

Fear and Volatility Return

We Never Expected the Return from the Abyss to be a Smooth Ride

There is always risk in investing. If there was not, the potential for return would not exist. This past quarter, risk meaningfully escalated in global financial markets. In addition to the long-term structural issues facing the developed economies, many impactful issues came on the scene seemingly all at once. What caused investor anxiety to increase this past quarter? Take your pick.

RECENT SOURCES OF UNCERTAINTY	
North Korea tensions	Financial contagion in Portugal
U.S. Financial Regulation	Financial contagion in Spain
Germany short selling ban	Thai protests
China Tightening & Slowdown	U.S. lawsuits against financial firms
UK election	U.S. "flash crash" & technical glitches
German election	Failed terrorist attack in NYC
U.S. Primaries / Election	Disrupted air travel with the Iceland volcano
Greece riots / fiscal restraint	Gulf oil spill concerns
Israel flotilla incident	

Tables/charts in commentary courtesy of Strategas RP, unless otherwise noted on chart.

Of all the issues causing market angst, we view the increase in sovereign risk spreads in troubled European countries, as well as the renewed weakness in U.S. housing, as the most serious. Also of note is that the tax rate on income and dividends is expected to rise in 2011 unless Congress extends the Bush tax cuts.

The speed at which the dynamics of the global economic recovery and character of the stock market have changed has many seasoned professionals scratching their heads and lamenting over recent poor equity market returns. Indeed, when over a trillion dollars in wealth evaporates in the global stock markets in less than a three-month period, the question for investors is "how much of my portfolio was preserved?" as opposed to "how much money did I make?" From that perspective, we are satisfied with our equity strategies' performances this quarter. The Blue Shores Global Equity Strategy returned

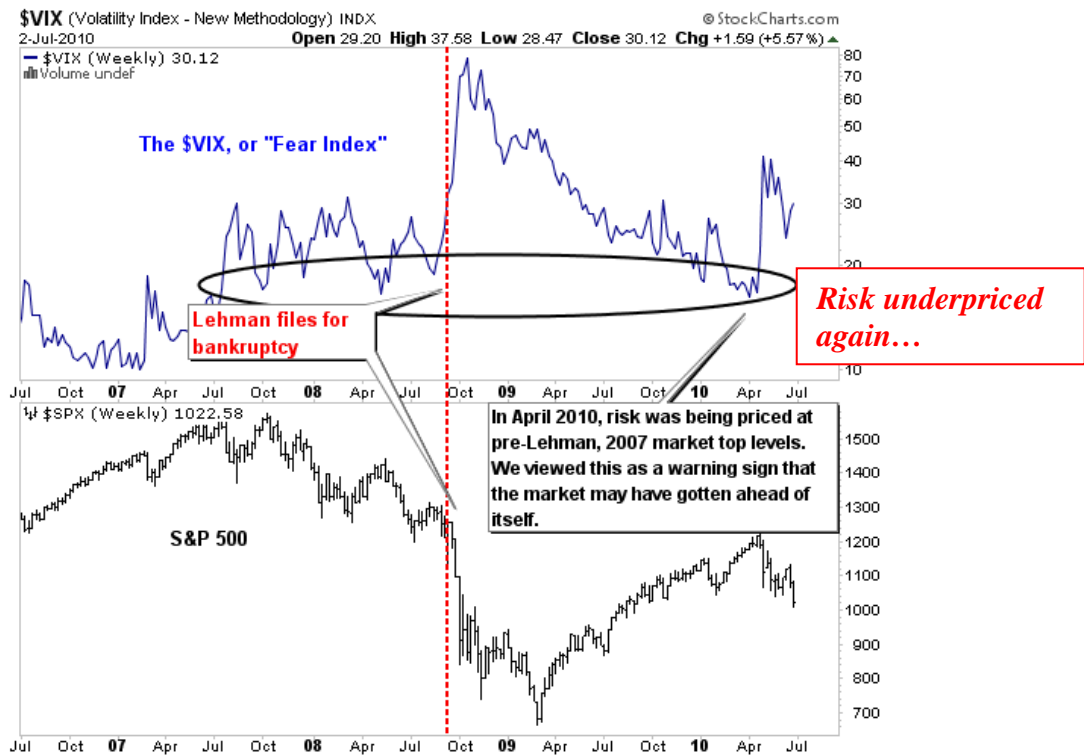
-7.6%¹ this quarter, versus the MSCI World Index Net return of -12.7%. The U.S. Core Equity Strategy returned -6.4%, versus the S&P 500 Total Return of -11.4%. Of course, a negative absolute return is never the desired outcome, but considering the stock market's 80%+ return from the March 9, 2009 low to the April 23, 2010 high (which Blue Shores mostly participated in), some type of correction, at a minimum, was due.

