alternative Investments	25%	31%	28%	33%	30%	33%	30%	33%
Diversified Strategies	19	27	22	29	24	30	24	30
Real Estate & REITs	2	0	2	0	3	0	3	0
Inflation-Indexed Securities	4	4	4	4	3	3	3	3
Cash/Cash Equivalents	10%	10%	7%	7%	5%	5%	3%	2%
U.S. Dollar	10	10	7	7	5	5	3	2

The risk designations are relative only to the four Strategic Allocation targets and do not represent comparisons with any other investment or risk of the overall strategies.

[1] www.hussmanfunds.com



Important Disclosures

This material has been prepared for informational purposes only and is not an offer to buy or sell or a solicitation of any offer to buy or sell any security/instrument, or to participate in any trading strategy. Any such offer would be made only after a prospective investor had completed its own independent investigation of the securities, instruments or transactions, and received all information it required to make its own investment decision, including, where applicable, a review of any offering circular or memorandum describing such security or instrument. That information would contain material information not contained herein and to which prospective participants are referred. This material is based on public information as of the specified date, and may be stale thereafter. We have no obligation to tell you when information herein may change. We make no representation or warranty with respect to the accuracy or completeness of this material. Aurum Wealth Management Group has no obligation to provide updated information on the securities or information mentioned herein.

Estimates of future performance are based on assumptions that may not be realized. Actual events may differ from those assumed and changes to any assumptions may have a material impact on any projections or estimates. Other events not taken into account may occur and may significantly affect the projections or estimates. Certain assumptions may have been made for modeling purposes only to simplify the presentation and/or calculation of any projections or estimates, and Aurum Wealth Management Group does not represent that any such assumptions will reflect actual future events. Accordingly, there can be no assurance that estimated returns or projections will be realized or that actual returns or performance results will not materially differ from those estimated herein. This material should not be viewed as advice or recommendations with respect to asset allocation, any particular investment, or any tax advice. Persons should not use any information contained herein or linked presentations as a primary reason for investment or tax decisions.

The content on the website links and reports provided is general information only and should not be taken as investment advice. All site and report content shall not be construed as a recommendation to buy or sell any security or financial product, or to participate in any particular trading or investment strategy. The ideas expressed on these sites and reports are solely the opinions of the author(s) and do not necessarily represent the opinions of firms affiliated with the author(s) or Aurum Wealth Management Group.