

## quarterly INSIGHTS

### EXECUTIVE SUMMARY

#### Global Stock Markets Strongly Rebound In Q3

**I**n the Third Quarter, the domestic S&P 500 Index rose 11.29% while the MSCI EAFE Index (foreign) rose 16.53%. Almost all global equity markets had double digit positive performance (the exception was Japan). The US Dollar was pressured while concerns regarding the Greek debt crisis abated. The Euro considerably appreciated and the European stocks led the equity markets.

Many investors missed the Third Quarter stock market rebound. Trading in shares listed on the New York Stock Exchange (NYSE) was down by 11% in July from 2009 levels and 30% in August. Investors continued to move to bonds, as evidenced by lowered yields on all maturities of US Treasury bonds. Stock market pessimism has prevailed despite a market that has risen over 70% since its May 2009 low.

We maintain our belief that 2010 global equity markets will advance 12% to 16%.

#### Cheap Debt Fuels Earnings Growth

Corporations are able to borrow money (issue bonds) at low cost with surprising ease. The issue proceeds are being used to buy back stock, retire higher-cost debt, finance acquisitions, and/or fund daily operations. No matter the use of the proceeds, the end result is a higher company earnings per share (EPS). A higher EPS usually translates to a higher future stock price.

As long as interest rates are low, we expect this trend to continue. We believe corporate balance sheets can handle substantially more debt. This bodes well for stock valuations as we anticipate increased EPS. Standard & Poor's estimates that corporate earnings will set new records next year. Stock prices are currently more than 25% off their all-time high level. We are bullish.

Third Quarter 2010

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**EXECUTIVE SUMMARY**

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## **We Remain Bullish On Stocks**

Real gross domestic product (GDP) eased from +3.7% in the First Quarter to +1.7% in the Second Quarter (source: Bureau of Economic Analysis). We view the economy in an expansion phase, albeit a slower expansion. The portfolio is positioned to benefit from an economic expansion. We remain bullish on stocks.

During the Third Quarter, we adjusted the sub-sector weightings in the Financials sector. We increased our exposure to investment banking via a European company because we anticipate more stock offerings. At the same time, we sold a company that derives its revenues from money market funds because we anticipate an investor shift from cash to stocks.

## **Bond Prices Rise In The Third Quarter**

The Fed interest rate was maintained in the Third Quarter as part of a globally coordinated effort to stimulate economic growth. The Barclays Capital U.S. Government/Credit Bond Index rose 3.46% in the Third Quarter.

Investors continued to move to US Treasury bonds. The heightened bond demand bid Treasury bond prices up and drove yields down on every part of the yield curve.

Fed quantitative easing has caused US Dollar depreciation and will likely increase future inflation and interest rates. We favor a balance between Treasury Inflation Protected Securities (TIPS) and corporate bonds.

### **TRIVANT CUSTOM PORTFOLIO GROUP, LLC**

### **Third Quarter 2010 Review**

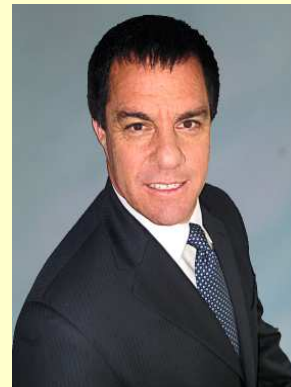
Commentary in this review reflects our portfolio strategy. Many of our clients have different objectives and circumstances which are reflected in unique portfolio considerations. Please note that accounts may not contain all elements of the strategy discussed here. Additionally, individual client customizations and start dates may preclude certain elements of this strategy from being implemented. Past performance is no guarantee of future results. A risk of loss is involved with investments in stock markets.