Whereas rising uncertainty harmed equity investors' portfolios during the quarter, it benefited fixed income investors, or at least those who did not reach for yield with risky credits. A flight to quality pushed government bond prices higher and yields lower during the quarter. While credit spreads did widen during the quarter, it was not enough to offset the price gains made on the back of Treasuries. The Blue Shores Taxable Fixed-Income Strategy returned a positive 1.8%, but underperformed the Barclays Intermediate Government/Credit benchmark return of 3.0%. The story was similar on the tax-exempt fixed income side, with the Blue Shores Tax-Exempt Fixed Income Strategy returning 1.1% versus the Lehman Five Year Muni benchmark return of 1.7%. Simply stated, we started the quarter concerned about rising yields, which could make fixed income investments lose value. Our conservative, below benchmark duration limited upside participation in the large Treasury rally that unfolded. Nonetheless, the high-quality underlying securities provided a positive return in a tumultuous environment. We will address fixed income markets in greater detail later in this commentary.

At Blue Shores, the most common type of account we manage is global balanced, and of the different available balanced allocations, 50% equity and 50% fixed income allocations are the most common. Our 50% global equity and 50% taxable fixed income composite returned -2.9%, versus the blended benchmark return of -5.0% for the quarter.

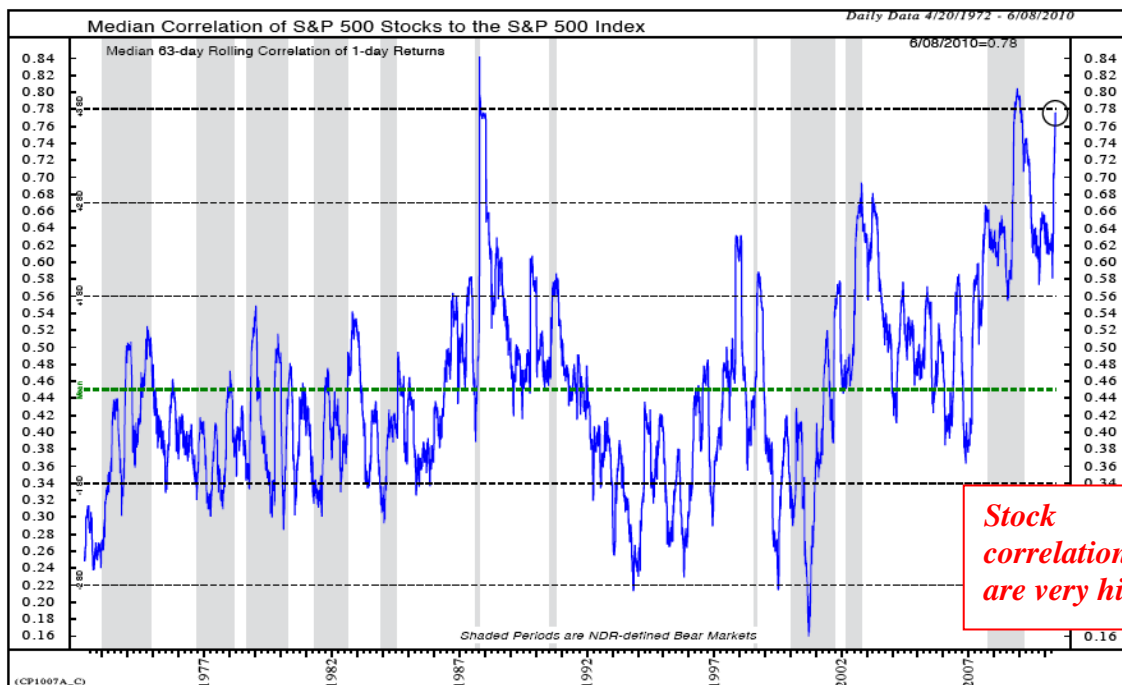
In hindsight, it is often easy to see when risks were rising in financial markets. **Fortunately for our clients, we began reducing equity exposure before much of the market rout unfolded.** We first become nervous at the end of Q1. At the time, economic momentum and earnings growth were generally still quite strong, but the VIX index (also known as the volatility or fear index) caught our eye. It was trading at levels lower than it was when the stock market was making new highs in 2007 prior to the financial chaos that was to unfold in the coming year. This suggests investors were less fearful in 2Q 2010 than when the market was making new highs several years earlier. Since then, however, private credit growth has become non-existent, unemployment has risen to over 9%, and the world economy is on shaky ground as it attempts to recover from a debt implosion. In our opinion, you did not need a PhD in economics to see that risk was mispriced. On March 19, we purchased a security that follows \$VIX.

