Fall Investment Commentary
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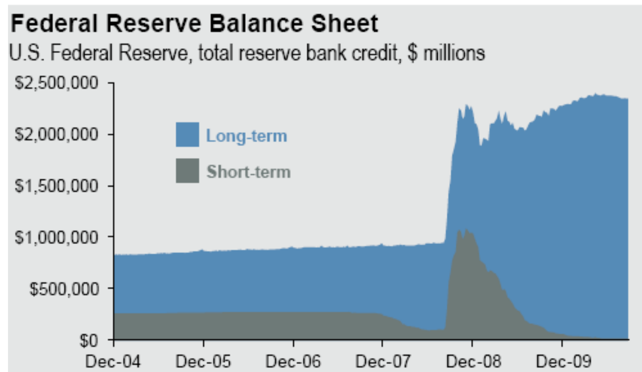
The "Fall Investment Commentary" has seemingly slipped into December. Our apologies for the delay, but it has been a busy few months in the capital markets. Global equity markets have rallied considerably since our last letter was distributed on September 1st. Several factors contributed to the gains including positive earnings announcements and expected turnover at the midterm elections. In our opinion though, the largest contributor was the Federal Reserve ("The Fed"). The Fed was signaling additional stimulus from the U.S. government and in the first week of November, they delivered. The Fed confirmed its intention to engage in a second round of quantitative easing by announcing that a total of $850-900 billion dollars would be injected into the economy. This is commonly referred to as "QE2".

Index	Return % Since 9/1/10	Return% YTD
S&P 500 Index	19.1%	13.5%
DJ UBS Commodity Index	18.8%	11.7%
MSCI EAFE Index	16.6%	7.4%
MSCI Emerging Mkts. Index	16.9%	16.5%
BC Aggregate Bond Index	-2.1%	5.6%

As of 12/14/10

What exactly is Quantitative Easing?

Let's review the Fed's stated purpose: price stability and full employment. In measurable terms, this means The Fed wants to keep inflation at 2% and unemployment at 5%. In order to achieve their goal, they can stimulate or dampen economic activity by adjusting short term interest rates (i.e. the Fed Funds rate). By lowering rates, they entice banks to borrow and, in turn, banks lend the money to businesses, entrepreneurs, individuals, etc. The money is then spent and economic activity is created. The Fed used this tool in 2007-2008 and took short term interest rates from 5.25% down to the 0.0-0.25% range in a matter of 15 months. Their last cut was December 2008 and it was clear that this tool was not enough to stimulate the economy through the deepest recession seen in 80 years. How would Ben Bernanke and the Federal Reserve bring back and maintain stable prices and full employment while the economy continued to crater?



Source: J.P. Morgan

Enter "Quantitative Easing". This refers to the expansion of the Fed's balance sheet, meaning they would buy assets in the open market with newly "printed" money. In the last few months of 2008, following the Lehman Brothers collapse, the Fed bought $1.3 trillion in credit securities in the open market. This was followed in March 2009 with the announcement to buy $1.1 trillion in Mortgage Backed Securities and Treasury Bonds. Coincidentally, capital markets turned in mid-March and a global economic recovery ensued. The Fed's actions clearly indicated that they were going to avoid a deflationary spiral at all costs. In the short term, we think quantitative easing worked and a global economic meltdown was averted. We are in good company. On November 16th, the New York Times published an op-ed piece titled, "Pretty Good for Government Work" penned by Warren Buffet. It was an open letter to Uncle Sam, thanking the government for its role in steering capital markets from *"a destructive economic force unlike any seen for generations"*. He went on to add:

> *"The challenge was huge, and many people thought you were not up to it… Well, Uncle Sam, you delivered. People will second-guess your specific decisions; you can always count on that. But just as there is a fog of war, there is fog of panic – and, overall, your actions were remarkably effective."*

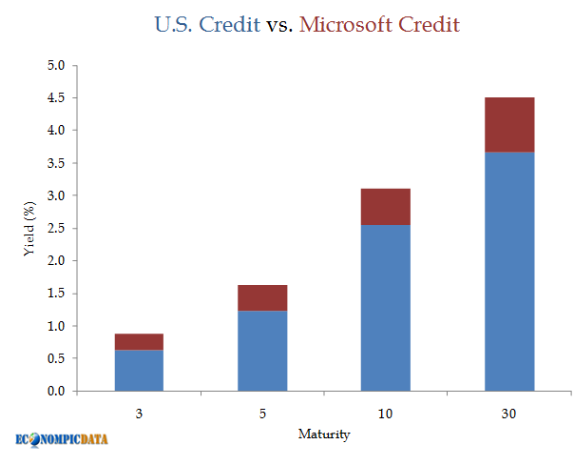
Great! QE1 Worked…What About QE2?