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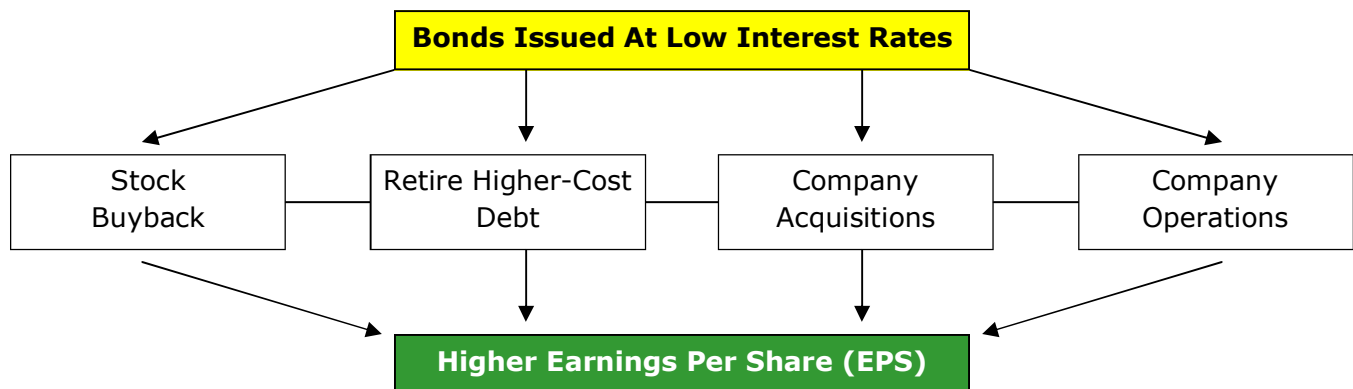
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## Cheap Debt Fuels Earnings Growth

### Record Low Interest Rates Allow Companies To Increase Earnings Per Share

**H**ow can corporations grow their earnings while persistent issues such as housing market weakness and high unemployment remain unsolved? These issues dominate media attention, reduce consumer confidence, and drive up investor pessimism. There is no letup in sight as politicians will take advantage and continue to keep these issues in the forefront as the November elections approach. The answer lies with record low current interest rates.

Corporations are able to borrow money (issue bonds) at low cost with surprising ease. The issue proceeds are being used to buy back stock, retire higher-cost debt, finance acquisitions, and/or fund daily operations. No matter the use of the proceeds, the end result is a higher company earnings per share (EPS). A higher EPS usually translates to a higher future stock price.



We will briefly examine how each potential use of bond issue proceeds leads to a higher EPS.

#### 1. Retire Higher Cost Debt

Interest rates have fallen over an extended time frame. Previous corporate bond issues carried a higher rate of interest than the same bond issue would carry today. Consequently, it is in a company's best interest to retire higher cost debt and replace it with lower cost debt when feasible. In an environment where the market is embracing bond issues, this is an easy maneuver to make. When higher cost debt is replaced with lower cost debt, interest payments are lower, earnings are higher, and EPS increases (more earnings are spread over the same number of outstanding shares).

#### 2. Company Acquisitions & Operations

No matter whether the bond proceeds are used for acquisitions or operations, there will be a higher EPS if:

$$\text{Return on capital} > \text{Cost of capital}$$

In other words, if the bond proceeds can generate a greater return to the company than its cost, EPS will increase. Right now, the interest payments required on bond issues (cost of capital) are very low, in the range of 1% to 4% (depending on the maturity of the bonds). This is a low hurdle rate to find worthwhile projects.

#### 3. Stock Buyback

In a stock buyback, the company takes the low-cost bond proceeds and buys back stock. The cost is the obligation of bond interest payments, but the benefits include less shares outstanding and dividends paid (where applicable). When the same earnings are spread over less outstanding shares, EPS will increase.

## Example Of A Stock Buyback: Microsoft Inc. (NASDAQ: MSFT)

Microsoft has a AAA credit rating and is using it to take advantage of an opportune bond offering. It plans to issue \$4.75 billion in bonds (spread over 3,5,10 and 30 year bonds) at an average yield (cost to the company) of only 2.39%. Microsoft has over \$35 billion in cash on its balance sheet so there is virtually no risk to the bondholders regarding repayment.

The bond proceeds are earmarked towards stock buybacks, company acquisitions and working capital. Why does Microsoft need more cash? The short answer is tax efficiency versus actual need. Much of its held cash is overseas, and bringing the funds back to the US would trigger taxes. Therefore, it is more efficient to leave its current cash where it is and raise additional cash with a cheap bond issue. Bonds will be issued as follows:

Bond Maturity	3-Year	5-Year	10-Year	30-Year	Total
Amount	\$1 billion	\$1.75 billion	\$1 billion	\$1 billion	<b>\$4.75 billion</b>
Treasury Yield	0.62%	1.27%	2.51%	3.68%	
Spread Over Treasury	0.25%	0.40%	0.55%	0.83%	
Forecast Yield	0.87%	1.67%	3.06%	4.49%	<b>2.39%</b>

Source: Bloomberg as of 9/30/10

For the sake of illustration, let us assume that the entire bond proceeds are used for a stock buyback. As of September 30, Microsoft was valued at \$24.49 per share. With \$4.75 billion, Microsoft can buy back 194 million of its outstanding shares, taking its outstanding shares from 8.813 billion to 8.619 billion.