¹ Represents gross total returns for Blue Shores Global MCC Equity Composite; individual client returns may vary. A fully GIPS compliant performance presentation is available upon request for each of Blue Shores strategies.



On April 27, we began raising cash, and on May 4, began building short positions via allocating cash to inverse ETFs. Throughout the quarter, as economic and market conditions deteriorated, we continued to reduce the equity strategy’s long-market exposure. **We ended the quarter with approximately 55% long market exposure, down from approximately 95% at the end of April.**

Systemic risk has risen. That is, non-diversifiable, macroeconomic risk, which affects all financial assets, has increased. This is something we monitor on an empirical basis. The following chart, courtesy of Ned Davis Research, measures the median 63-day rolling correlation of 1-day returns of stocks in the S&P 500 index to the index as a whole. At the beginning of June, it was already nearing levels similar to those occurring during the 2008 meltdown, with a median correlation of .78. You have to go back to the crash of 1987 to find similarly high correlations.



It is important for investors to understand that, within the equity market, you cannot diversify your way out of systemic risk by adding more and more stocks or investment styles. In fact, all risky assets are affected at the same time, whether it is equities, credit, commodities, or real estate.

Index Name	06/30/10 Last 3 Months %
Large-Cap Indexes	
Russell 1000®	-11.44
Russell 1000® Growth	-11.75
Russell 1000® Value	-11.15
Mid-Cap Indexes	
Russell Midcap®	-9.88
Russell Midcap® Growth	-10.2
Russell Midcap® Value	-9.57
Small-Cap Indexes	
Russell 2000®	-9.92
Russell 2000® Growth	-9.22
Russell 2000® Value	-10.6
International Indices	
MSCI EAFE	-12.26
MSCI Emerging	-9.84

Nowhere to hide

In a changing systemic risk environment, an active money manager generally needs to adopt a market call in order to have an opportunity to meaningfully add value. The

decision is primarily one of how much market risk does one want to assume (i.e. how much exposure should an investor have to the market?) This is a very different decision than what stocks to buy. **Having a market exposure decision in the investment process is a hallmark of the Blue Shores approach to managing money.**

As we review our performance attribution, as we do each quarter, it is important to keep in mind that, beyond the sector allocation and stock selection decisions, the market exposure decision added value this quarter. In terms of sector allocation and stock selection, however, stock selection added meaningful value during the quarter (>3%), whereas sector allocation had a small negative effect (<-0.5%) on overall performance in the global equity strategy.

Stock selection proved particularly strong in the financial sector, followed by the consumer staples and energy sectors. In fact, stock selection was a positive contributor to performance relative to the benchmark index in all sectors other than the healthcare and telecom sectors. Sector selection, however, was detrimental in more sectors than it was positive. The portfolio's underweight in consumer staples stocks had the largest negative sector effect versus the benchmark, followed by an overweight in materials stocks. On the positive side, the 10% underweight in financials benefited performance the most, from a sector weight perspective.

The best performer in the Blue Shores' Global Multi Cap Core Strategy was Mariner Energy (ME)². This stock, which was a member of the value element, returned 57% for the quarter before it was sold on May 7th. Mariner is involved in oil and gas exploration in the Gulf of Mexico and the Permian Basin in West Texas. Much of this stock's outperformance this quarter can be attributed to a merger agreement the company entered into mid-April to be acquired by Apache.

