



Quarterly Financial Update

Second Quarter 2011

A number of major problems have been weighing on the markets:

A Greek default is a significant concern, particularly the risk of contagion spreading to other weak EU countries and the broader financial system.

We are increasingly concerned that China could face a “hard landing” for its economy.

At home, the debt/deficit problem is worrisome. We probably only have a few years before borrowers start demanding higher rates for the risk of lending to a fiscally challenged U.S.

Given the wide range of potential outcomes, which are skewed to the downside, we remain underweighted to equities and overweighted to non-traditional, lower-risk asset classes.

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Quarterly Investment Commentary



Quick Take

There are a handful of important points that underlie how we view the world in general and the investment landscape in particular. If this brief summary section is all you choose to read, we hope it gives context for the investment decisions we are making on your behalf. If you want more detail, the subsequent sections provide it.

First, we continue to see potentially serious risks that could be damaging to investment markets. The possibility of a Greek default is in the headlines, but there are other significant risks as well, including the chance that China sees a sharp slowdown that affects the global economy, our own debt problems (both at the household and government level), and ongoing weakness in the economy highlighted by persistent weakness in jobs and housing. These issues matter because they have the potential to roil markets and, in a bad case scenario, cause significant losses. And even if these problems fail to precipitate an actual crisis, their very presence still strongly suggests that it will be harder for the economy to grow at a normal pace in the years ahead.

Second, it is especially difficult to predict how these global and domestic issues will unfold in the years ahead because of their attendant complexity. We are confident, however, that there is more downside risk in a bad outcome than there is upside potential in a good one.

This brings us to our third takeaway, that stocks and other risky assets aren't priced cheaply enough to reward us adequately for the risks we see. Meanwhile, we believe we can get similar or better returns with less volatility and less downside risk from other investments that we own, like flexible bond and absolute return strategies, which don't depend on tailwinds from rising markets to earn their returns. The net of this is that our portfolios are conservatively positioned at this time and we expect this to continue until we see better return potential from riskier assets.

Finally, we acknowledge that markets could continue to climb in the short term. Very low interest rates encourage investors to take risk and, as time passes, can contribute to complacency. But time won't fix problems like our federal deficit or Greece's unsustainable debt load. These problems will either come to a head on their own, or actions will be taken to fix them; and either course will result in pain. If we do see markets get roiled, we will be prepared to take on more risk at levels that promise better long-term returns. In the meantime, our portfolios will probably lag in a rising market. Given that possibility, we would like to remind our readers and investors that our investment process focuses on the analysis of longer-term factors, which we can undertake with much higher confidence than attempting to anticipate short-term market moves. Predicting the short term is not something we believe anyone can do reliably and consistently. This is why we want our clients to fully understand our reasoning, as well as the work we've done to arrive at our conclusions. For more on that, please continue reading, and if you have further questions don't hesitate to contact us.

Greek Debt Crisis Fears (Again)



It appears that the European Union, the European Central Bank, and the International Monetary Fund will once again provide Greece with additional financial assistance (i.e., loans

at below-market interest rates) in return for Greek promises of more fiscal austerity. The aim is to buy more time, hoping to give Greece additional opportunity to get its fiscal house in order and pay back the debt. Unfortunately, we (along with most other investors) believe that some type of Greek default or "restructuring" – in which the debt repayment schedule is extended but the principal value is not marked down – is inevitable given the severity of their situation. As one investment strategist put it, "Everyone knows Greece will default; it's just a question of whether it's orderly or disorderly."

Given the very high likelihood of some form of default, the key question for us as portfolio managers is what the timing and, more importantly, the global impact of such an event would be. Unfortunately, the answers to these questions remain deeply uncertain at this point, though the potential consequences could be quite severe.

The global financial system could probably withstand a Greek default, taken by itself, without devolving into a crisis. The big risk, obviously, is

that a Greek default could spread to other heavily indebted European countries, such as Ireland and Portugal, and possibly even Spain or Italy. Even if these other countries have the capacity to service their *existing* debt, the market could eventually force them into default by refusing to re-finance – or “roll over” – those current obligations. If this were to happen, their only recourse would be to appeal to the European Central Bank and IMF as lenders of last resort. Even then, there is no absolute guarantee that those institutions could muster enough financial support to restore confidence to the entire system before it is overwhelmed.

