

JULY 2011 QUARTERLY NEWSLETTER

**THE WORLD ECONOMY & THE CASE OF THE
DOG THAT DID NOT BARK**



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I have always liked detective stories. Judging by the popularity of the character and series “Columbo” starring the late Peter Falk, I’m certainly not in the minority.

Sherlock Holmes was one of my favorite sleuths. I wonder how he would have approached solving the enigmas that currently perplex our global financial leaders.

One of the most memorable of the Sherlock Holmes short stories was “Silver Blaze”, a tale about the disappearance of a race horse. The most important clue in solving the mystery came not from the obvious clues, including the events leading up to the crime, but from a dog that did not bark. This clue became known as the “curious incident of the dog in the night-time”:

Gregory (Scotland Yard detective): "Is there any other point to which you would wish to draw my attention?"

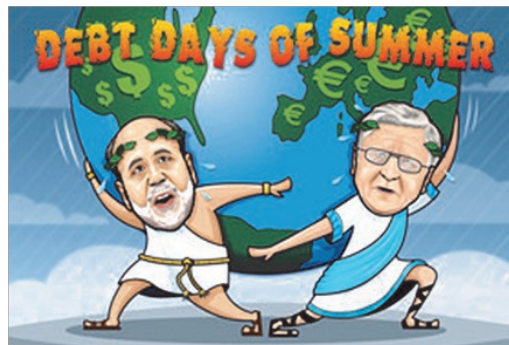
Holmes: "To the curious incident of the dog in the night-time."

Gregory: "The dog did nothing in the night-time."

Holmes: "That was the curious incident."

At Silver Oak, we often function as sleuths – economic sleuths! The case in which we are currently mired might be titled, “The

Case of the Disappearing Worldwide Financial Recovery.” Critical investment decisions hinge on correctly interpreting diverse economic clues and the solving of this Case. How is “the dog who did nothing analogous to an economic clue? Read on.



Two modern-day “financial sleuths”: Federal Reserve Chairman Ben Bernanke & Jean-Claude Trichet – President of the ECB (European Central Bank)



An Invitation to *Women’s Circle*

When: 5:15pm - 7:00 pm
Last Tuesday of each month

Where: 10866 Wilshire Blvd, Suite 1270. Los Angeles, CA 90024

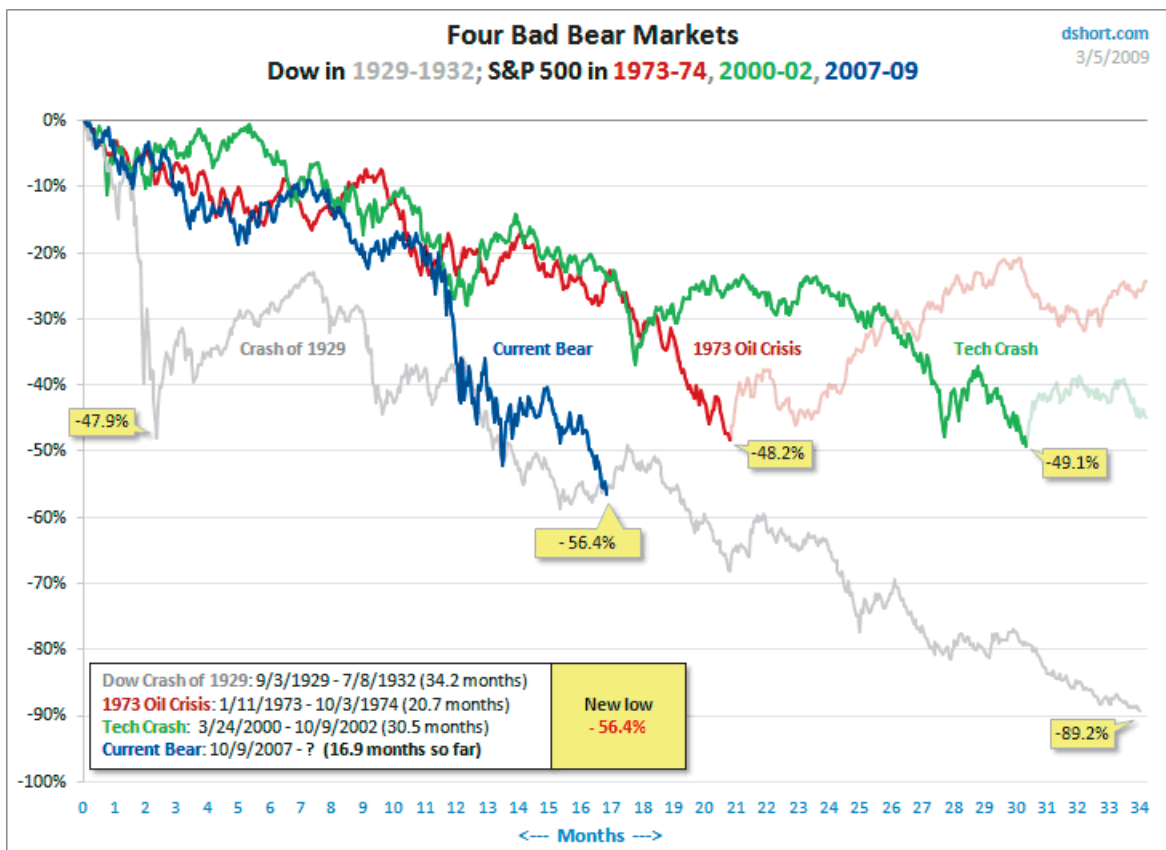
Refreshment will be served. Please RSVP at 310.207.4800 or email to lcao@silveroakwa.com

