Market Commentary by Craig Buckhout

Capital Market Recap
Investors experienced positive returns in virtually every asset class during the first quarter of 2011. Small U.S. stocks led the way with returns exceeding 8%. Emerging international markets were in negative territory for most of the quarter but ended in the black. Large company stocks around the world managed to shrug off the impact of natural disaster and nuclear crisis in Japan, political upheaval in the Middle East, and lots of other bad news, to provide returns in excess of long-term expectations.

Trailing period returns now incorporate two years of recovery since the market bottomed out in the spring of 2009. Major indices like the S&P 500 remain well below the peak values reached in the fall of 2007 (1320 now versus 1560 then) but well-diversified portfolios have recovered their value thanks to the strength of small company stocks and the receipt of dividends. The major indices now show positive returns when we look back three, five and ten years, with the exception of international stocks (EAFE) over the three-year period.

The bond market continues to labor under the burden of low current yields and the threat of higher inflation, which could push interest rates up and bond prices down. In the meantime, bond returns were slightly better than break-even for the quarter, as the asset class continues to perform its role of adding stability to a diversified portfolio.

Investing is for Optimists by Anthony Farella

One of the many benefits of owning an iPhone is free subscriptions to interesting podcasts. Recently, I listened to Matt Ridley give a talk at the Long Now Foundation’s Seminar of Long-Term Thinking called “Deep Optimism.” Ridley is the author of The Rational Optimist. In his book he argues that we all collectively prosper through trade and that we only productively trade with those we trust.

In his talk on “Deep Optimism,” Ridley presented a well-researched and documented case for progress in all areas of our lives. In one very illuminating example, Ridley showed how it takes less time each year to work for a constant benefit, say an hour of artificial light at night.
Market Commentary (cont.)

Walmart versus Gold – How will investors be rewarded?
In a recent issue of Grant’s Interest Rate Observer I saw a discussion of the inflation hedging attributes of gold, compared to the common stock of Wal-Mart Store, Inc., and some interesting comparisons of how the two investments have performed over the past three decades.

In the summer of 1999 gold was worth about $250 per ounce. It now trades for more than $1,400 per ounce. Walmart stock, on the other hand, has traded in a range around $50/share since 1999. So, it’s easy to see which was preferable to own over the past ten or eleven years.

Why have Walmart investors seen such poor returns? Has the company been doing that poorly? The answer – the company has done very well. In fact, sales have grown at a compounded annual rate of 8% over the period while earnings have grown at a rate of 11% and dividends at a rate of 17%. Book value per share has grown at a rate of 13%, but the market value has not changed! The difference – investors were willing to pay 50 times earnings in 1999 but only 12 times earnings today. So the company has grown and been profitable, and is expected to continue its profitable growth, and yet investors were not rewarded. The market seems to have concluded that it will now be difficult for the largest retailer in the world to continue growing at the explosive pace it set in the 1990’s, which justified the large multiple for its price relative to earnings.

The collapse of the price/earnings ratio implies a change in the underlying assumptions about Walmart’s growth prospects, while the price of gold tells us something about the market’s fear of inflation. But what conclusions can we draw about returns over the next ten years?

If markets are rational, we would expect similar risk-adjusted returns from gold and Walmart stock – why were they so different over the past eleven years? Well, the events of the past 11 years would have been difficult to predict in 1999. Walmart was growing like a weed, on its way to becoming the largest retailer in a world driven by exploding consumer demand. Gold, on the other hand, had been worth $850 an ounce in 1980, when inflation in the U.S. reached double digit levels and the value of the dollar was in jeopardy. From that point gold lost 70% of its value.

If someone told you in 1999 that Walmart’s price would stagnate while the price of gold grew to five times its value, you would not have believed them! No one could have predicted the series of events about to occur. The collapse of the technology bubble was followed by America’s war on terror, a real estate bubble, and then the credit crisis that led to the deepest recession since the Great Depression. Will the next ten years be as unpredictable....probably.