Let us examine the earnings impact on Microsoft prior to calculating the EPS impact. Prior to the new bond issue, Microsoft had earnings of \$18.76 billion. The newly issued bonds will incur annual interest payments of \$113 million (the cost), but there will be a \$40 million tax credit (interest payments are tax deductible, and Microsoft's corporate tax rate is approximately 35%). Therefore, there will be \$73 million less earnings.

Bear in mind that there are also less shares outstanding. Let us calculate the old and new EPS for comparison:

**Old EPS:**      **\$18.76 billion / 8.813 billion shares = \$2.13 / share**

**New EPS:**      **\$18.70 billion / 8.619 billion shares = \$2.17 / share**

EPS has increased because the cost of issuing debt is so low. Additionally, Microsoft saves \$100 million in dividend payments because of less shares outstanding. This improves its cash flow.

### CONCLUSION

Over \$600 billion in high grade bond offerings have been brought to the market year to date. This is significant considering the US stock market is barely over \$10 trillion in market capitalization. Record amounts of bond offerings are headed to the market because interest rates are so low and the investor appetite for bond offerings is so high. Notable companies include Microsoft, Johnson & Johnson, Home Depot, IBM and Hewlett Packard.

As long as interest rates are low, we expect this trend to continue. We believe corporate balance sheets can handle substantially more debt. This bodes well for stock valuations as we anticipate increased EPS. Standard & Poor's estimates that corporate earnings will set new records next year. Stock prices are currently more than 25% off their all-time high level. We are bullish.

## Equity Market Review

### Global Stock Markets Strongly Rebound In Q3

**I**n the Third Quarter, the domestic S&P 500 Index rose 11.29% while the MSCI EAFE Index (foreign) rose 16.53%. Almost all global equity markets had double-digit positive performance (the exception was Japan). The US Dollar was pressured while concerns regarding the Greek debt crisis abated. The Euro considerably appreciated and the European Monetary Union (EMU) stocks led the equity markets.

Many investors missed the stock market rebound. Trading in shares listed on the New York Stock Exchange (NYSE) was down by 11% in July from 2009 levels, and August volume was off near 30% (source: New York Times). Investors continued to move to bonds, as evidenced by lowered yields on all maturities of US Treasury bonds. Areas of note for the quarter include:

- EMU stock out-performance versus the S&P 500 Index was entirely attributable to US Dollar depreciation
- Telecom (+19.10%), Materials (+17.24%) and Cyclical (+14.72%) led sector performance
- Financials (+4.06%) significantly lagged in sector performance
- India was the only Emerging Markets BRIC nation with notable out-performance year-to-date (+18.33%)
- US small cap stocks (+10.94%) fared identical to the large cap S&P 500 Index (+11.29%)

#### Equity Index Performance

Index	Q3 2010	2010
S&P 500 (Domestic)	11.29%	3.89%
MSCI EAFE (Foreign)**	16.53%	1.46%
MSCI World	13.89%	3.01%
MSCI Emerging Markets	18.16%	11.02%
Russell 2000 (Small Cap)*	10.94%	8.11%
MSCI Japan	5.89%	3.09%
MSCI UK (United Kingdom)	19.78%	2.59%
MSCI EMU (European Monetary Union)	20.06%	(5.47%)

\* Performance data does not include dividends

\*\* Europe, Australia and the Far East

### We Remain Bullish On Stocks

Real gross domestic product (GDP) eased from +3.7% in the First Quarter to +1.7% in the Second Quarter (source: Bureau of Economic Analysis). We view the economy in an expansion phase, albeit a slower expansion. The portfolio is positioned to benefit from an economic expansion. We remain bullish on stocks.

During the Third Quarter, we adjusted the sub-sector weightings in the Financials sector. Stock prices rose and we believe the ascent will continue. We increased our exposure to investment banking via a European company because we anticipate more stock offerings. At the same time, we sold a company that derives its revenues from money market funds because we anticipate an investor shift from cash to stocks.

## Currency, Country, & Sector Performance at a Glance

### The US Dollar

The US Dollar considerably depreciated versus the Euro, modestly depreciated versus the British Pound, and depreciated versus the Japanese Yen in the Third Quarter. The Federal Reserve Board Funds Rate was maintained at a target 0% to 0.25%. The European Central Bank (ECB) maintained its rate at 1.00%. Oil prices remained unchanged at approximately US \$80 per barrel over the quarter in spite of a falling US Dollar.

