

Second Quarter 2011
Investment Commentary



Investment Insight
Fiduciary Focus



As uncertainty about the impact of first quarter's global events in Japan, the Middle East and North Africa subsided, investors resumed their focus on the prospects for global economic growth. Low interest rates, good corporate earnings and generally positive economic data pushed risk assets higher early in the second quarter. However, signs of an economic soft patch, government debt issues and heightened inflation fears in emerging markets lead to a collapse in investor sentiment through mid June. A late quarter rally undid some of the damage, leaving most stock indexes with their first quarter gains in tact. The fear and volatility which gripped the stock market sparked a "flight to quality" bond rally. Most bond sectors turned in solid results for the quarter. A "typical" 60% equity pension plan portfolio added about 1.2% for the quarter while liabilities rose by 2% according to the BNY Mellon Liability Index.

Volatile Stock Markets Stall Out

Despite a familiar list of economic issues, US stocks rallied in April as corporate earning reports surpassed investor expectations. As second quarter progressed, U.S. economic signals turned negative causing the early quarter market gains to vanish. First quarter GDP data surprised to the downside, unemployment and national home price data sank while rising material and energy costs weighed on consumer confidence and supply disruptions following the Japanese nuclear disaster hit manufacturing. Government debt issues also dampened risk appetites. The US government hit its debt ceiling in mid May. As a result, Congress was required to raise the debt ceiling by early August or face a technical default. As the quarter ended, contentious political negotiation over spending and taxes was at a stalemate. Markets sank further in June as the Greece debt crisis reignited. Greece adopted further austerity measures to secure additional aid which triggered a late quarter recovery rally, but contagion beyond Greece, Ireland and Portugal to Spain and Italy remained a critical concern.

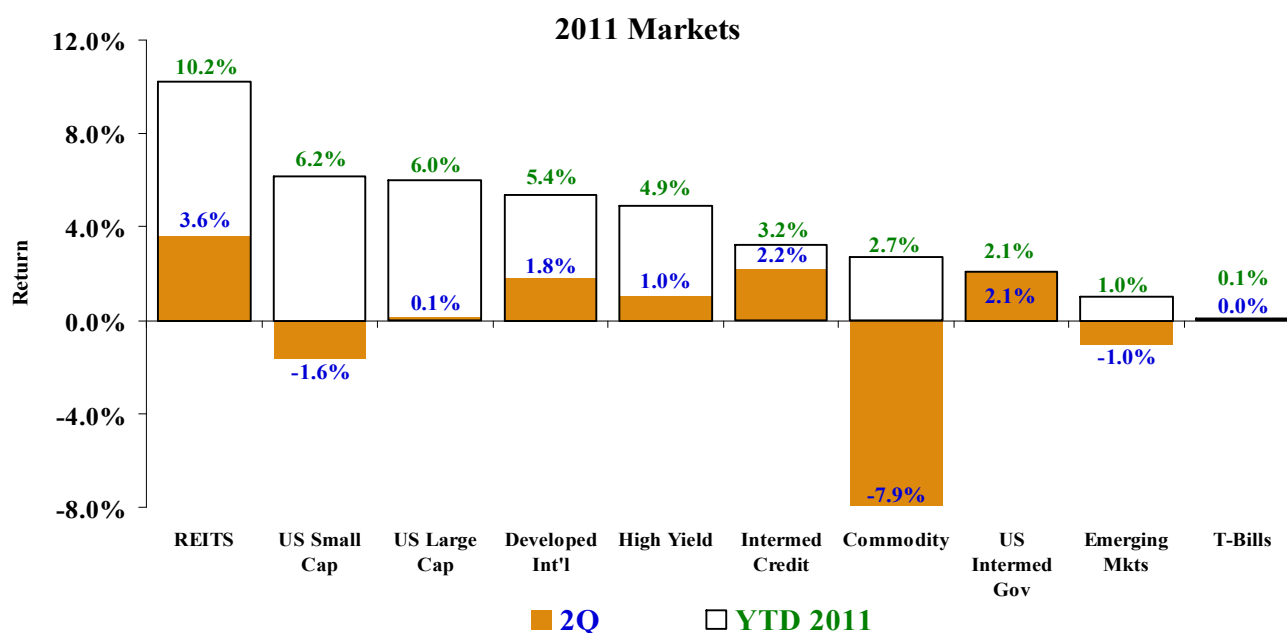
Despite the gloom, the S&P 500 advanced 5.6% over the final four days of the quarter to finish .1% higher for the second quarter and 6% year to date. Small-caps trailed large caps for the quarter. Small-caps are more domestically focused than are larger caps with over 80% of their revenue coming from the U.S. so their performance is more correlated to US growth expectations. The small cap Russell 2000 index lost -1.61% for the quarter, adding 6.2% so far in 2011. Growth outperformed value by 1.3% in large caps and by 3.2% in small caps.

