

Newsletter – May 2011

MARKET TRENDS 03/31/2011

	Total Return	
	12 Mos	Q1
US Stock Markets		
S&P 500 Index	15.7%	5.9%
S&P MidCap 400 Index	22.5%	9.4%
S&P SmallCap 600 Index	25.3%	7.7%
Int'l Stock Markets		
EAFE Index	10.2%	3.2%
Emerging Mkts Index	17.3%	2.3%
Fixed Income		
Barclays Intermediate		
Gov't/Credit Bond Index	4.6%	0.3%
Barclays Capital Muni Bond		
3 Year Index	1.8%	0.8%
Commodities		
SPDR Gold Shares	28.3%	0.8%
Goldman Sachs		
Commodities	22.7%	11.6%
Real Estate		
Dow Jones US Real Estate		
Index	24.3%	7.2%

Sources: Total Returns from WSJ Market Data Group, Standard & Poor's, Barclays

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MARKET RECAP

The first quarter continued to be volatile for global equities. The strong start to the year was briefly stunted by a 6% correction in the Standard & Poor's 500 Index from mid-February to early March. This correction was precipitated by political upheaval in the Mid East and North Africa as well as natural disasters in Japan. The uncertainty fueled market volatility and led to negative investor sentiment. Retail investors pulled \$8.5 billion from domestic stock funds in March and missed the subsequent rally in the market. The late March rally wiped out the year-to-date losses and the S&P 500 posted a 5.9% quarterly return, its best first-quarter since 1998. US mid and small cap stocks outpaced large cap stocks for the quarter. Developed international and emerging market equities trailed U.S. equity market returns. Bonds finished the quarter with slight gains and the Barclays Municipal 3 Year Bond Index was up 0.8%, rebounding from the fourth quarter despite calls for Armageddon in muni land by Meredith Whitney. The Goldman Sachs commodity index finished up 11.6% led by a spike in oil and food prices while gold was only up 0.8%.

COMMENTARY

In Nassim Taleb's, The Black Swan, written in 2007, the author analyzes the impact of highly improbable, unpredictable events. The metaphor derives from the concept that a preponderance of white swans should not imply that all swans are white, a fact supported by the existence of the occasional black swan. Conventional wisdom and our natural means of perception and thinking seem to defy the truth. We go around seeing white swans and equate white with swans, unprepared for the outlier and thus susceptible or vulnerable to randomness.

Applied to the financial world, the argument has been advanced that our minds are wired for narrative and we crave extrapolation and predictability, as opposed to the statistical randomness that exists in our increasingly complex universe. In the last ten years, we have had at least two highly unpredictable events that shattered our perspective on life as we know it: the September 11, 2001 terrorist attacks and the 2008 global credit crisis/panic. One could argue about the unpredictability of these events, but certainly the timing and particulars, as well as the devastation caused, resisted rationale, logic, or extrapolation. In hindsight, our minds shape these events into being conceivable, but it would be difficult to argue that one could have anticipated the events themselves prospectively on the morning of September 11th or in the summer of 2008 as dominos began to fall.

Since we are in the process of looking backwards to make sense of these horrific events, our natural thinking has been corrupted or inverted by the recent past. We see black swans everywhere—a spike in oil and gasoline prices, Middle East and North African political upheaval, high unemployment, weak U.S. housing market, geopolitical vulnerability, massive global and local government deficits, Standard and Poor's putting the U.S. under credit watch for a downgrade, dollar weakening

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and risk of losing status as world currency reserve, natural disasters, Japan’s nuclear catastrophe, higher food prices, end of QE2 (Federal Reserve’s quantitative easing), etc. But what if these issues are actually everyday white swans? What if we are back in the normal simmering pot of life’s challenges? After all, the problems are known, and solutions can be formulated for many of them. As we consider the daunting list of concerns, the equity markets have shrugged them off, yet retail investors have a disdain for equities. We believe the heightened anxiety of backward looking investors in a normalizing world, provides opportunities for those with an eye towards the future.

Our tendency is to focus just on the negatives and to extrapolate the harsh and pernicious conditions from the recent past into the future usually in a straight line. However, some of these issues may actually result in positive outcomes and/or reversals such as: the opportunity for Middle East and Africa to become more democratic, alternative energies to be utilized, oil prices to come down this summer, improving job market, stabilization and improvement in the housing market, better US diplomacy and standing in the world, action taken to address budget deficits, and with the dollar remaining the primary reserve currency. It is normal to have market cycles, and despite black swans, a reversion to the mean is likely. After an obsession with the bleak and scary, we have difficulty seeing the white swans. Who would have predicted the US finally catching and killing Bin Laden?