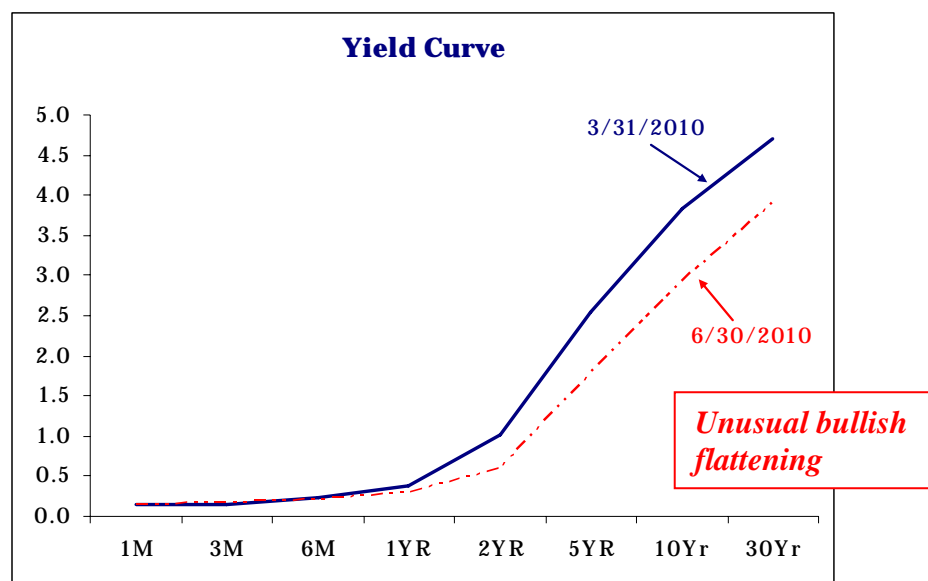
Also in the value element, the iPath VIX Mid-term ETN (VXZ) returned 46% over the quarter. We bought the VIX ETN, which is a measure of volatility, in mid-March when risk looked cheap, as discussed earlier. This proved to be a timely purchase as volatility increased significantly over the past quarter.

The worst performing stock for the quarter was Monsanto (MON) in the growth element, which declined -35% during the quarter. Monsanto is a leading supplier of agricultural inputs, including seeds, biotechnology traits, and herbicides. The profitability of one of the company's biggest products, Roundup herbicide, fell more than expected, and the launch of two new products is taking longer than anticipated to ramp up. Nonetheless, we still hold Monsanto because we believe it dominates its market and its commitment to research and development has positioned it to reward shareholders over time, in our opinion.

² *The securities referenced in this report are used to illustrate BSC's methodology. Securities selected by BSC for client portfolios under management may decline as well as increase in value. A list of all securities purchased and sold during the past 12 months by accounts using a similar investment strategy is available upon request.*

BP (BP), which was in the international element, declined -35% over the quarter before it was sold May 28th. We were initially optimistic that the “top kill” procedure would be successful in stopping the oil, or perhaps other early attempts would find success. The stock looked cheap, if in fact the spilling would stop sooner rather than later. However, there is no end in sight. We took the loss and moved on.

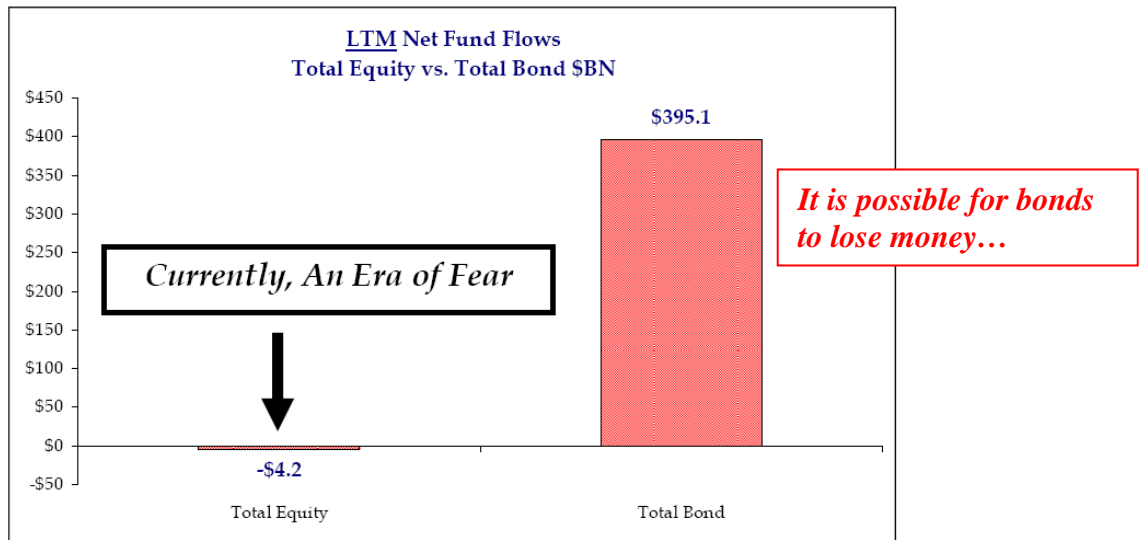
Turning to the fixed income markets, the yield curve underwent an unusual bullish flattening this quarter. This occurs when the yield curve becomes less steep as a result of long-term yields coming down, as opposed to short-term yields rising.