Greece remains a rapidly evolving situation. We continue to analyze the likelihood and possible impact of its potential outcomes on the asset classes in which we invest. Should there be a crisis in the near term related to Greek debt, we’d expect Treasury yields to fall (and prices to rise) while “risk assets” such as stocks and emerging market currencies would fall. Treasury bonds are still perceived as a “safe haven” asset class, despite the U.S.’s own debt problems.

China Hard Landing

Another risk that we see and that is becoming more important in our macro analysis is a potential “hard landing” for the Chinese economy (as opposed to a gradual slowdown) along with the global ripple effects that would result. Most experts agree that at least some segments of China’s property market are significantly over-valued. The general consensus is that this “real estate bubble” is not widespread and can be managed by the Chinese government, as it has been in the past. There is a risk, however, that valuations may already be so extreme that a sharp and sudden reversal will have an adverse impact on the Chinese economy as a whole. The possibility of such a contraction does not appear to have been priced into risk assets, such as equities, commodities, and emerging markets local currency bonds. Experts who follow the



Chinese economy present us with both optimistic and the pessimistic readings of this situation. It is difficult to gauge who is right, partly because information from China can be unreliable. However, we find ourselves

leaning toward the bearish view because of the following macro observation.

For much of the last two decades, China has been building infrastructure – residential and commercial real estate, factories, roads, bridges etc. – that may have made sense for the urbanization rate it was experiencing at the time. In large part, this urbanization was

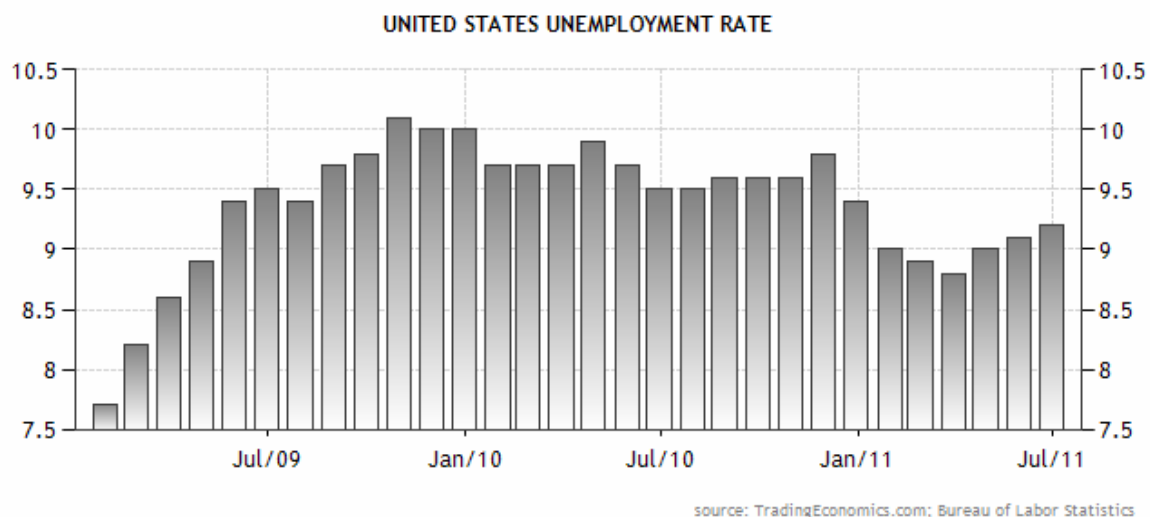
driven by much of the developed world taking on excessive debt in order to spend beyond its means. So, the question is this: has China factored the ongoing, developed market deleveraging into its infrastructure plans? This does not appear to be the case. In

fact, spending on fixed investments has grown at a faster rate in the past two years than it did before the global financial crisis. It is difficult to imagine that all the new capacity that has resulted will turn out to have been justified at a time when the developed world is deleveraging (and must continue to deleverage) and China's domestic consumption is still relatively small. The numbers just don't add up: China has a \$1.5 trillion consumer economy compared with

\$20 trillion for United States and Europe combined. Furthermore, if China induces a negative wealth effect among its rich urbanites by deflating the domestic housing bubble, the consumer sector will take a hit. With diminished urban wealth and a still-developing rural population, we do not believe that China's domestic market will be able to absorb all the excess industrial capacity that they probably now possess.

