

Fourth Quarter Commentary



OUR INVESTMENT PHILOSOPHY

MINIMIZE COSTS

Since taxes and transaction costs are every investor's largest expense, we minimize tax liability while utilizing low and no-cost investment vehicles.

PORTFOLIO CONSTRUCTION

Proper asset allocation is essential to aligning your investments with your objectives, time horizon and risk tolerance. Proper diversification within asset classes can reduce volatility and manage risk.

INDEX INVESTING

We adhere to a prudent, proven and profitable investment strategy known as index investing. We are not stock pickers, market-timers or active traders.

STRATEGIC MANAGEMENT

We seek to identify macro trends and invest accordingly.

Happy New Year!

Outlook for 2011

Economic Highlights and Headwinds

Our outlook has remained fairly constant over the past year. At risk of sounding like a broken record, we want to recap our macro outlook and portfolio positioning heading into the new year. The domestic economy continues to grow at a slow pace, with corporate earnings continuing to lead the way on the backs of innovation and increased labor productivity. Despite the Fed-fueled earnings growth, the US is facing many, many headwinds.

Among other fiscal problems, implementation of the landmark healthcare legislation will begin creating a drag on our economy, although pending litigation can either relieve or exacerbate the situation.

Unemployment remains high, with few signs of abating anytime soon. This continues to weaken housing, as are foreclosure moratoriums, useless Treasury programs, a growing inventory of houses, and the continued reverberations from the housing bubble's crash. While each of these macroeconomic issues will undoubtedly be a drag on the American economy for years to come, we do not foresee a domestic double-dip recession.

Globally, the continuing economic recovery has been uneven. Some regions are in the midst of worsening recessions and depressions, marked by austerity measures, currency devaluations and inflation, and civil

unrest. Other regions bounced back from 2008 with incredible resilience. Both types of countries present risks to the American and global economy. The weaker countries' debt problems threaten to spread globally through the bond and credit markets, while also threatening pan-sovereign backstops like the IMF and World Bank. Strengthening economies are beginning to feel inflation pressures, which will require their central banks to strike a difficult balance between fighting inflation and growth. Unfortunately, at this juncture, much rests in the hands of politicians.

Inflation Accelerating

For the past year, we have worried about the threat that policy mistakes pose to the global economy. Unfortunately, those fears are coming to fruition as European political wrangling and paralysis in the face of ongoing crises have escalated both the costs and dangers to the global economy. Furthermore, many are questioning the prudence of monetary policy in the three largest economies: the US, China, and Japan. While the merits of some aspects of the US Federal Reserve's second round of quantitative easing (QE2) operations are still being vigorously debated, nearly all observers are in agreement that the Fed is creating a lot more inflation than it bargained for (or can handle, for that matter). We still do not see domestic inflation flaring in the near-term, but are wary of the increasing medium- and long-term dangers.



I never think of the future. It comes soon enough.

~ Albert Einstein

Chasing the past, I stumbled into the future.

~ T.A. Sach

Rates Rising

As long as the Democrats won't cut spending and the Republicans won't raise taxes, the deficit will continue to add trillions to the nation's debt each year. This fiscal profligacy should crowd out private borrowing and drive rates upwards. Unless global growth slows significantly or the Fed decides to lend substantially more money to the US Treasury, it seems unlikely that rates can drop below their recent autumnal lows.

Positioning

Bonds Dropping

Consequently, with inflation and interest rates poised to rise from historic lows, we are none-too-bullish on bonds. For nearly a year now, we have been rotating out of longer-duration bonds and into shorter-term bonds and preferred stock. Additionally, since the investment-

grade bond market has more than fully healed from the trauma of 2008-2009, we believe the best opportunities to capture the American recovery remain in the high-yield market. Despite their inferior credit quality, the economic fundamentals of smaller companies are improving and the coupons offered more than compensate for the possibility of default. Given the fixed-income environment we are becoming increasingly selective and will likely underweight bonds until economic data dictates otherwise.

Equities

With corporate earnings continuing to grow and inflation beginning to affect the markets, stocks are the most promising asset class. Stocks are positively correlated with the business cycle and provide a hedge against inflation. As more money is printed worldwide, it should gravitate towards more regions with superior

growth prospects and towards industries with favorable supply-and-demand dynamics. Thus, we are overweight in high-growth regions such as emerging markets, Canada, Australia, and Korea. Industry-wise, we feel that agriculture has the best long-term prospects, while energy and metals have favorable shorter-term to mid-term prospects. We are also overweight domestic large-caps, which happen to constitute our largest position. Although we have ridden all of these sectors for decent gains over the past six months, most equities are now fairly or over-priced and new opportunities are less prevalent than just a few months ago.

Case for EM Assets, and potential risks

Several times, we have written about changing global dynamics and our bias towards emerging market equities and debt. Of course, the risks of investing in emerging markets



are many, from opaque accounting to increased market volatility/risk. However, as we've outlined several times, the largest risk we see to EM growth is inflation. While inflation is somewhat of an academic topic in developed markets, it is reaching double-digits in many developing nations. Thus, policymakers are being forced to choose between hurting their own export-centric economies or letting inflation spiral out of control. Either way, it seems that real growth rates will have to decrease.

Despite slowing rates of growth, the emerging markets are still out-growing the developed world at a blistering pace. We expect this to continue for some time more. Whether this translates into equity market returns or not is really a function of valuation. For instance, China had the strongest GDP growth in 2010, but was one of the worst-performing stock markets. Historically, valuation is a far superior predictor of investment returns than GDP growth. So while we are bullish on EM generally, that opinion is contingent upon local valuations.

Gold and Why

More and more people have been asking us about gold. It's no wonder, given endless currency printing, expectations of massive inflation, global instability, and plenty of demand as demonstrated by ads offering to buy your jewelry. Objectively, it is debatable whether gold is a hedge against inflation or geopolitical fears, as are arguments that central banks and Indian weddings will ensure an unending demand for gold at any price. Additionally, gold does not earn money or produce cash flows like a stock, bond,

or real estate, so it is almost impossible to value. Despite these issues, there has been immense demand for gold in the market and it has been a top performer since we bought it in mid-2009. We continue to hold it and will continue to monitor the fundamentals that do affect its price, such as interest rates and market demand.

Final words

It is easy to forget how volatile 2010 really was with the market rising steadily over past few months. Believe it or not the S&P 500 had in excess of a 20% swing between the low (July 10) and high (December 27) last year, and that didn't even account for all the gyrations in between. All in all, we fared very well in the midst of the domestic and global uncertainty. Our decision to replace the European ETF with Asia Pacific and Canada ETFs immediately following Q1, and our early exit from longer-term bond maturities helped lower our portfolios volatility and at the same time offered some rewarding upside. We continue to see an uncertain economic environment for 2011, but feel positive with the overall progression of our slow paced recovery. We will continue to monitor the situation closely and want to thank you for giving us the opportunity to manage your and your family's financial well being. We hope you will keep us in mind when a friend or family member needs financial planning or investment management services.

Wishing you a very Happy New Year!

Your MFA Team



Beginning in 2011, your custodian Charles Schwab is required to report gain/loss information for sold investments to the IRS. You can go to www.schwab.com/costbasis to learn more about the new reporting legislation and cost basis methods available at Schwab. If you have questions about this new tax reporting law, please call us.

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