



## 2010 Mid-Year Investment Review and Outlook

Midway through 2010, we are still in one of the most difficult periods in history. Periods of cheap and plentiful money led to financial excesses, and credit-fueled asset booms ended badly. The financial system now faces an extended period of credit restraint as both borrowers and lenders focus on repairing balance sheets.

The crisis may be over, but a self-sustaining recovery remains elusive, despite ongoing efforts by policymakers to stimulate growth. The world will continue to be deflationary in the near term since the governments face double headwinds as both private and public sectors are in a painful deleveraging process. Private credit in the U.S. is contracting, but government debt is still expanding (the ratio of total debt-to-GDP has reached a new peak as increased government borrowing more than offset a modest contraction in private credit). The U.S. deficit is also a big issue due to spending on healthcare and pensions. The fiscal problems in Europe are more serious due to the European Union members' debt situation. However, that does not mean that the economy cannot recover; it will just recover slowly.

Economic growth will take place at a slow pace with support from the corporate sector. Productivity is also at a record high in the U.S., which is positive for margins and therefore for corporate earnings. U.S. export data shows that U.S. companies are getting more business from global sources. The record low fed funds rate allows for debt to be refinanced and balance sheets to be cleaned up. Banks have a chance to strengthen their balance sheet through just playing the yield curve (banks borrow at a lower rate than they lend).

Nonetheless, the economy and financial systems are fundamentally unstable and confidence is fragile. Negative unknown shocks such as another banking crisis, oil disruption, cyber and terrorist attack, etc. could occur and depress business and consumer confidence at any time. Therefore, in an environment with increased volatility and uncertainty, wealth preservation is the single most important thing.

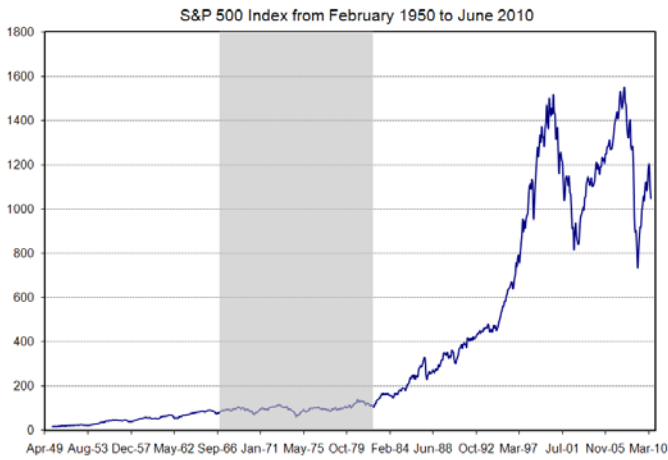
SFG expects that the equity market in the next 5 to 10 years will be another choppy market, similar to the period from 1965 to 1982 (Chart 2). In this entire period, the market was bearish and experienced no growth (indicated with a shaded area in Chart 1). However, there were numerous rallies and corrections of 25% to 45%. Simply, buy and hold investing was out of favor for the entire 17 years. On the flip side, however, this choppiness was the opportunity for good "stock pickers." During this period, the market had strong rallies and yielded big winners, including Automatic Data, Digital Equipment, Disney, Hilton, McDonald's, Sony, Toys "R" Us and Waste Management. We believe that managers who find the next winners will deliver good value even in this volatile period.

	2Q10	2009	2008
S&P 500	-6.65%	26.46%	-37.00%
Barclays Agg	5.33%	5.93%	5.24%
MSCI EAFE	-13.23%	31.78%	-43.38%
High Yield	4.74%	57.51%	-26.39%
CPI	-0.14%	2.78%	-0.04%
Commodities	-9.66%	18.71%	-36.61%
Gold	14.39%	25.04%	4.32%
Hedge FOF	-1.06%	11.46%	-20.85%

*Source: Pertrac Indexes*

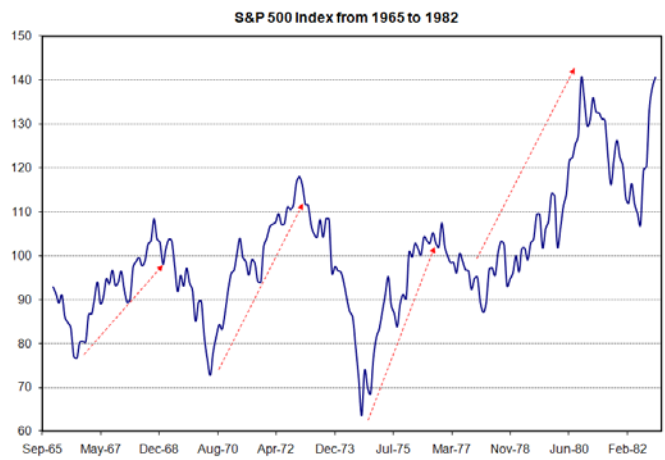


Chart 1.



