ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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Market Monitor

Last Monday's worst broad market performance in a month (funny how a 2%-plus loss barely ruffles a feather anymore), followed by another 2-3% drop for the major indexes this Monday, has many calling it an end to the rally that has helped us recoup a third or more of last year's losses. While we would suggest that a test of the advance is basically part and parcel of any advance, and continue to expect a test of some magnitude, it doesn't go without saying that such a test would lay the groundwork for a second rally's wave of relatively similar magnitude. We see the near-term trend remaining one of light profit taking in the wake of the biggest rally since the Great Depression.

A quasi-consumer bellwether, Best Buy, is exhibiting signs of consumer tentativeness. But we wouldn't overreact to its numbers; who was going to buy a new game console, TV or laptop in May? Not only is the beach the order of the day, but with school out there's no rush to purchase a laptop, and every reason to assume prices will fall ahead of the Fall back-to-school rush come August.

If the consumer electronics bellwether Best Buy didn't check out as well as hoped, FedEx, a business and consumer-driven bellwether we frequently refer to as a key litmus test of and for economic activity, failed to deliver on both counts, posting weaker results and declining to provide a forecast for 2010. While tough business conditions aren't surprising to us, for those who hope to simply put the recent past well behind them, a traffic jam of neutral news is less than good news.

Last Thursday's report on unemployment claims turned a negative morning into a positive one as there continue to be mixed signals as to how the economy is faring. More of those mixed signals were seen this week, as reports came out showing durable goods orders rose 1.8% last month (defying expectations of a drop) and new home sales dropped 0.6% in May (defying expectations of a rise).

And, with leading indicators up at the fastest 3-month rate since mid-

2004, and consumers more confident that the worst of the recession is in the rear-view mirror, a bit of relief is currently washing over equity markets.

Inflation readings remain muted. The PPI came in with a 0.2% increase, which is nothing, and the CPI was up just 0.1%. You can guess what drove this increase: Fuel prices. Oil at $71 is a fair bit higher than the $45 it was at when 2008 turned into 2009.

The results of the Fed's two-day meeting were as expected on Wednesday, with no change to the key bank lending rate of zero to 0.25%. The committee also backed up the inflation readings cited above, saying that they did not see inflation as an immediate threat.

A 17.2% increase in housing starts in May, led mainly by multi-family versus single family home building, sounds good given where we've been recently, but compared to where we were a few years ago it's still paltry. Rising mortgage rates are not going to help the housing market as buyers will begin to wonder if they've missed the best time to buy, and owners will wonder if they've missed the best time to refinance.

On its face the industrial production numbers for May would certainly put the lie to the notion that the economy is beginning to come back—industrial production fell at a faster rate than the month before. But production remains below final demand and is bound to begin picking up if simply to replace depleted inventories, and the rate of slowing has slowed so there is hope in these numbers. Of course, the losses due to the auto industry's massive cuts will probably never be replaced, but that's another story.

From North Korea to Iran, the headlines are threatening, but the markets haven't priced in undue volatility. The assumption may be that containment is the probable outcome there, while growth remains the probable outcome for the more stable poles of the global economy: US and China.

The Street was nervous ahead of the new administration's plans for financial regulation and reform, then relieved after it was unveiled. We'd be a lot less nervous if the politicians would start with regulation and reform of themselves first and then move on to preach to the rest of us. Regulation and reform of both is needed; but the rush to judgment and imposition is rarely the best path to take. Is the current outline fairly benign? There was the expected tone of oversight levied against banks and hedge funds, and a rumored and likely problematic clause about the extent and extension of the Fed's new powers to regulate even private entities will have chins wagging for a while to come.

Market technicians are out in force these days. The fact that the Dow Transports aren't currently keeping up with the Dow Industrials is seen as a negative. But the crossing of the S&P's 200-day moving average by the 20-day moving average, and the almost crossing by the 50-day average, known as the "golden cross" means some chartists are getting bullish.

While a 10%-20% retreat shouldn't be blithely dismissed, it shouldn't mask the post-20%-plus rally that is likely to ensue, born of increased economic stabilization, stimulus money actually flowing through the various pipelines, earnings comps that begin to look dramatically more attractive come October, consumer confidence gaining the upper hand, politicians trumpeting the successful rescue of the global economy, all prompting those who missed this recent 40%-plus uptick to come back into the game with their multi-trillion dollar bench-warming dollars.

Vanguard Convertible Securities Closes

As of June 19th, Vanguard has once again shut the door on Convertible Securities and placed a $25,000 annual contribution limit on existing investors to try to keep asset levels manageable. The move was made, in part, to protect manager Larry Keele, who operates in a small market and may be finding it difficult to handle the flow of new cash, which had been pouring into the fund rapidly over the past five months, nearly doubling assets from $867 million up to $1.5 billion.

This is not a new trend for this fund—several times in the past decade, investors have flooded the fund with new cash, chasing periods of outperformance. Starting in the Spring of 1999 and into early 2000, the fund outperformed 500 Index substantially, and investors tried to catch the lightning in a bottle, with the fund showing a net cash inflow starting around October 1999, reversing a steady outflow. Soon after, Convertible Securities began lag the market, and by the time it was outperforming again later in 2000, investors had begun selling off their shares. Something similar happened a year later, with new money moving into the fund just as its relative performance began to lag the market.

Vanguard shut the doors in May 2004 and it wasn't until months after the June 2005 reopening that money began to flow back into the fund. A fairly steady, but small flow of new money has been moving into Convertible Securities over the past couple of years, but that flow picked up in November 2008 and the continuation of that trend is what forced Vanguard's hand.

But over the past few months, as stocks have rallied, convertibles have lagged and Convertible Securities is once again underperforming. It may not be long before investors, in lemming-like fashion, begin to sell, rather than buy, and cash starts flowing the other way.

We've invested in Larry Keele's Convertible Securities fund in the past in some client accounts, finding that its best use is in an income-focused portfolio where higher yields and lower risk are more important than absolute tax efficiency and performance. But it has very specific uses in a portfolio and is not necessarily the best choice for most investors. We suspect that investors who rushed the gates as the fund outperformed may now wonder whether they did the right thing for their individual investment objectives.

These types of trends are a big reason why we've come to preach the idea of *time in the markets, not market-timing*—when you try to chase outperformance based on short-term results, you can find yourself grasping at straws, even in well-managed funds. It's better to trust quality managers over longer periods of time than try to catch "hot" funds at just the right time.

About Adviser Investments

Adviser Investments is an independent, professional money management firm specializing in Fidelity and Vanguard mutual funds. With 1,500 clients and $900 million dollars under management, Adviser is one of the nation's largest mutual fund research and money management firms. Our staff of 35 investment professionals focuses on helping individual investors, trusts, foundations, and institutions meet their investment goals. Our minimum account size is $350,000.

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