Typically at this stage in the cycle, short-term rates begin to edge higher as an eventual Fed tightening is priced in. **However, it is clear now that Fed tightening has been postponed most likely until the second half of 2011.** We, like many professional economists, are a bit shocked to see the ten-year Treasury yield end the quarter at 2.95% and the two-year at 0.62%. It certainly *feels* like a run on Treasuries, although a drop in inflation expectations, weakness in private credit growth, anchored short rates, and risk aversion continue to provide a fundamental bid under the securities. Still, the change in sentiment toward assets tied to risk and economic growth happened astonishingly quickly over the past quarter and is quite uncharacteristic of normal topping action.

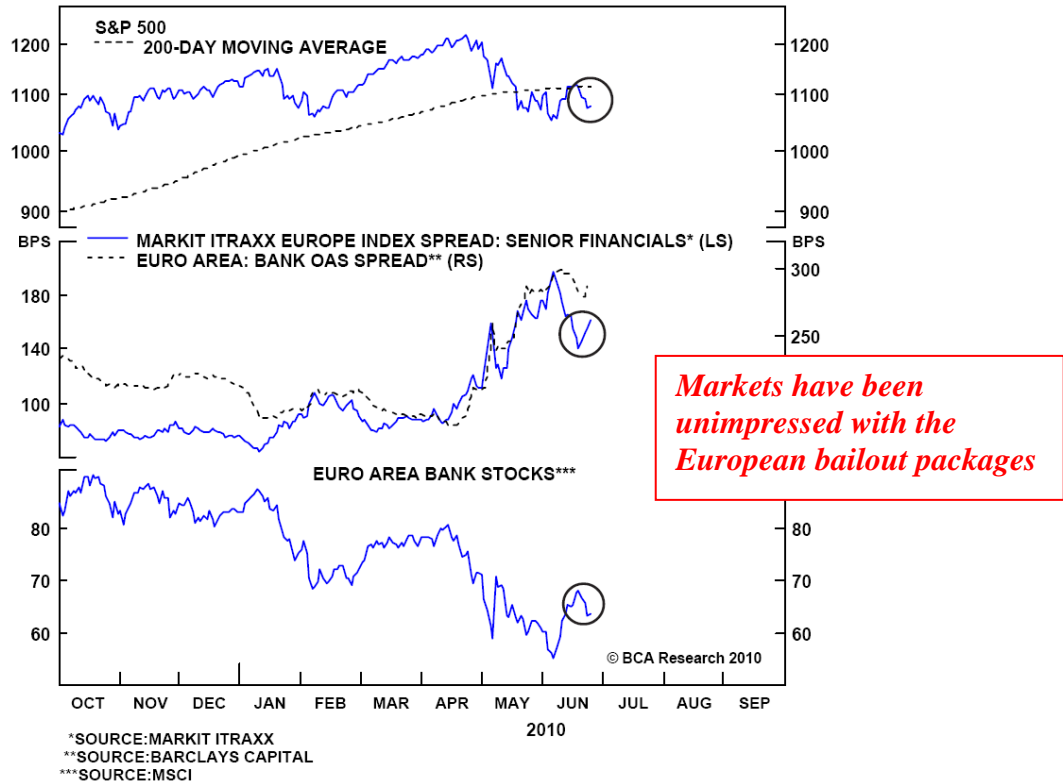


At the beginning of April, rising yields seemed like a real possibility as the economic recovery appeared to be intact. Our fixed income mandate is a “sleep well at night” mandate, and as such, we have erred on the side of caution with a short duration. We are continuing to evaluate whether or not to lengthen at the next opportune juncture. If the U.S. economy ends up going through a deflationary bust, 3.0% yields will look like a steal. However, currently, we are not enthralled with the idea of entrusting capital to the U.S. government for a decade at 3.0%.