Source: SFG

Chart 2.

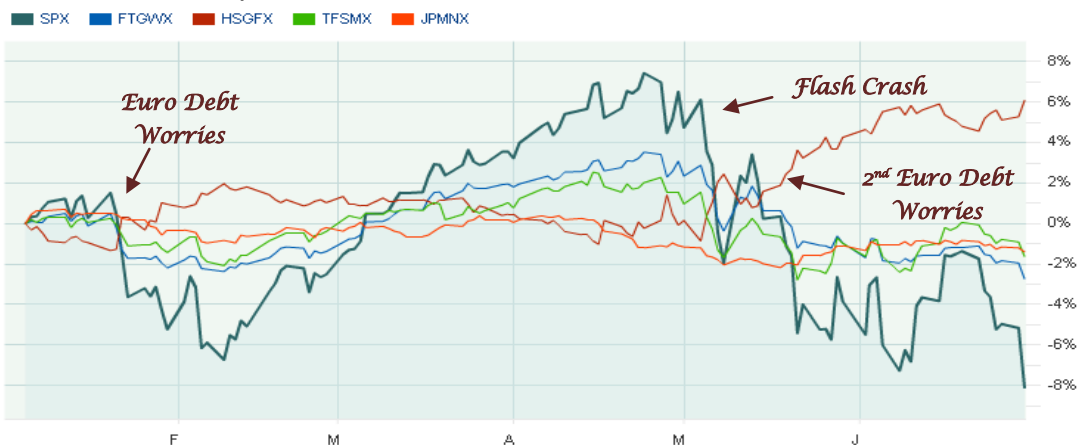


Source: SFG

We approach international markets in the same way that we invest in the domestic market by focusing on good “stock pickers.” As the financial markets are more integrated globally with the improvements in communication technologies, the diversification benefit of investing internationally is now very low (international markets are about 95% correlated to the S&P 500 – this figure once was as low as 40% in the mid-1990s). But we believe that experienced managers who know how to find good stocks in Europe, Japan, China, and many other countries in emerging markets can still provide value.

Investment strategies such as market neutral and sector rotation will help investors navigate more smoothly in this volatile market by providing capital preservation (Chart 3). Market neutral strategies reduce the market exposure (beta) to almost zero when there is a high degree of volatility in the equity markets. Sector rotation strategies also incrementally increase or decrease the portfolio exposure based on the manager’s view of economic factors. They take short positions in certain industry sectors when the view is negative and gradually increase the portfolio exposure to capture alpha/returns as the equity market looks positive.

Chart 3. Performance comparison from 1/1/2010 to 6/30/2010 \*

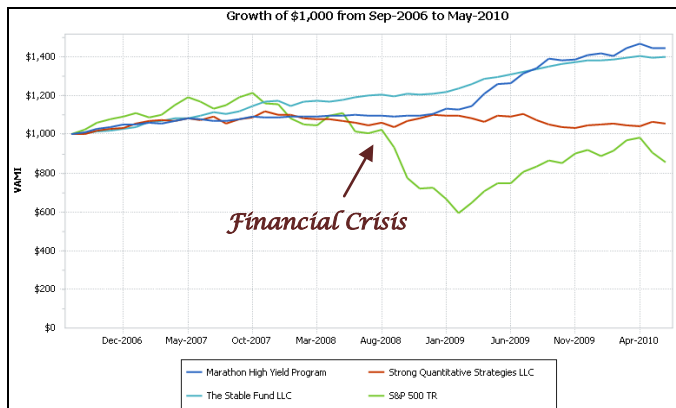


\* Forward Tactical Growth Fund (FTGWX), Hussman Strategic Growth Fund (HSGFX), TFS Market Neutral Fund (TFSMX), & JPMorgan Research Market Neutral Fund (JPMNX)