#### US Dollar Appreciation Versus Foreign Currencies

Currency	Q3 2010	2010	2009	2008
US Dollar/Euro	(8.76%)	6.88%	0.00%	5.88%
US Dollar/Japanese Yen	(5.02%)	(9.60%)	2.18%	(18.37%)
US Dollar/British Pound	(4.04%)	3.77%	(10.14%)	44.00%
US Dollar Index*	(7.37%)	2.30%	(4.24%)	6.20%

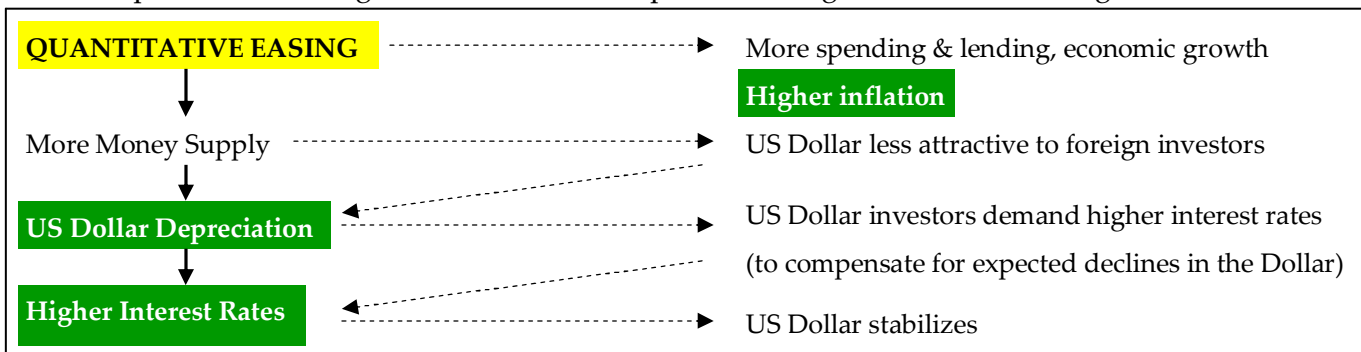
\* The Dollar compared with a weighted basket of currencies

Source: Telemet

In Q3 2010, the dollar fell 7.37% against a basket of diversified currencies.

The US Dollar depreciated in the Third Quarter for two main reasons:

- There is much attention regarding the state of the US economy. Real GDP eased from the First to Second Quarter. The concerns of a challenged economy now and looking forward weakened the US Dollar.
- The Fed's mandate is to promote maximum employment and price stability. With inflation under 1%, the Fed is concerned with the threat of deflation. In response, the Fed has been buying Treasury bonds from the private market, a policy called "quantitative easing". By pumping money into the economy, the goal is to stimulate economic growth through more spending and lending. Since September, 2008, the Fed has placed nearly \$2 trillion into the economy, and it appears another \$1 trillion is forthcoming. The net effects of quantitative easing include US Dollar depreciation, higher inflation, and higher interest rates.



### The US Dollar: Portfolio Strategy Considerations

US Dollar depreciation helps US exporters. Since our current target domestic stock portfolio weighting remains at 85%, and the stocks we hold have significant international operations, we do not view further potential US Dollar depreciation as detrimental. However, the ramifications of potentially higher interest and inflation rates are detrimental to bonds (see page 9, Bond Market: Portfolio Strategy Considerations).

## Japan

Japan (+5.89%) lagged global performance in the Third Quarter. In the beginning of October, the Bank of Japan lowered its key interest rate from 0.1% to between 0% and 0.1%. It also said it would purchase about \$60 billion of government bonds and other assets in an effort to stimulate the economy. Investors looked favorably upon the monetary policy. At the same time, the bank downgraded its economic forecast.

### Japan: Portfolio Strategy Considerations

We previously removed almost all Japanese portfolio exposure and see no compelling reasons to change our stance.

## Emerging Markets

Emerging Markets (+18.16%) had strong Third Quarter global market performance. There was regional performance disparity. Of the BRIC nations, India is the lone star performer year-to-date.

### Emerging Markets Performance By Region

Country	Q3 2010	2010
Brazil	21.76%	3.15%
Russia	13.42%	2.49%
India	15.44%	18.33%
China	10.73%	4.11%

Source: MSCI

### Emerging Markets: Portfolio Strategy Considerations

We maintain Emerging Markets exposure in Brazil (banking), India (banking) and China (telecom). During the Third Quarter, we pared back our exposure to India to take some profits on considerable gains. Emerging Markets economies are expanding and represent an important aspect of portfolio diversification.