The U.S. Economy Is Slowing Again

Recent U.S. economic news has been disappointing, with sluggish GDP growth and continued weakness in employment and housing, both important drivers of consumer confidence, income, and spending. On the jobs front, the latest employment report for May showed growth in



nonfarm payrolls of only 54,000 for the month, a big drop from the 220,000 monthly average increase in the prior three months. Economists estimate that the U.S. economy must create between 100,000 and 200,000 net new jobs each month just to absorb the natural flow of new entrants into the labor force, thus keeping the unemployment rate flat. Given May's poor job creation numbers, the unemployment rate ticked up to 9.1%. Meanwhile, many economists have been cutting their growth forecasts for the year to below 2.5%–3%.

What Would Lead Us to Become More Optimistic?

We are occasionally asked what would lead us to become more optimistic about the macro environment or increase our equity exposure. With regard to the equity exposure question, first and foremost we would need to see enough of an improvement in market valuations to raise our return expectations for stocks over our five-year analysis horizon. All else being equal, a drop in stock prices improves the expected future return.

Alternatively, if our assessment of the economic fundamentals – including corporate earnings growth – materially improves while stock prices remain flat, we could also justify an increase in our exposure to equities based on higher expected returns. We also continue to reassess the positive impact on our earnings growth estimates from the growing share of U.S. corporate profits coming from emerging markets demand. Finally, credible and concrete policy actions to control the United States’ long-term structural budget deficit, along with concrete evidence of both public and private sector deleveraging, would materially improve the macroeconomic environment and would therefore improve the outlook for riskier assets in general.

A Concluding Reminder About Downside Risk



Having outlined what could turn us more positive, we will conclude with a reminder about the potentially severe downside risks we see. Faced with one of the global economic crises described above, we would expect risk assets to depreciate. When we evaluate the likely impact of this type of scenario – a severe downturn, though not as bad as 2008 – on our Balanced Portfolio, we estimate that the portfolio is likely to exceed its 10% (12-month) loss threshold by a couple of percentage points. That would be a tough loss to swallow, even though it beats benchmark performance. That said, we believe that the likelihood of such an outcome is sufficiently low to justify maintaining current allocations. We don’t manage our portfolios to a worst-case scenario because the opportunity cost can be significant. On the other hand, it is certainly possible that equities are at greater risk than we estimate. Clients should

therefore think about whether they will be able to withstand something in excess of their “normal” 12-month loss without panicking. If not, then moving to a lower-risk portfolio model probably makes more sense. If you would like to reconsider your own portfolio strategy, please contact us.

The good news for clients who are in the appropriate model for their risk tolerance is that in the event of a severe market downturn, our relatively defensive positioning should enable us to redeploy capital from lower risk investments into assets with (at that point) much better return potential. As we’ve written before, if there is one thing we can be almost certain of, it is that there will be market shocks over the next few years and they will create investment opportunities for us. There may also be events that magnify certain risks. In either case, we will continue to invest based on where our research and analysis leads us. In the long run this approach has paid off for our clients in the past, and we believe it will continue to do so.

Well, And Wisely, Done



John Beule, 1942

Many of my clients and regular readers are already aware that my father, John Beule, is nearing the end of his long life journey.

As I look back on the past 4 ½ years – the period of his final decline – I am amazed by how much I have learned by being with him as he made his way down his path.

Everybody's circumstances are, of course, different. Nothing happens the same way twice. Yet I am convinced that much of what I have learned through the process of caring for my parents over the past several years is generally applicable. And while some of my experiences confirmed what I thought I knew, other aspects surprised me.