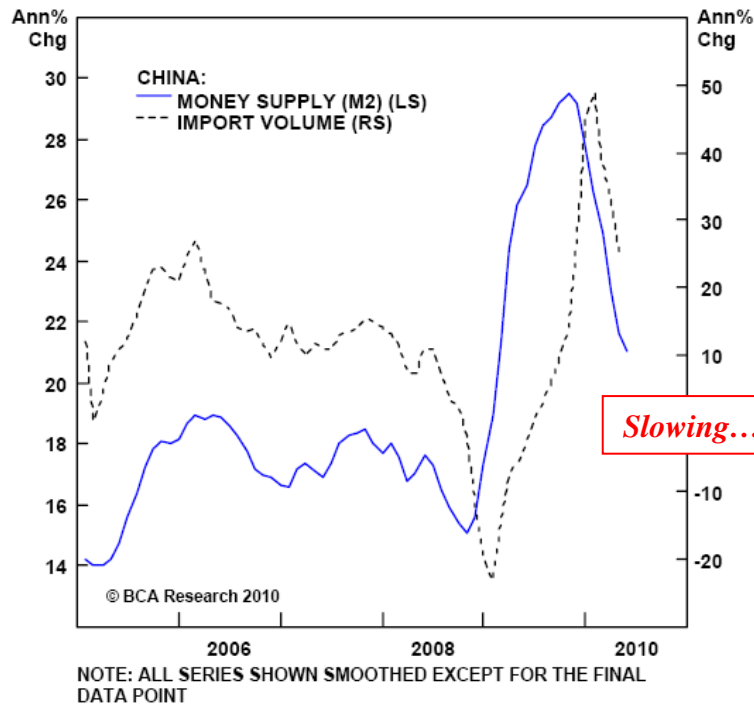
Given the amount of money that has flown into fixed income funds over the past twelve months, one cannot help but wonder if investors have forgotten they can lose money in fixed income securities when yields rise.

Looking forward, we think more downside risks remain until credit markets in Europe improve and global economic momentum stabilizes. Thus far, markets remain unimpressed with the European bailout packages.



The only bid for Southern European debt is coming from the European Central Bank (ECB). There are also reports of banks cutting back loans to the hedge fund industry.

As we have written before, it is not just Europe that investors need to watch. Asia ex-Japan, while not facing the structural headwinds the G7 economies face, is undergoing a slowdown of its own. The Chinese government orchestrated a slowdown to cool its frothy property market. Now the question is whether or not the authorities achieve the desired surgical result of cooling property markets without sending the rest of the economy into a funk. Time will tell.



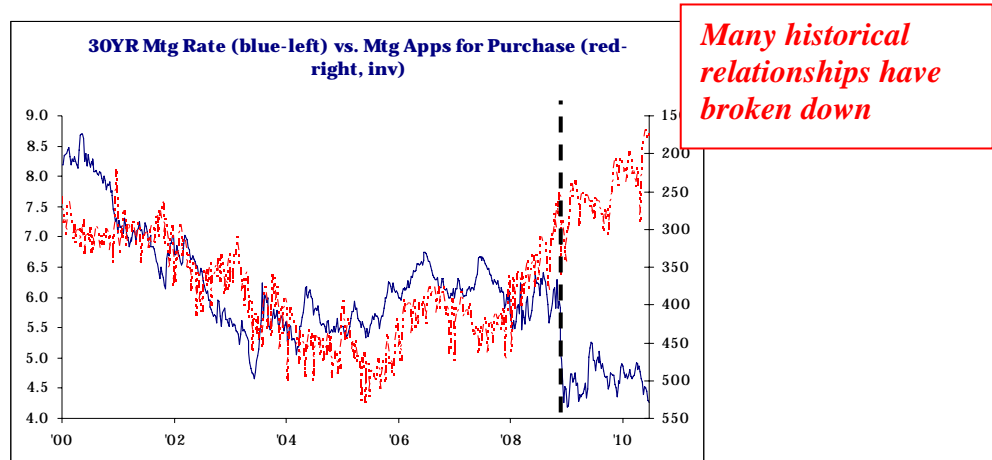
As we start the third quarter, we do not currently see any positive catalysts to drive the markets meaningfully higher and believe a defensive portfolio posture is warranted. A rigorous improvement in the labor market would be a welcome development, as would a reduction in LIBOR and EURIBOR rates, both of which measure stress in the inter-bank lending market.