## Europe

Europe (+20.06%) led Third Quarter global market performance, largely fueled by a rebound in the Euro. However, Europe is still by far the worst-performing global market year to date (-5.47%). The significant performance lag has been largely due to debt and unemployment concerns regarding the "PIGS" (Portugal, Ireland, Greece and Spain), although these concerns toned down considerably in the Third Quarter.

### Europe: Portfolio Strategy Considerations

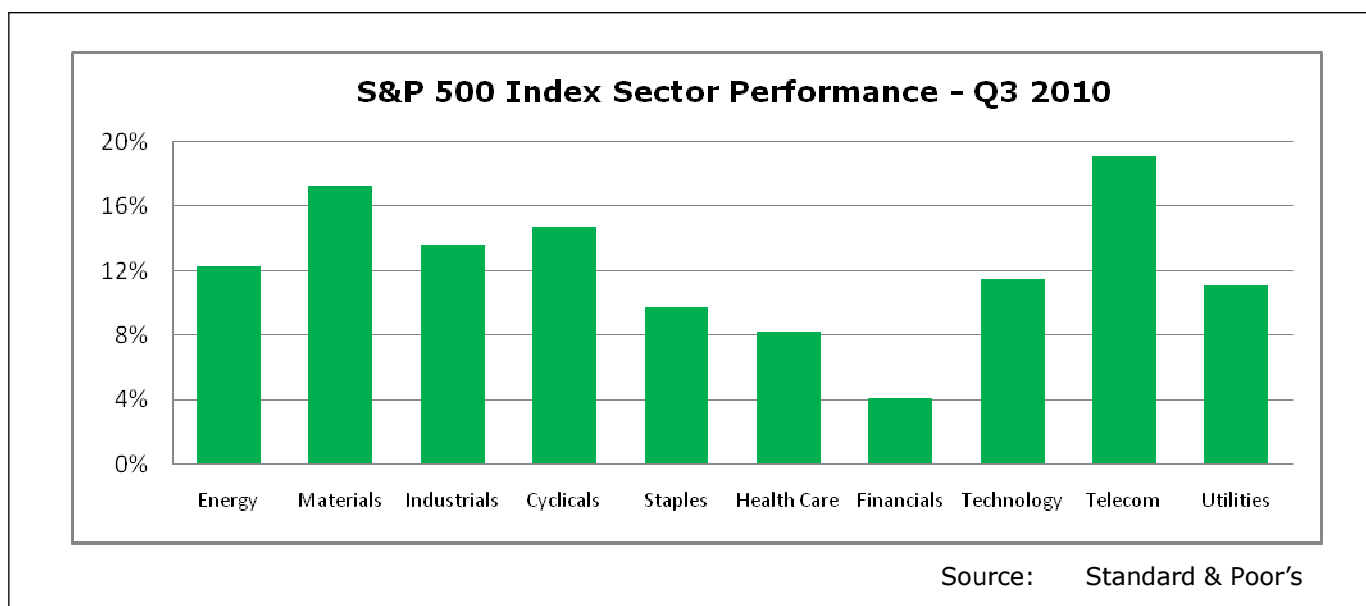
We added to our European exposure in the Third Quarter via a large Swiss investment bank. We believe investment banking (helping corporations with debt offerings, mergers and acquisitions, and initial public stock offerings) is poised for a very strong cycle as the worldwide economy recovers. Additional European sector exposure is in Health Care, Energy, and Materials.

## Sector Performance

Telecom (+19.10%) and Materials (+17.24%) were the best-performing sectors in the Third Quarter. Year to date, Cyclical (+12.10%) and Industrials (+11.45%) are the best performing sectors. We expect these sectors to lead in the transition from a recovery to expansion phase of the business cycle. This confirms our view that the economy is expanding.

Financials was the worst performing sector in the Third Quarter (+4.06%), followed by Health Care (+8.22%) and Staples (+9.76%). Technology (+11.50%) was in line with the S&P 500 Index after lagging the two previous quarters. Energy (+12.30%) was slightly ahead of the S&P 500 Index, although it is the worst-performing sector year to date (-2.48%).

Utilities (+11.11%) was a market performer.