See page 6 for more details

CHAPTER ONE: 2008-2009 AVOIDING THE ABYSS



There are a number of key clues that we might follow as potential evidence in our case. This graphic of the performance of the Vanguard S&P 500 Index Fund is one piece of evidence. The big question back in March of 2009, lest you forget, was whether the market could keep on falling. The biggest fear at the time was that the path of the market would replicate what the stock market did during the Great Depression, as in the next chart:



Fortunately, Ben Bernanke is a history buff. Fearing that a market decline of 56% could lead to a further decline all the way down to 89%, Ben and his fellow fiscal detectives believed that a massive infusion of cash into the economy would help solve the dilemma.

By reducing interest rates to virtually zero, their strategy included inducing people to invest in more risky assets. As 2009 came to a close, it appeared that the stimulative actions were effective as the stock market rose dramatically.

CHAPTER TWO - 2010 TO 2011

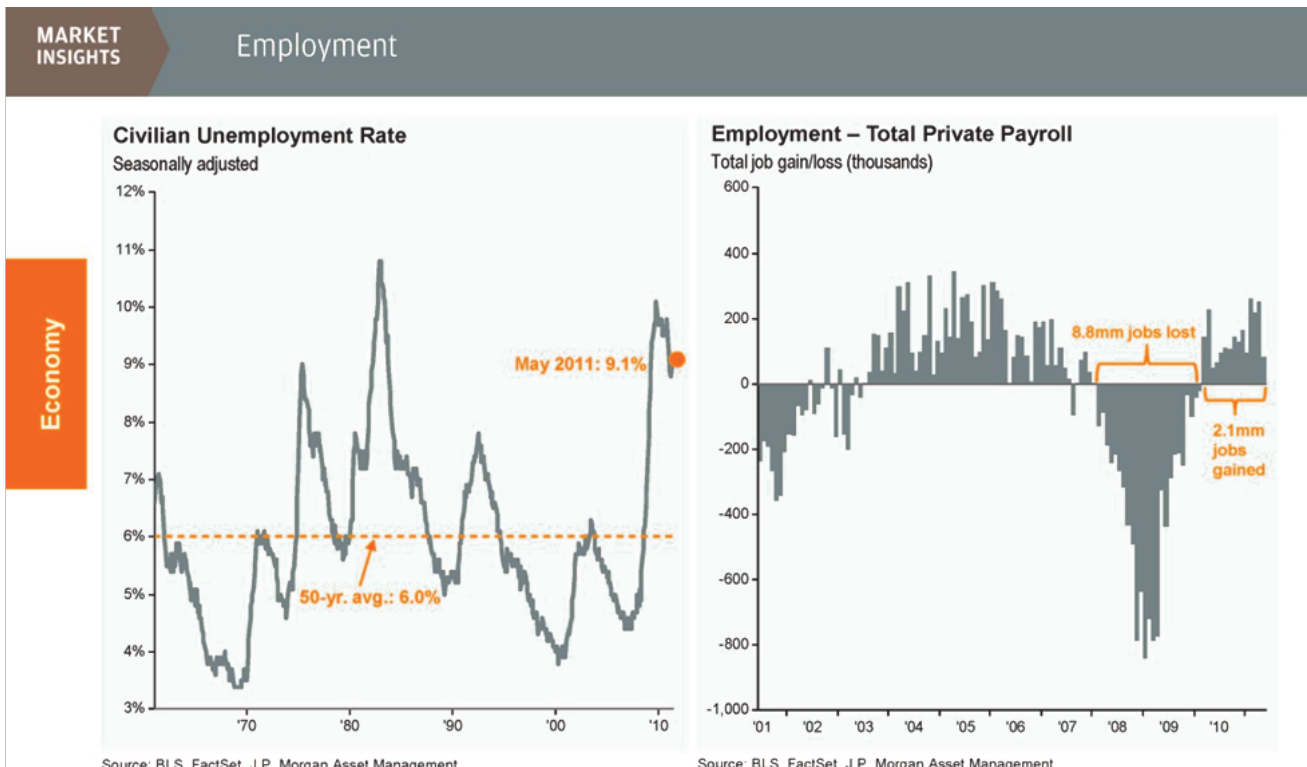
Optimism seemed pervasive and it seemed that the country had dodged a disaster and was on the road to recovery. The stock market continued to rise through March of 2010. Although a substantial “correction” ensued through the summer, the market finished stronger by year-end.