As we all try to envision our lives in the future, I believe it helps to have had some concrete experiences to shape our thinking. I would therefore like to share some of what I have learned (or had confirmed) with my readers. I hope it will both help and comfort readers as they consider not only their

own but also their parents' and children's lives and future plans.

Planning Works

Even those of us who plan for a living sometimes suffer a disconnect between the future we're planning for and a sense of reality. But if there's one thing that I have had confirmed over the past few years is that good planning pays off.

Although it wasn't written down in a formal sense, my Dad had a plan for everything in his later life. In the parlance of our industry, he had a great cash flow plan, good contingency plans, and a robust asset transfer plan. With very few exceptions, all of those plans worked as intended. His forethought resulted not only in far better outcomes for him and my Mother than would otherwise have been the case, but also made the process more manageable for my sister and me.

I'd like to highlight two parts of that overall plan that I came to particularly admire.

Cash Flow Planning For A Long Life.

My Dad always said that he thought he was going to live to be 92 – largely because his parents and grandparents had reached similar ages. Instead, he has made it almost to 96. That's the good news, of course. The bad news is that those last four years have been more expensive than anything he could possibly have imagined.

Those (largely unanticipated) expenses would have destroyed a cash flow plan that was less robust than my Dad's, yet his stood up fairly well. It did so because my parents followed a few simple financial rules.

First, they minimized their ongoing cash requirements in retirement. They paid off their mortgage long before they retired. And though they never denied themselves anything that was truly important to them, my Dad just knew how to conserve cash. They did things for themselves that other people pay for. They wasted nothing. (“Recycle, reuse, repurpose” anyone?) They bought things they needed, but never went shopping just “for fun.” These behaviors were so natural for them that I hardly noticed them before I was well into middle age and got formally involved in their financial lives.

My parents had less useless ‘stuff’ in their lives than anybody else I have ever known. Their ability to lead full and happy lives sans ‘stuff’ was undoubtedly a byproduct of their formative years in the depths of the Great Depression, but what amazed me was realizing how useful those skills

continued to be for them. The fact that their committed expenses were so low gave them a tremendous amount of financial flexibility – without sacrificing their sense of fulfillment.

Second, my Dad had created secure funding for basic retirement expenses through a combination of old-fashioned pensions, annuities, and Social Security. In their early retirement years, in fact, my parents needed very little supplemental income from their portfolio in order to maintain their lifestyle. As a result – and also I suppose due to the life-long habit of saving that they couldn’t shake – their portfolio continued to grow until very recently, when a combination of the financial crisis and my Dad’s medical needs finally conspired against it.

When I asked my Dad why he didn't own any bonds, his answer was simple: “Bonds don't grow,” he said.

Third, my Dad knew the value of growth. I was, in fact, shocked when I first examined my father’s portfolio. It seemed to break all the rules for a portfolio that an 80-something should own; it consisted almost entirely of stocks. When I asked my Dad why he didn’t own any bonds, his answer was simple: “Bonds don’t grow,” he said. As someone who had been investing for more than a half a century, he truly knew the value of growth. And what I eventually came to realize was that the ‘fixed income’ component of his financial strategy consisted of the pensions and annuities described above. This freed up

his managed portfolio to hold more volatile growth assets. And it was portfolio growth that eventually gave us the means to meet his medical needs over the past several years. The beauty of this approach is that it left a reserve for unexpected expenses

toward the end of Dad’s life. Most people, of course, try to avoid this; I’m just glad my Dad wasn’t one of them. We needed most of it.

I find it a bit annoying that the financial planning industry has been congratulating itself recently for “inventing” such secure-against-market-downturns-but-flexible-on-the-upside financial strategies. Yes, it’s a good thing for all of us to be thinking about more than simple, long-term return maximization when we consider the role of cash flow in the arc of our clients’ lives. But it’s also a mistake to believe that all good things are new inventions. (Perhaps that’s a conceit of the Baby Boomer generation.) Sometimes getting back to tradition and to basics works quite nicely.