Observations:
1. There is no way to predict which company or asset class will blow through market assumptions to provide surprisingly good or bad returns. The future is unknowable and we will continue to be surprised.
2. Succumbing to emotion, or placing too much value on what has happened recently, will almost certainly have ill effects on investment outcomes.
3. Non-earning assets, like commodities and precious metals, will continue to be difficult to value precisely because they are non-earning. The value of any asset can be defined by the cash it is expected to produce in the future, but the only cash gold can produce is the price some future buyer is willing to pay.
4. Ten years is simply not a long period of time when looking at history to develop expectations for the future. It is very unlikely that the next ten years will look anything like the past ten.

As investment advisors our job is to understand what risks are important and help clients navigate through uncertainty. Sometimes it is necessary to look beyond the past ten years to gain perspective.
The Folly of Active Management and TV Gurus by Patrick Rohe

Last year I wrote an article about where to invest in 2010 and took that opportunity to remind investors not to fall into the excitement of active management and stock trading. Instead I cautioned them to focus on what you can control, like investment cost, risk, and asset allocation and to ignore the rest. So did I steer readers in the right direction? I was most confident that I had, but figured I would do some research on how one of the loudest stock trading icons had fared over the past year.

As the host of his show Mad Money, Jim Cramer is constantly on CNBC giving investment advice to listeners. In December of 2009, he stated that 2010 was the year of active investing and in particular certain sectors had a clear advantage. After the turmoil in 2008, he saw the financial industry as a definite opportunity in 2010 and named off several companies to buy. Not to my surprise, half of the stocks rose in value over the year while the other half showed negative year-end returns.

Furthermore, Cramer saw an opportunity in the energy sector, specifically in the recovery of natural gas versus oil. Here he listed over a dozen companies to invest in, with one of his favorites being a company that makes engines that run on natural gas and other alternative energies. The total return of these stocks for the year was 11.72%, and that is before you take into consideration trading costs. An investor in the small-cap index, Russell 2000, saw a 26.9% rate of return while taking on considerably less individual company risk.

Yet maybe 2010 was just a bad year for Cramer. I mean he does have a show on national television so he must know what he is doing, right? Since 2000, an objective research team from Massachusetts has tracked Cramer’s stock predictions to see how he has done. What they found was that over those ten years only 47% of the time had Cramer beaten the benchmark return through his stock picking! After watching his show, that seems like a lot of wasted energy to only beat benchmark returns at a rate less than that of a simple coin toss.

There is one takeaway from Cramer’s show that I do think all investors should listen to. On more than one occasion, Cramer reminds listeners that “no one will ever care more for your money than you do” and there is so much truth in that statement. Television ratings are the main goal of Cramer’s Mad Money series, and most investors have very different goals when it comes to their retirement accounts. A trusted advisor will put your interests first, and by doing so, you will have a much higher likelihood of achieving a successful retirement!

Investing is for Optimists (cont.)

• In 1800, it took six hours of typical labor to purchase an hour’s worth of candles, so few working people did.
• In 1880, it took fifteen minutes of work to purchase an hour’s worth of kerosene for a lamp.
• In 1950, it took eight seconds of work to pay for an hour’s electricity for a light bulb.
• In 1997, it took only half a second of work to light a compact fluorescent bulb for an hour.

Ridley proclaims we are becoming healthier, cleaner, smarter, kinder, happier, and more peaceful. He argues that the root cause of global prosperity is the exchange of ideas and specialization. And, more importantly, our progress is real, enduring, and for the near future unlimited. That’s a lot of optimism in the face of the pessimism that’s peddled in our daily news.

(Continued on page 4)
Investing is for Optimists (cont.)

To me, Mr. Ridley’s optimism is based on his belief that exchange leads inevitably to market efficiency. In a free market there are willing buyers and willing sellers. Both are motivated to exchange based on their ideas or expectations of future returns. This belief in market efficiency greatly simplifies the investing process. It allows us to focus on what’s important in the process:

1. Understanding risk – How much risk are you willing, able or need to take
2. Diversification – Globally diversifying across various asset classes
3. Control Costs – Lowest cost to gain exposure to an asset class

As an investment advisor, my job is to deliver a well-diversified portfolio based on my clients’ risk tolerance and goals. I continually focus on controlling costs and measuring results. Those are all very valuable services but there is something more valuable I offer clients. Recently, during the interview process, a prospective client asked me what my greatest value was. I don’t think anyone had specifically asked me that question before, but I had given it thought, especially after my experience during market meltdowns, most recently in 2008. My greatest value as an advisor is to keep my clients from making disastrous emotional mistakes in times of turmoil or deep pessimism. Investing is not an easy task especially undertaken on one’s own. While there is a cost to advice, it’s often worth the price to have someone optimistic by your side.