S&P 500 Sector Returns	2Q 2011
Health Care	7.3%
Utilities	5.0%
Consumer Staples	4.5%
Consumer Discretionary	3.1%
Telecomm	0.8%
S&P 500 Index	0.1%
Industrials	-1.2%
Materials	-1.4%
Information Technology	-1.6%
Energy	-5.1%
Financials	-6.3%

Sector performance leadership shifted during the second quarter in concert with investors "risk-off" preference. Defensive sectors including Health Care (7.3%), Consumer Staples (4.5%) and Utilities (5%) provided return leadership for the quarter. Cyclical sectors such as Energy (-5.1%) and Materials (-1.4%) were hurt by the rising U.S. dollar and weaker economic data. Even Technology (-1.6) lagged the benchmark during the quarter. The Financials sector was the worst performer for the quarter (-6.3%) and the only sector with negative returns (-3.7%) year to date. This was due to the effect of negative headlines and the expectation for slowing revenue growth due to new banking regulations and impaired loan activity.

Active US equity managers continued to struggle with market volatility and the macro trading nature of the markets. The number of US large cap equity managers beating the index improved slightly over first quarter when energy dominated returns. However, high quality mega cap US stocks such as Microsoft, Google, Coca-Cola, JP Morgan and Wells Fargo continued to under-perform. Since the market lows in 2009, the S&P 500 has outperformed the S&P 100, which is comprised of the 100 largest companies in the US, by approximately 2.5%. Many investment managers believe that the markets preference for risk over quality has created a long term opportunity in U.S. mega cap stocks and have tilted their portfolios in that direction.

International stock returns were positive for the quarter as the MSCI ACWI ex USA was up .61% for the quarter and 4.1% YTD. Local returns were generally negative but broad based dollar weakness added about 2% to returns for dollar denominated investors. Developed markets outperformed emerging markets as MSCI EAFE was up 1.8% for the quarter while MSCI EM lost -1%. Despite the sovereign debt issues in Europe, core European markets such as Germany (7%), France (5.3%) and Switzerland (7.3%) did well while the countries with energy and natural resources based markets such as Brazil (-4%), Russia (-5%) underperformed. China's tightening regime appeared to be slowing its growth so its second quarter return was negative (-1.8%), though investors continue to favor its future prospects. Japan's market recovered somewhat during the second quarter (.2%) but remains -4.7% down for the year. India's stock market, also afflicted by worries about rising interest rates and inflation, suffered an even-greater decline (-3.4%) than China. International stock funds tended to fall short of the EAFE developed market index thanks to underperforming emerging markets. Funds with stakes in Europe and Japan had a better quarter.

