Recent market volatility – May 21, 2010

Following a steady and virtually uninterrupted rise that began in March 2009, the stock market has become much more volatile over the past month. Since reaching a recent high of 1,217 in April, the S&P 500 has fallen 12% to 1,071. This drop marks an official "market correction," which is defined a drop of at least 10% from a recent peak.

A 12% market correction is not extraordinary given the gains of the prior 13 months – the stock market had gained almost 70% from valley to peak, has risen in 11 of the past 13 months, and is still 57% above its March 2009 level. In fact, most observers believed that a correction was inevitable and possibly beneficial for longer term growth. Unfortunately, while most realize that corrections are inevitable, no one ever knows when a correction will occur, or how long it will last.

Factors impacting volatility and pullback

While there is never a single answer to this question, we believe that there are a few factors that are contributing to the recent volatility and pullback. These factors include the following:

- Greece's debt crisis and the potential that it may derail the global economic recovery.
- Mixed signals from our own economy. Despite a number of encouraging signs for a sustainable recovery, the data has been mixed with high unemployment and tepid growth.
- The uncertainty associated with major health care reform and potential finance reform.
- Realization that at some point we need to reign in fiscal and monetary policy in order to more effectively manage our own debt levels and avoid a fate similar to Greece's. Regardless of political affiliation, most people realize that we need to make difficult decisions in the relatively near future (higher taxes and lower spending).
- A natural level of skittishness that comes with experiencing such a severe market downturn as the one experienced in 2007 and 2008. We believe that many investors simply needed to take a breather after the prior 13 months of gains, and this provided an excuse to do so.

This is certainly not an exhaustive list, but we suspect that these factors are significant contributors to what is going on in the markets.

Will this downturn intensify?

The question currently on the minds of many investors is whether this downturn will intensify. The honest answer is that we don't know, and no one does. A further pullback of up to 5% would not surprise us, but we do not think that a significant pullback from these levels is probable unless there is further deterioration in the situation in Greece, or some as of yet unknown issue surfaces to derail the economy.

Here's why we believe this:

- At current levels, the stock market does not appear overvalued by most metrics. We do not believe that it is undervalued, but we do not think that there is significant risk purely from a valuation standpoint.

- The consensus of most economists that we read and respect is that the economy is becoming increasingly healthy and that a sustainable recovery and expansion is now probable. Projected economic growth has risen over the last few months, and the risk of a “double-dip” recession has dropped significantly.

- Corporate earnings have increased sharply over the past few quarters, and most estimates are for continued improvement.

- We do not believe that Greece will default on its debt. As painful as the austerity measures required of the bailout package will be, they will be far less painful than the alternative of default. And as much as it may pain the IMF and other EU countries to bailout a country that is sometimes associated with tax evasion, excessive spending, and an overly generous entitlement system, the pain associated with Greece’s default is likely to be far worse.

While we do not believe that a significant pullback is likely, we do acknowledge that risks remain (as they always do), and that a further pullback is possible. And we do expect to see continued volatility in the stock market.

So what do we do from here?

Absent a crystal ball, which we have never enjoyed, we continue to believe that a well diversified portfolio is the first step in an effective long-term investment strategy. When appropriate, we plan to rebalance portfolios to take advantage of what may become buying opportunities. And we are regularly revisiting our portfolio strategies – asset allocation targets and fund selection – to provide what we believe to be the best mix of investments for each investor’s particular situation.

We also recognize that market downturns can often be uncomfortable, particularly when occurring so closely on the heels of 2008 and when coupled with the level of economic uncertainty that currently exists. As always, we encourage you to contact us if you have any questions or concerns about your financial planning or investment management, or if there is anything else that we can do for you.

Thank you.

Sincerely,

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