It continues to be rewarding to take advantage of market disruptions caused by black swans as markets end up reverting to the mean – this requires discipline (adding slightly to equities on pullbacks), conviction (adding to positions on market overreactions) and patience (may be early in purchases, dollar cost averaging is beneficial). After all, markets rarely make tops in times of negativity but instead in times of euphoria. ***This is one of the reasons that we have been advocating increasing equities in accounts since June 2010. In addition, the bearish sentiment for equities and record cash flow into bond funds are both contrarian indicators.***

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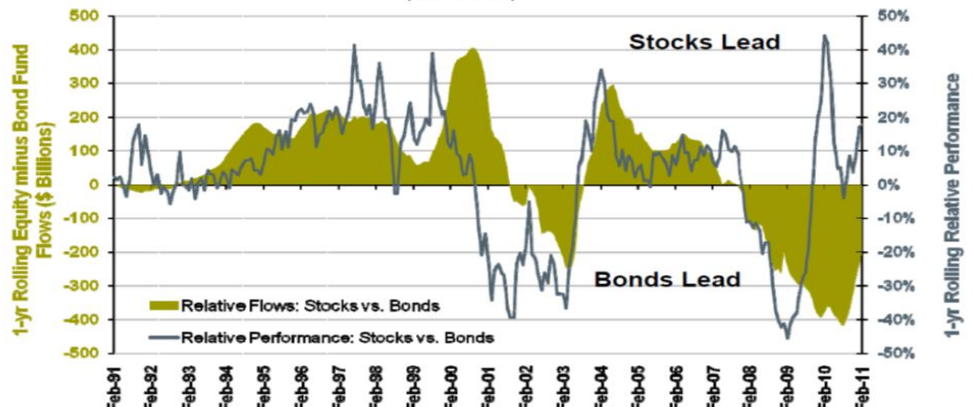
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Mutual Fund Flows and 1-Year Performance (1991-2011)



Relative Flows reflects net sales to stock funds minus net sales to bond funds. Relative Performance reflects total stock returns minus total bond returns. All references to stocks represented by the Standard and Poor’s 500 Index. All references to bonds represented by the Barclay’s Capital® U.S. Aggregate Bond Index. Source: Ibbotson Associates, Investment Company Institute, FMRCo (MARE) as of 2/28/11. Past performance is no guarantee of future results.

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“...it is not in your best interest to react to every perceived black swan.”

“...better off to add to risk assets like stocks when fear and perception of risk are elevated.”

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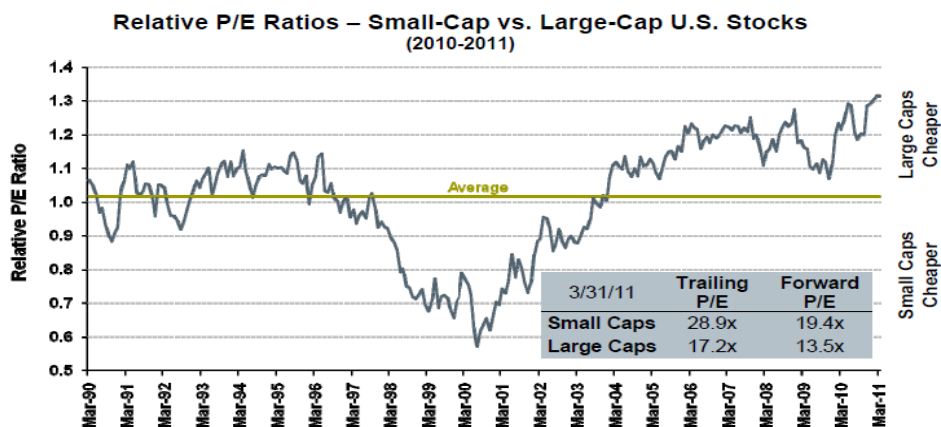
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CONCLUSION

We get the question on market pullbacks about what we are doing *right now* to protect your portfolio(s). First, it is not in your best interest to react to every perceived black swan. Egypt, Libya, the Japan quake and the largest nuclear catastrophe in history resulted in a 6% correction, but the market rebounded quickly. Some clients wanted to get defensive and decrease equities – hard to do with money markets near zero and 10 year U.S. Treasury yields at 3.15%. We would have been better off again to do just the opposite – adding to risk assets like stocks when fear and perception of risk, if not true risk, are elevated. Instead of making massive shifts in the moment, we strive to have completed the majority of the appropriate prep work upfront-to thoroughly understand your goals and risk tolerance and to establish long term asset allocation targets. However, we reserve the discretion to make shifts with asset classes of +/- 10%, so if the equity target is 50%, your actual allocation maybe between 40% to 60% depending on our market views and valuations.



Price-to-earnings ratio (P/E): The price of a stock divided by its earnings per share. Also known as the "multiple," the P/E ratio gives investors an idea of how much they are paying for a company's earnings power. Chart shows relative P/E ratios excluding negative earnings for the Russell 2000 Index vs. the Russell 1000 Index. Source: FactSet, FMRCo. (MARE) as of 3/31/11

We also utilize methods to enhance the risk adjusted returns of your portfolio. For example, the addition of alternatives (investments with different return and risk expectations than either stocks or bonds) should reduce overall portfolio risk and help hedge portfolios against inflation (commodities and inflation protected securities), weakening US dollar (international stocks and bonds), and higher interest rates (floating rate loan funds). Our goal is to create portfolios that produce attractive risk adjusted returns based on market opportunities while factoring in your personal objectives. Our expectation is that short term tactical shifts will be infrequent and incremental if we have been thorough at the outset. Even though we are watching revolutionary events in real time, it doesn't mean that the ultimate implications will be clear quickly.