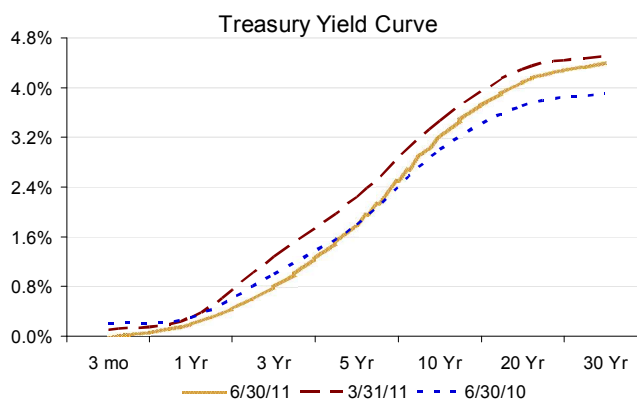


The perception of a global economic slowdown depressed a variety of commodity prices causing the S&P GSCI to fall -7.9% over the quarter. Agricultural commodities fell the most (-12.1%) due to continued flooding and cool temperatures in the Midwest. The energy sectors lost -7.9% while precious metals were up 2.5% and industrial metals down -2.9% for the quarter. REITS continued to show strength as the FTSE Nareit Equity index returned 3.6% for the quarter.

US Bonds Rally – The Best of the Worst

Fixed income investments generated good returns in the second quarter as interest rates declined. The Barclays Capital Aggregate Bond Index, which measures the performance of the taxable investment quality bond market, generated a 2.3% return for the quarter. Treasuries were very resilient during the quarter despite the fact that; S&P placed the US AAA debt rating on negative outlook, the Federal Reserve terminated its asset purchase program and debt ceiling negotiations were at an impasse. The yield on the 10-year Treasury bond declined from 3.5% to 3.2% during the quarter, bottoming at 2.9%. The decline in rates can be attributed to concerns over a slowing US economy and the flight to quality from less attractive alternatives such as European debt. Mortgages (2.3%) and Intermediate credit (2.2%) performed in

line with the Aggregate Index while long duration Treasuries outperformed (3.4%) according to Barclays data. High yield returns for the quarter (1%) moderated with risk appetites. Despite the recent dollar rebound, and deteriorating conditions in the peripheral Eurozone bond markets, inflows into global bond funds remain high as investors attempted to diversify their bond holdings outside the US. The Merrill Lynch Global Broad Market ex US index was up 3.6% for the quarter, aided by a weak US dollar. The majority of intermediate bond funds underperformed for the quarter as they were generally short the benchmark duration. This inhibited performance more than their collective credit overweight. Many of the leading bond funds are also raising cash to deploy when yields inevitably turn higher.



Prime Money Funds - Return-less Risk

Prime money market funds were in the headlines this quarter due to their holdings in the short term debt of European banks. The European bank investments, estimated at \$900 billion, are primarily short-term borrowings known as commercial paper, certificates of deposit and overnight “repo” loans collateralized by U.S. Treasury and agency securities. This represents about half of these funds assets which total \$1.8 trillion. The fear is that the banks exposure to the government debt of Greece, Portugal, Ireland, Italy and Spain (which are regarded as default risks due to their high debt levels) may trigger a high level of fund redemptions which might in turn cause a fund to break a \$1 share value.

The short term risk of a run on money market funds seems limited. Since the financial crisis of 2008, money market funds have been subject to additional disclosure, asset quality and liquidity rules to increase investor confidence and minimize the risk of a fund “breaking the buck”. In addition, the successful negotiation over another financial rescue for Greece has reduced investor’s fears of a default, at least for the moment. Meanwhile, Prime funds collectively have been reducing their exposure to European banks. During the quarter, we contacted the manager of each of the Prime money market funds in our client portfolios to determine their exposure and to learn how they were managing this risk. We will forward that information as appropriate. While these risks are reported to be appropriately recognized and managed, investors, for the most part, are not receiving any incremental return (yield) from them over a lower risk US Treasury money market fund.

Enjoy your summer.

Sincerely,

Timothy C. Burns, CFA
Hunter Capital Advisors, Inc

