

SECOND QUARTER REVIEW

The strong performance in high relative strength securities from the first quarter didn't carry over to the second quarter of 2010. It was a poor three months for the stock market and many other asset classes. After peaking early in the quarter (April 23rd), the S&P 500 moved lower, finishing the quarter down -11.4%. The performance of our Systematic RS strategies was mixed with some strategies outperforming and some underperforming.

The market correction in the 2nd quarter was very broad—just about every asset class and sector participated in the downside. As we close the quarter, our relative strength methodologies are not picking up any extreme trend changes. We aren't seeing massive shifts from one asset class to another, or large changes in sector leadership. Looking into the next quarter we expect to be making some changes to the portfolios, but those changes are looking like they will be more evolutionary rather than revolutionary. It would actually be a positive sign for relative strength if we can get through this correction without the major trend changes that cause relative strength to lag while the portfolios play catch-up.

Despite reasonably good economic growth in the first half of the year, investors are consumed by fear of a new slowdown or a double-dip recession. It's true that there is a lot of uncertainty both economically and politically right now. Significant structural changes are being proposed or executed with respect to health care and financial services, two of the largest sectors of the economy. Until the political debate is finished and the market has had to live with the final results for a few quarters, businesses and consumers will hold back. There is also major uncertainty about tax policy and government budgets, from the municipal level all the way up to the federal level. Whenever there is a lot of legislative change, the market tends to tread water until the outcomes are a little clearer. Changes may be perceived as favorable or unfavorable for corporations or various industry groups, but once the changes are

implemented, the great strength of our flexible capital markets system is that adaptation takes place. People adjust to the changes, whatever they may be, and find a way to move forward once more. Even during periods of turmoil, there are many, many companies that thrive by adapting more quickly than their competitors or by filling a newly-created niche. Relative strength is well-positioned to identify these new winners.

One positive thing is happening in the background while consumers and businesses stand aside. The system is building up cash that will eventually serve as the foundation of a new bull market. Corporate earnings have been extremely strong, but companies are tending to stockpile cash on the balance sheet instead of committing funds for expansion. Consumers, both in the U.S. and developed Europe, are now saving more than they are borrowing. Net consumer credit is dropping for the first time in memory. Some of the deleveraging is voluntary when families have decided to pay down debt; some of it has been involuntary, as some families have had reduced access to credit. Bond funds and low-yielding time deposits at banks have gathered record assets. The net result is that liquidity has been building up at a rate never before seen.

It's not clear what will persuade businesses and consumers to release the flood of liquidity, but often just the passage of time will do it. Federal Reserve policy is still very accommodative and probably won't derail any recovery once underway. We plan to wait patiently for what could be a massive bull market, although the timing is still uncertain. In the meantime, our relative strength portfolios are designed to adapt to the investing environment, regardless of what course the economy eventually takes. The market will eventually reflect a more settled state, as it did in the first quarter. We are confident of the portfolios' ability to perform well over time, and this quarter is another step down the path toward what we expect to be a good year.