Could we then say, “case closed?” Not so fast.

Domestically, there were many signs revealing the fragility of the “recovery.” Food and oil prices were rising, creating a concern that inflation and higher gasoline prices might reduce consumer spending. By May, a major index of consumer sentiment showed a dramatic decline.

Our rate of economic growth as measured by GDP had appeared to be increasing to a fairly healthy rate of 3.0% to 3.1% annually in the fourth quarter of 2010, leading some economists to look for even higher growth in 2011. However, as the first quarter of 2011 ended, the rate of GDP growth had slowed to only 1.9%. What other factor might help explain this growth slowdown?

We need to look to the jobless rate as our next clue to understanding this decline in the GDP rate of growth. By June, 2011, the unemployment rate that had dipped to 9.1% rose again to 9.2%. More people were out of work. We can look at a graph of the labor force to gain some perspective.



Source: BLS, FactSet, J.P. Morgan Asset Management. Data reflect most recently available as of 6/30/11.

Source: BLS, FactSet, J.P. Morgan Asset Management.

These employment charts tell us that only 2.1 million jobs have been created since the “recovery” began. Since we had lost 8.8 million jobs during the recession, the important point is that 6.7 million people who were employed in 2007 are still out of work. This number does not include people who have given up and have dropped out of the labor force.

Home prices and the sale of new and existing homes

2011 - 2012

When solving a mystery there are often too many clues. Some turn out to be red herrings, distracting us from the important issues. Other clues appear to be quite obvious because they become part of the news bytes we continually see and hear in our prolific news media.

We must examine and filter both the positive and negative input to independently determine how to understand “The Case of the Disappearing Worldwide Recovery.” However, after consideration of all the clues, most of which involve either economic facts or an interpretation of the available data, we believe we have found this case’s “dog that did nothing in the night-time.”

The “dog that did nothing” refers to **Uncertainty**. It is the clue that is right in front of us. Yet because it cannot be quantified like many statistical factors, it tends to be overlooked or underappreciated by analysts, Wall Street, and politicians.

Uncertainty breeds fear and “no confidence” votes when it comes to investment markets. Like the dog that didn’t bark, uncertainty is the silent factor that explains a big part of the volatility seen in the investment world. No one likes Uncertainty – not businesses that need to factor taxes and interest rates into their growth targets, not banks who are afraid to lend, not investors who want to know how our fiscal policies will impact their portfolios, and not the average citizen who is fed up with our political system which seems incapable of doing the right thing for our country.

Investing In This Time of Uncertainty

At Silver Oak, we utilize a process which we call a Risk

continue to decline putting continued strain both on consumers and on the banks holding underperforming mortgages. Since 70% of our GDP is dependent on consumer spending, the combination of high unemployment and depressed home prices serve to put a damper on consumer spending. Therefore, while there is anecdotal evidence alluding to a strengthening of the economy, there are still too many critical clues to be uncovered before concluding that this case is solved.

Factor Framework (RFF) for evaluating the risk/reward paradigm. Risk is a little like speed in that a little at the right time and place is good but too much can be deadly.

There are three components to our RFF method. First, it is critical to understand the various types of risk that might affect any given investment. Second, we must have a way of quantifying the magnitude of each investment risk. Third, we must have an understanding of the macro-economic environment we find ourselves in at a given time.

While every investment vehicle typically has a fundamental value that supports its price, each also is affected by other factors that are purely subjective. For example, consumer sentiment, the momentum of the markets, and the news headlines are subjective factors that often move our markets.

These subjective factors have been the primary drivers of our equity markets this past year, initiated by the Fed’s August 2010 announcement of QE2. We have since seen a phenomenon that the press has labeled “risk-on” trading periods and “risk-off” periods. Depending on the news, one day the trading activity may be “risk-on” and the next day the market drops and is described as having switched to “risk-off”, as traders switch into bonds. Such is the whimsical nature of traders who attempt to capitalize on, or avoid, the subjective factors moving our markets.

As we decide where to invest the hard-earned dollars of our clients, uncertainty is the one overriding factor that

we find to be the most persuasive in explaining why the risk-on or risk-off periods repeat themselves so often.