Planning To Pass It On. About ten years ago my Dad asked my sister and me to sit down with him and take a look at his estate plan, including his living trust. At the time he was fit, active, and in his mid 80s. He had everything laid out, including some things that he wanted one or the other of us to end up with, along with a suggestion for how to ‘make it up’ to the other one. As usual, his suggestions were rational and well thought out. There were only a couple of things that we, as the recipients of his largesse, asked him to adjust, but not many. In the end, giving us adult children the time and opportunity to have some input into the asset transfer process was one of the best things he ever did. I don’t think we would have ended up having serious issues with what he had proposed in the first place, but knowing in advance made the transition a family project – not just something that our parents did and that my sister and I passively or grudgingly accepted.



We also talked about the possibility of my taking over the management of his financial affairs if something were to happen to him, since I am the “numbers person” in the family. At the time, such an eventuality seemed remote. Little did I realize that, as co-trustee of my parents’ revocable living trust, I would end of working within the framework that he set up for four and a half years and managing all of their financial affairs. If either of these things had not happened – if I hadn’t been familiar with my parents’ financial affairs, or if I hadn’t been enabled to act on their behalf – I can’t even imagine how much more difficult my life would have been beginning with my Dad’s first major stroke at age 91.

While it’s possible to think of a trust only as a more flexible kind of a will, i.e., an instrument used to efficiently transfer assets upon the death of its maker, in my experience one of its key – and frequently overlooked – advantages is its ability to deal with the incapacity of its beneficiaries. In many ways incapacity is a more difficult situation to deal with than death. It is open-ended and can persist for a very long time. What’s more, incapacity is frankly far more likely to be financially devastating than a simple death. And so it was in our case. Thank goodness Dad had given us a good set of tools to work with.

Things I Learned That Don’t Surprise Me In Retrospect



Old Age Is Incredibly Expensive. How many financial plans call for decreased spending toward the end of our lives? Lots of them do. And while that is always a possibility, the greater likelihood is that most of us will spend dramatically more for care in our later years than we anticipate.

The difference between what we plan for and what is likely to happen is the cost of the personal care that is necessitated by extreme old age. We don't anticipate this because, as capable adults, we can't envision a time when we can't feed or dress or bathe ourselves. What's more, we don't realize that we will begin to need such support services long before our need is complete enough to trigger a long-term care policy or force us into a nursing home (see also below).

The Elderly Need Advocates. Every elderly person needs at least one adult who will advocate for him or her. All the agencies and government programs in the world do not substitute for a person who cares and who is willing to get involved. Why? Because the world is impossibly complex; you just can't make up (or write rules to anticipate) the kinds of situations that need to be dealt with.

Even if you don't personally care for an elderly individual in your life, just playing the advocate role takes tremendous time and emotional energy. If you have an aging parent, think about how you and your family members may want to address and share this task. Preparing for it won't make it go away, but it will make it easier.

For yourselves, think about who you might wish to advocate for you one day. Do you know someone whom you would literally trust with your life? You will need one.

Change Is The Only Constant.

Every time we thought we had succeeded at stabilizing our parents' situation, the situation changed. Indeed, the process of final decline is just that – a continuous process. I now wonder why I didn't see this coming because it is analogous to its counterpart, the growing-up process, which also seems never to end.

One of the reasons that managing an elderly individual's care can be so emotionally draining is that one is constantly fooled into thinking that the job is done. What we finally learned – after a couple of years – was to anticipate and prepare for the next phase wherever possible. Getting out in front of the planning curve was our only defense against being forced to constantly play a panicked game of catch-up.