The most we can say is that it's worked so far. When we last wrote you, equities were treading water in 2010. Since then, global equities are up 18% (on average). Commodities have benefited equally and our recommended commodities fund is up 17% over the same timeframe. Alas, there's no free lunch. With the "powers that be" forcing new money into the system, inflation remains an obvious concern. Therefore, it should come as no surprise that assets like commodities have participated equally in the rally because they are heavily utilized as a hedge against inflation.

In early 2009, True North's Investment Policy Committee reviewed our stance on inflation. This was during the first round of quantitative easing when inflation concerns were quite rampant. Despite the massive inflow of new dollars into the system, we recognized that those dollars were not being circulated and that deflation within the U.S. was the near-term concern. Since then, official inflation statistics indicate a small degree of inflation, but below the 2% target that the Fed wishes to maintain. In other words, nothing has really changed. As a side note, our research in early 2009 indicated inflation outside of the U.S. was a concern and that the continued thirst for resources from countries like China and India could drive higher prices even while the U.S. mired in a slow growth phase. This is another reason why we maintained the Commodities allocation mentioned earlier.

A common concern regarding the actions of the Fed is a potential interest rate shock. An unexpected jump in interest rates could occur if buyers decide they own enough U.S. Government bonds. Through QE2, the Fed's intent is to suppress interest rates in order to stimulate the economy. This has a potentially adverse impact on our bond portfolios, and is one of the reasons why we have maintained a defensive posture within fixed income (as described in our last newsletter). One specific concern regarding the potential spike in rates is the resulting losses for the investors that have poured $600 billion into bond funds since early 2009. For now, interest rates remain at historic lows and demand for fixed income is at historic highs. Does this really make sense? As previously mentioned, we believe we are positioned defensively, but we will be addressing additional measures to fend off risks in this area very shortly (this topic will be addressed in our Winter Investment Commentary).

Regardless of the logic of bond buyers, certain companies are taking full advantage of the low interest rate environment. For example, in September Microsoft raised $4.75 billion in 3, 5, 10 and 30 year debt. The 3 and 5 year issuances were at the lowest coupons on record. IBM, Johnson and Johnson, and Dupont all recently issued debt at incredibly cheap rates. Microsoft had almost $37 billion in cash on their balance sheet and about $5 billion in debt before the issuance. Does anyone think that they desperately needed another $5 billion of capital? No, they just see how cheap it is to borrow and jumped on the opportunity. Let's recap: Rock bottom interest rates and insatiable demand from investors for fixed income? If you were CFO for a Fortune 500 company would this be an attractive way to raise capital?



This activity is certainly a positive example of what the Fed it trying to accomplish. Microsoft has even more capital in their war chest to invest or send back to shareholders. Either way, it's a positive for the economy which is one way the Fed expects to stimulate growth.

Portfolio Management in Uncertain Times

Investopedia.com defines portfolio management as "the art and science of making decisions about investment mix and policy…". Some have said that portfolio management is *more* art than science. We hesitate to disagree. The art could be the decision for how much to allocate outside the U.S. 30%? 40%? 50%? Or it could be the decision to add money to a strategy that is out of favor. There's no formula that will tell anyone the exact answers. We use experience and data to make these decisions and below we highlight a few areas of importance today.

Diversity at a Global Level

As investors in the United States we are obviously subject to a certain "home bias". This means we focus on what's going on here more than the rest of the world. For a good example, see the first half of this newsletter! But what we would remind you of, is that your investment dollars are not solely invested in assets tied to the U.S. economy or the U.S. dollar. In fact, we are invested with managers that should benefit as the dollar declines. There's no question we have a fair amount exposure to U.S. companies, but it's not exclusive. Most equity portfolios have in the neighborhood of 40% invested in foreign companies. In addition, most U.S. companies are now generating a significant portion of their sales from outside the U.S. For example, Microsoft and MasterCard are large holdings for several of our managers. Those companies generate 42% and 55% of their respective revenues from outside the U.S.

We seek out managers with the ability to access parts of the world that have attractive demographics and economic landscapes. This is why our equity, fixed income and even our alternative allocations have exposure outside the U.S. in varying degrees.