Source: Marketwatch.com

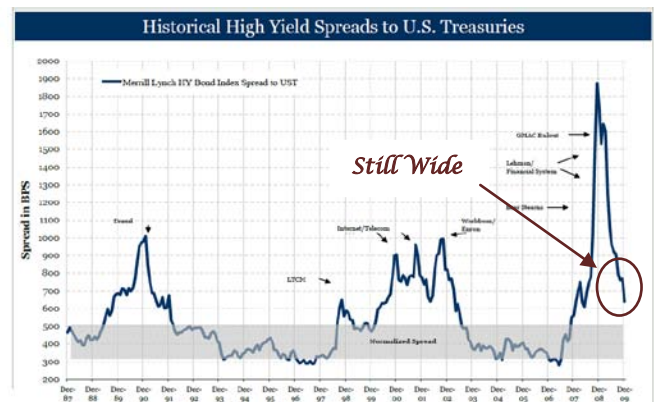
Tactical trading is another strategy that will help investors navigate more smoothly in this volatile market. The managers use proprietary quantitative models to make decisions regarding which securities/sectors long or short positions should be taken within the portfolio. Historically, they have provided consistent returns with very low volatility since they are using very low or no leverage (Chart 4). We believe that managers in market neutral, sector rotation, and tactical trading investment strategies will provide less volatility in this uncertain period and outperform in down markets by repositioning and/or hedging their portfolios dynamically.

Chart 4. Tactical Trading Strategy Performance



Source: SFG

Chart 5.



Source: Merrill Lynch

Investing in fixed income, especially in high quality corporate bonds and distressed debt will be another place to find value in this environment. Forced selling by large institutions during the financial crisis devalued corporate bonds of such companies as Coca-Cola, Johnson & Johnson, IBM, etc., so there were bargain opportunities in the market due to the wide corporate spreads. Although spreads came back a lot, SFG believes that managers who find these undervalued, good quality bonds will keep providing stable income with some capital appreciation (Chart 5). These managers will also manage duration to control interest rate risk. Managers in distressed debt will benefit from becoming the alternative credit provider in this market. As long as banks are in the deleveraging process and not willing to refinance companies' bank debt, these managers can provide financing to those companies with better terms.

Commodities offer diversification to a portfolio through real assets (e.g. oil, metals, and agricultural products) whose prices are driven by supply and demand. Commodities are generally more useful during times of inflation and historically have had little correlation to financial assets. Commodities are also negatively correlated to the U.S. dollar; so if the dollar weakens, commodity prices should rise.

Investing in oil and gas programs is an additional way to diversify the energy sector. Some of ways to invest in these energy sectors are as follows:

- Acquiring mineral and royalty interests which provides incomes to investors. Royalty interests are the least "risky" of direct investments in oil & gas.
- Investing in proven, producing oil and gas properties.



- Participating in working interest drilling programs in natural gas and oil properties.<sup>i</sup>

At SFG, we consider gold to be an “insurance policy” for the portfolio. Holding the physical gold does not generate any cash flow for investors. Gold funds hold both bullion and stocks. We recommend gold since it could provide value to investors, especially in the environment that we are in right now (ultra low real interest rates, gold purchases by central banks, concerns about rising fiscal deficits, and the inflationary impact of easy monetary policy).

Investment in real estate projects in defensive, distressed, and/or opportunistic sectors provide further diversification. We have recommended projects in medical office buildings, rehabilitation hospitals, and distressed residential properties.

Like we mentioned in the last investment message, staying with the premise from which SFG started years ago, which is to “Buy Brains,” is more important now than ever before. There is still a high degree of uncertainty and the next economic cycle/shock and reactions will be different from the last one. We have experienced managers in each investment sector and are actively looking for more to diversify your portfolio. As we review your portfolio and have meetings to discuss your goals and objectives, we will discuss investment strategies with you and help construct an investment portfolio to meet your comfort level.

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<sup>i</sup> The Tax Reform Act of 1986 provided for the “working interest exception” which allows most joint venture participants to write off a significant portion of the investment amount in the year they invest. This provision was kept as a part of the tax code in an effort to encourage US gas and oil drilling. Monthly cash flow from gas and oil production begins approximately six months from the date of investment and should continue for 15 to 30 years. Return of principal is provided by the first year tax savings and the annual natural resource depletion allowance, which is 15% to 25% of gross income.

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