Returns from Various Markets
The following table shows the returns from various markets over periods ending March 31, 2011:

<table>
<thead>
<tr>
<th>Market/Asset Class</th>
<th>Quarter</th>
<th>1 Year</th>
<th>3 Years</th>
<th>5 Years</th>
<th>10 Years</th>
<th>20 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Money Market</td>
<td>0.0%</td>
<td>0.2%</td>
<td>0.5%</td>
<td>2.2%</td>
<td>2.2%</td>
<td>3.6%</td>
</tr>
<tr>
<td>Bond Market</td>
<td>0.3%</td>
<td>5.3%</td>
<td>4.8%</td>
<td>5.8%</td>
<td>5.5%</td>
<td>6.8%</td>
</tr>
<tr>
<td>Large-Cap Stock Market</td>
<td>5.9%</td>
<td>15.6%</td>
<td>2.4%</td>
<td>2.6%</td>
<td>3.3%</td>
<td>8.7%</td>
</tr>
<tr>
<td>Small-Cap Stock Market</td>
<td>7.9%</td>
<td>25.8%</td>
<td>8.6%</td>
<td>3.3%</td>
<td>7.9%</td>
<td>9.8%</td>
</tr>
<tr>
<td>International Equity Market</td>
<td>3.4%</td>
<td>10.9%</td>
<td>-2.5%</td>
<td>1.8%</td>
<td>5.8%</td>
<td>6.0%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>6.7%</td>
<td>24.4%</td>
<td>1.5%</td>
<td>0.7%</td>
<td>11.2%</td>
<td>10.7%</td>
</tr>
<tr>
<td>Inflation</td>
<td>1.2%</td>
<td>2.1%</td>
<td>1.5%</td>
<td>2.2%</td>
<td>2.3%</td>
<td>2.5%</td>
</tr>
</tbody>
</table>

Market Benchmark Portfolios
The following table shows returns from our market benchmarks over periods ending March 31, 2011:

<table>
<thead>
<tr>
<th>Benchmark</th>
<th>Quarter</th>
<th>1 Year</th>
<th>3 Years</th>
<th>5 Years</th>
<th>10 Years</th>
<th>20 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Preservation</td>
<td>0.6%</td>
<td>4.2%</td>
<td>2.9%</td>
<td>3.9%</td>
<td>4.0%</td>
<td>5.4%</td>
</tr>
<tr>
<td>Conservative</td>
<td>1.7%</td>
<td>7.7%</td>
<td>3.7%</td>
<td>4.4%</td>
<td>4.8%</td>
<td>6.8%</td>
</tr>
<tr>
<td>Moderate</td>
<td>2.8%</td>
<td>11.0%</td>
<td>4.2%</td>
<td>4.5%</td>
<td>5.5%</td>
<td>7.8%</td>
</tr>
<tr>
<td>Aggressive</td>
<td>3.9%</td>
<td>13.2%</td>
<td>3.6%</td>
<td>3.8%</td>
<td>5.3%</td>
<td>8.1%</td>
</tr>
<tr>
<td>All Equity</td>
<td>5.2%</td>
<td>15.5%</td>
<td>2.2%</td>
<td>2.2%</td>
<td>5.1%</td>
<td>8.1%</td>
</tr>
</tbody>
</table>

Note: These results were developed by simulating past returns in the various markets included in each benchmark, assuming the reinvestment of dividends and other earnings and deductions of costs totaling 0.20%. The money market is represented by 90-Day Treasury Bills; the bond market by the Barclays Capital Government/Credit Bond Index; the domestic large cap market by the S&P 500; the domestic small cap market by the Russell 2000 Index; and the international equity market by the EAFE Index. This data is presented to show the long-term relationship between returns at various levels of investment risk. It is not intended to present performance results experienced by clients of Rockbridge Investment Management, but is intended to provide a benchmark against which actual performance might be judged. Also, readers should recognize that future investments would be made under different economic conditions. It should not be assumed that future investors would experience returns, if any, comparable to those shown above. The information given is historic and should not be taken as any indication of future investment results.