If you have ever watched a squirrel try to cross the street in front of your car, perhaps you will gain a perspective on what we mean by uncertainty. The squirrel stops and alternates between going back or continuing across the street until finally going one way or the other. Our nation, in fact the whole developed world, is mired in oceans of uncertainty not experienced in dec-

ades. When can you recall our political system ever being so divided? Can you recall a period of time when major European countries were on the verge of defaulting on their debt? In the Middle East, a region in which we still depend on for critical energy needs, we are observing a revolution which may embroil the whole area in conflicts and civil wars for many years. And we must mention the heretofore inconceivable possibility that the U.S. could default on its obligations.

WE ARE SLEEPING WITH ONE EYE OPEN

Anecdotally, we know that this uncertainty has been weighing on our clients psyche based on the phone calls we have received over the past several months. Most recently, questions have focused on the portfolio consequences if our legislators do not reach an accord on raising the debt ceiling, causing the U.S. to default on its obligations.

We continue to monitor the numerous issues contributing to this uncertainty. Our Risk Factor Framework involves assigning probabilities to the potential occurrence of any specific event with a concomitant assessment of the magnitude such occurrence would have on various investments. While the failure to raise the debt ceiling is a current event which concerns us, the bigger long-term issue concerning us is the size of our nation's debt itself. The investment consequences of not demonstrating to the rating agencies and to those countries buying our bonds that we have a viable plan are serious.

With regard to the debt ceiling issue before Congress, an example will clarify how we might implement our RFF process. For example, if we feel that there is a high probability that the U.S. might default on its debts and that such default would immediately cause interest rates to rise significantly, we would protect our domestic bond portfolio value by either selling certain bonds or by creating a hedging strategy to protect the downside. One hedging strategy against the global "no confidence" risk such an event might pose against our cur-

rency is to add to our gold and silver positions. Another is to take a position in an exchange traded fund denominated in a strong currency, such as Swiss francs.

There is one additional input to share with you as we consider our portfolio recommendations. Our analysis of risk, by definition, considers the various known risks that we have discussed earlier. However, over the past few years, we have too often been surprised by previously unknown global risks. These have included geopolitical factors as well as major environmental impacts. These events cannot be predicted and are difficult, therefore, to quantify.

To hedge against the possibility of unknown risks creating a major negative impact on our clients' portfolios, we have implemented an overall general reduction in portfolio risk. In speaking about this recently to a colleague, we used the analogy of always sleeping with one eye open. Her response was very supportive as she pointed out that we are sleeping with one eye open so that our clients do not need to.

The tactical changes we make to client portfolios are typically in response to our reassessment of the most imminent risks (and or opportunities) that we are evaluating. Our Low Risk Bucket, for example, currently contains more international bonds than we owned previously. We believe such diversification will help protect portfolios from rising domestic interest rates while capturing potentially higher returns in other parts of the world.

As mentioned above, we continue to own precious metals in our Higher Risk Bucket. While such investments are purely speculative in nature, they also provide a tool to hedge the unknown risks such as those associated with the reduced confidence in the U.S. dollar, while also addressing other specific known risks.

The domestic equity markets continue to vacillate between euphoria and pessimism. Therefore, we continue to hold equities in various mutual fund formats. We continue to believe, however, that the emerging market countries will experience stronger growth over the next few years than will the developed world. Consequently, we plan to overweight both the equities and fixed income vehicles in that part of the world.

By definition, as our interpretation of the various risks change, we will seek to make timely tactical changes in our portfolios. But after having said that, we do need to strongly mention one important philosophical point. **We are not market timers!** No one can consistently pick the bottom of a cycle or the top of a cycle. Please do not mistake making tactical changes in response to identifying risks and determining which part of the in-

vestment world may have investment opportunities for market timing.

We believe that asset and risk allocation should be based on expected future returns of various asset classes, not based on looking in the rear view mirror at what historical returns have been. The typical investment caveat that past performance is not a guarantee of future returns is a saying that we take to heart.

In conclusion, we continue to work diligently in order to be effective in our dual mandate of both protecting our clients' wealth and growing it in a prudent manner. While we know that these quarterly letters tend to be long since we cover a lot of territory, we hope that they are informative and meaningful to you.

As always, if you have any questions or feedback for us, please do not hesitate to call us.

Sincerely,

Joel Framson

President

Silver Oak Wealth Advisors Introduces *Women's Circle*

Life's transitions bring questions about money and resources. How much is enough? Will I have enough and how will I know? How do I define richness of life? What resources are essential for my own happiness? What resources will I need to maintain my lifestyle when I am no longer working? What responsibilities in terms of resources and support do I hold for those I love?

***Women's Circle* provides an opportunity for women to talk, learn, and share about money.**

We will explore the powerful money questions with other women in a confidential and supportive environment. Let's talk to each other about what truly matters to us and learn the best from sharing our own stories and experiences!

If you or someone you know might benefit from participating in *Women's Circle*, please contact Linda Cao for information, by email Lcao@silveroakwa.com or telephone (310) 207-4800.



Engage, Educate & Empower Women for a Better Financial Well-being