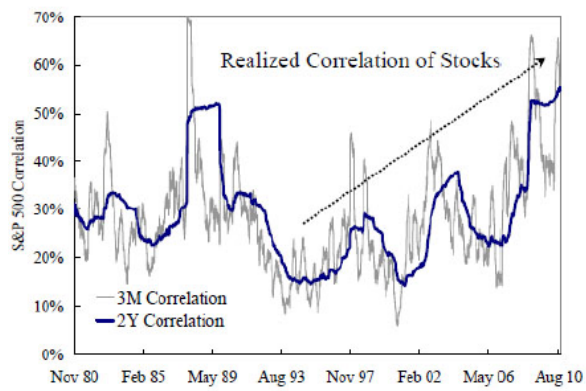
Patience

A common thread in our portfolios at all times is that some component will not be working. Maybe it's a manager underperforming its benchmark or a particular class of investments that just doesn't seem to be keeping up with broad markets. We expect this! For example, we have a large cap manager that underperformed in 2009 by a considerable margin. We reviewed their strategy and decided to *increase* our target allocation. Now, well into December, that manager is outperforming the S&P 500 by 5% (as of 12/14). The same manager reported to our research team that most investors were abandoning their strategy early this year. Bad timing.

One category of investments that seems to be treading water is our allocation to hedge fund of funds. Although the managers held up better than the markets in 2008, they did not have huge runs in 2009 relative to the stock market. Returns in 2010 are positive in the low single digits leaving many clients even over the past three or four years. We think high correlations amongst asset prices in 2010 have contributed to muted results in many hedge fund type strategies. We also feel there is a "coiled spring" effect at work here. As correlations decline, the opportunity to separate the winners and the losers should result in profits for good hedge fund managers. But patience will be required to see those results.

CORRELATION OF S&P STOCKS

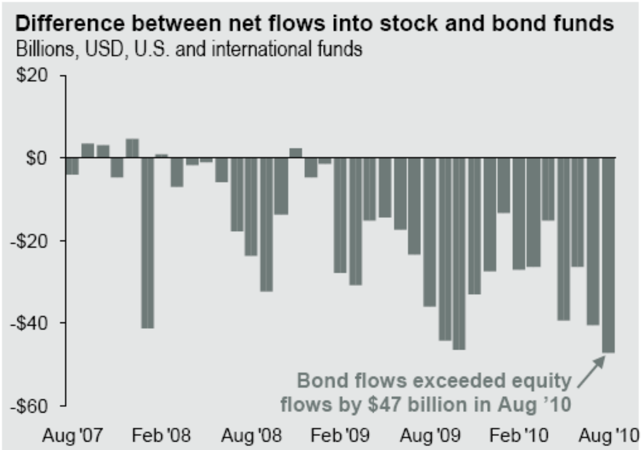
Source: JP Morgan Derivatives



Pay Attention to Relative Values

Relative value is simply comparing the relationship of two assets over time and seeing where their relationship stands today. For example, we have been watching the outperformance of small and mid cap companies since we increased our exposure in May of 2009. Today, when we compare small companies to large companies, we see that they are overvalued based on their historic relationship. We also verify this by talking to managers and other investors. As a result, our small cap managers tend to all be biased to larger cap names within their mandates, and we are okay with this. In fact, it makes our job easier in that we do not have to make any changes because we like their current exposure given our views of this relationship.

Lastly, we would like to leave you with a comment on the relative value between stocks and bonds today. The S&P 500 trades at 12 times expected earnings for the next twelve months. Another way to say this is that stocks have an expected earnings yield of 8.3%. Every $100 invested in stock is backed by an expected $8.30 in earnings. Now compare that to what one would earn investing that $100 in bonds. The 10 year Treasury Bond is currently yielding 3.45%. So an investor earns $3.45 for every $100 invested. In addition, <u>a net $600 billion has poured into bond funds</u> since the beginning of 2009 compared to <u>a net withdrawal of $235 billion</u> from domestic equity funds. On a monthly basis, you have to go back two years (to November of 2008) to find a month where additions to equity outpaced fixed income. As a side note, when we started writing this newsletter in late November, the 10 year yield was around 2.65%. So much for the Fed buying bonds (QE2) to hold yields down!



By our math, the S&P 500 is +45% since November 2008 versus +15% for the bond market (measured by the Barclay's Capital Aggregate Index). Yet main street investors have been running from equities ever since. We aren't saying that there's no need for fixed income in your portfolio, but we are concerned with the flood of assets and want to be defensive in this area.

In Closing…

Uncertainty is always a factor for investors, and investing through an environment of heightened economic and policy uncertainty feels particularly challenging. However, positioning aggressively for any one particular outcome could spell disaster if such an outcome is not realized. As a steward of your capital (and as a fiduciary) we tend not to make such bets. It is not because we lack conviction; we just believe it is common sense to spread our allocations amongst assets we think will perform well over time, coupled with assets we think will hedge against our largest concerns. We agree with author/journalist Robert Lowenstein and will close this investment commentary with his words of wisdom:

"It is generally more lucrative to sell prophecies of doom than to act on them."