A big picture concern is that the European authorities may be making a large policy mistake á la the U.S in the 1930s and Japan in the 1990s. The Eurozone economic recovery has been anemic compared to Asia and the U.S., and the economy is dangerously close to “double-dip” territory. Now, the Europeans are beginning to take fiscal austerity measures to cut government deficits, which will no doubt decrease aggregate demand at a time when more demand is needed. To be clear, the troubled Southern European economies *have to* undertake austerity measures immediately, as is evidenced by the blowout in their government bond yields. However, there currently is no pressure on the core European countries, or the U.S., to undergo austerity measures at this time, as evidenced by their sovereign debt yields.



Of course, we are assuming, as are many investors and rating agencies, that once the cyclical recovery is sustainable, measures will be enacted to avoid a future fiscal crisis, particularly in the U.S. Could the U.S. government spend itself into oblivion? Yes, we believe it could, particularly under the current administration and Congress. However, that is a worry for another day. At the moment, there is sufficient demand for AAA rated sovereign debt under current conditions.

The global economy is undergoing a structural change, as is the U.S. There are many examples of past economic and financial relationships that have broken down. The relationship between mortgage applications for purchase and the mortgage yield is just one of them.



The implication for investors is that they must not be dogmatic in their approach to the markets. **As a global opportunistic manager, such structural shifts create just as many opportunities as they do challenges for our clients' financial success, in our opinion. It is our job to search the global landscape for compelling businesses and purchase them at good prices, whether those businesses are large U.S. multi-nationals or mid-sized emerging market utilities.** Additionally, hedging those positions to varying degrees in changing market environments is an important priority and mandate as well. Lastly, we will continue to engage in unique trading ideas at the edges of the portfolio (via ETFs in commodities, currencies, etc) as they are presented in global markets.

Given all the changes that have occurred over the past quarter, we have been busy reviewing what characteristics, all else equal, that we should favor in stock selection in the current environment. Generally speaking, we continue to prefer companies with strong balance sheets, solid dividend yields, and the ability to grow dividends. We also think there are some special opportunities emerging as a result of recent headlines from the Gulf of Mexico and elsewhere.

It is tough to say what the immediate future holds for markets. As mentioned previously, we believe the risks are to the downside for now. We think Jason Trennert of Strategas accurately described the sentiment of corporate managers around the globe in a note to institutional research clients the other day. He wrote, "We suspect that few companies are comfortable taking undue risks in an environment in which a small number of policymakers in Washington, Brussels, and Beijing, rather than normal cyclical forces, are dictating the future character of the global economy. This might not be so bad if at least some modicum of altruism or competence on the part of the political class were evident. March's passage of a comprehensive, yet largely politically unpopular health care bill, the failed attempts to contain BP's oil spill, at times almost tribal contentiousness of European economic policymakers, and, most recently, the wrangling over a 1,900 page financial reform bill, haven't helped in this regard. There appears to be a fear that if you make money, you could become a political target – together, the Financials, Energy, and Healthcare sectors comprise 40% of the S&P 500 which have been in front of Congress recently."

Putting politics aside, are stocks cheap or expensive? The S&P 500 is trading around 13x forward earnings, which is historically pretty cheap. The key is economic growth. If the global economy has a relapse, or even severe slowdown, forward estimated earnings will drop and stocks will not be attractive from a valuation perspective. Nonetheless, if the labor market can improve enough to keep the U.S. recovery sustained, then 0% interest rates and strong corporate balance sheets may be enough to ultimately move markets higher. Lastly, while "we're due" arguments are intellectually weak, it is safe to say that we're due some type of positive surprise.

Blue Shores
C A P I T A L

We start the third quarter with approximately 55% long exposure. Where will market exposure be at the end of this quarter? That will depend upon incoming data concerning economic growth, corporate profitability, and interest rates and inflation. The economic and market cycle are at a critical juncture and volatility remains high. We have positions ready to be sold if we believe clients should become more defensive, as well as names we are eager to purchase on their behalf if it looks like the economy is improving. This is a market that investors do not want to be far away from as conditions continue to change quickly. Each day, we plan for various scenarios and prepare potential trades. **It is important to understand that we do not forecast the market at Blue Shores; rather we respond to new information that drives asset values and adjust client portfolios accordingly.**

As always, we thank you for your continued trust in Blue Shores and we welcome any questions or comments.

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