### Sectors: Portfolio Strategy Considerations

We remain under-weight to Energy and Staples, and have no Utilities exposure. Energy prices have been stagnant (oil has hovered around the \$80 per barrel range for several months) and oil inventories remain high. In anticipation of a continued business expansion, Staples exposure was previously reduced in the Second Quarter from a neutral to under-weight position.

In the Third Quarter, we adjusted our sub-sector weight to Financials, although we remain neutral-weight to the sector as a whole. We added a European investment bank to benefit from potential increased debt offerings, mergers and acquisitions, and initial public stock offerings. We remain light to the US banking sub-sector. New US financial regulations have curtailed proprietary trading (a previous significant profit driver), current low volume trading will pressure profits, and balance sheet exposure to mortgages remains risky as foreclosures mount.

We are overweight to Technology, Industrials and Cyclical. Although Technology has lagged the market year to date, we anticipate future out-performance as the economy expands. Over-weight positions in Industrials and Cyclical have been a major driver in S&P 500 Index out-performance.



## Bond Market Review

The Fed interest rate was maintained in the Third Quarter as part of a coordinated effort to stimulate economic growth. The Barclays Capital U.S. Government/Credit Bond Index rose 3.46% in the Third Quarter.

Key US Interest Rates	Sept. 30, 2010	June 30, 2010	Change
Federal Reserve Board Funds Rate (Target)	0.25%	0.25%	no change
2-Year Treasury (Constant Maturity)	0.42%	0.60%	- 18 basis points
5-Year Treasury (Constant Maturity)	1.28%	1.77%	- 49 basis points
10-Year Treasury (Constant Maturity)	2.53%	2.93%	- 40 basis points

Note: 100 basis points (bp) = 1.00% Source: Bloomberg

Investors continued to move to US Treasury bonds. The heightened bond demand bid Treasury bond prices up and drove yields down on every part of the yield curve.

Due to low yields, we have not held regular US Treasury bonds for almost two years. We hold Treasury Inflation Protected Securities (TIPS). The quoted yields are also low on the TIPS, so why do we hold them?

Inflation protection is an important component of our bond strategy. The principal value of the TIPS adjust (appreciate) for inflation. We anticipate a rising interest rate environment. In the event of rising interest rates, we would likely see rising inflation. With rising inflation, the TIPS will appreciate.

Merely looking at the quoted yield of a TIPS bond can be misleading. Calculating the total yield (appreciation) of a TIPS is a little complicated because there are two components to consider:

1. The value of the TIPS will adjust upward (appreciate) for inflation
2. The value of the TIPS will adjust upward with falling market interest rates and downward with rising rates

For example, consider a TIPS purchased on May 17 for \$100,000 that has a quoted yield of 1.375% and a maturity date in January 2020. On September 30, it was valued at \$105,590. During this time frame, inflation was fairly tame (0.1%\*), which very slightly increased the value of the TIPS. Interest rates fell, which further increased the value of the TIPS. The overall return on the TIPS was higher than it may have appeared on paper.

### Bond Market: Portfolio Strategy Considerations

We continue to favor a balance between Treasury Inflation Protected Securities (TIPS) and corporate bonds.

As interest rates increase, bond prices decrease. In anticipation of future rising interest rates, we made recent changes to the bond portfolio. We sold the interest-rate-sensitive investment-grade corporate bonds for a considerable profit. These bonds were replaced with lower duration corporate bonds that are more likely to preserve their value if interest rates rise.

\*Source: Bureau of Labor Statistics

## Closing Thoughts

**A**fter the S&P 500 Index fell 11.43% in the Second Quarter, we stated our belief that this was a market correction, and we kept the equity portfolio positioned for an economic expansion. We were right. The market rebounded strongly in the Third Quarter, and positive momentum has carried into early October.

We stated in January that we believed that global equity markets would advance 12% to 16% in 2010. Although markets have been anything but smooth, we still view our prediction as reasonable and feasible.

We are concerned about the bond market and if it is a potential bubble. It is important to stay disciplined regarding your appropriate asset allocation. Risk control is key. Your bond exposure where warranted is protected against inflation (TIPS) and less sensitive to rising interest rates (lower duration corporate bonds).

We will continue to closely monitor the market and adjust your portfolio as needed. Please feel free to contact us anytime to discuss questions or comments you may have. We will keep you informed of portfolio progress.

Respectfully submitted,

# TRIVANT

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*"It is always wise to look ahead,  
but difficult to look further than  
you can see."*

Winston Churchill

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