Things I Learned That Did Surprise Me



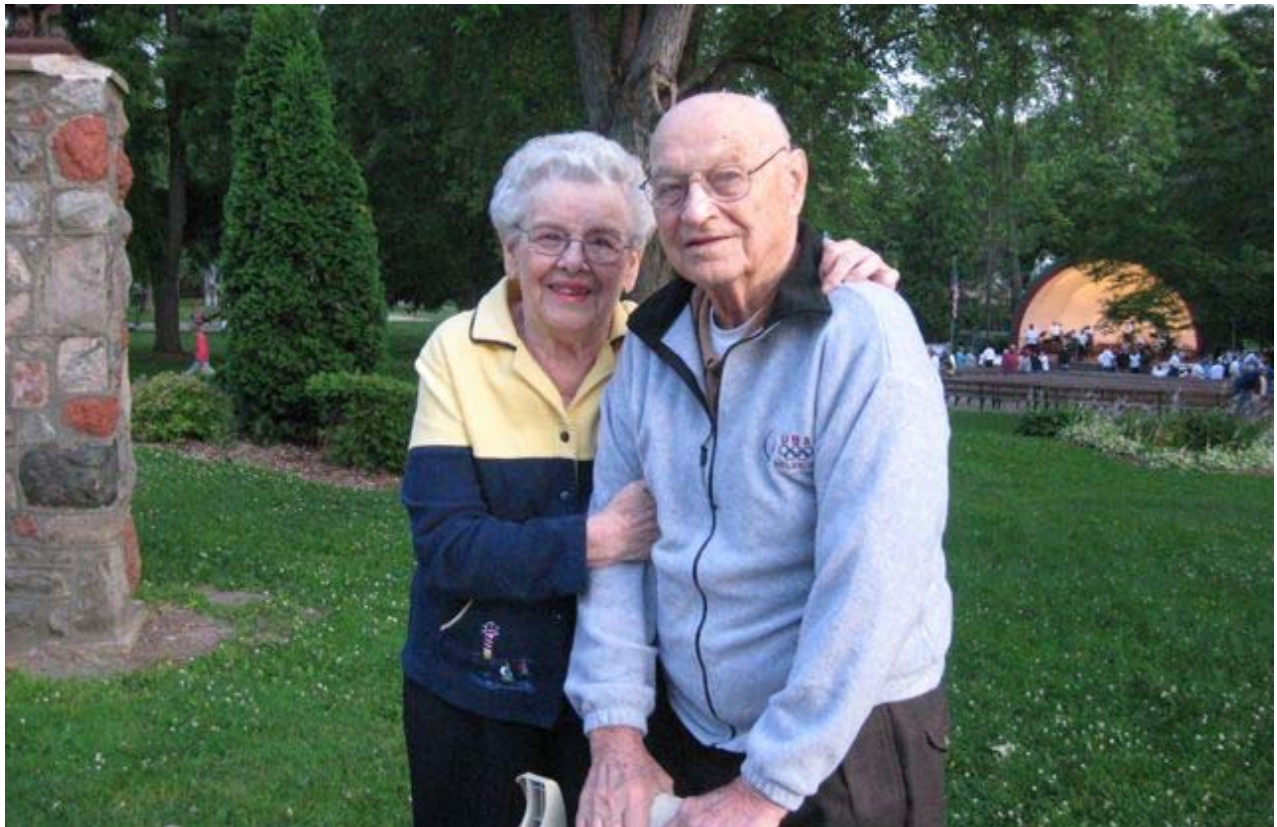
There Is No Such Thing As A Good

Nursing Home. I used to think that there were "good" nursing homes – the kind where we would send our parents – and "bad" nursing homes – the kind we would avoid. But my experience with actual nursing homes has changed all of that. It would now be extremely difficult to convince me that the former exist at all, including those associated with posh, continuum-of-care type retirement communities.

The reason for this is simple. Nursing homes are, by definition, institutions. They are tasked with the efficient care of a group of elderly patients, each of whom requires a different kind and amount of personal attention. The fact is that, in every nursing home situation I have seen or can imagine, the need for efficiency always sabotages good care at an individual level. Patients are awakened when the staff has time, not when it makes sense for the patients. Baths and therapy must conform to an external schedule, not be undertaken when the elderly individual happens to be alert and ready for it. Food is seldom fresh or appetizing or appropriate for each individual being cared for. It must be mass produced and conform to institutional standards. The list goes on.

None of this happens only if the managers or staffs in nursing homes are incompetent or uncaring. It happens, in fact, in spite of some truly remarkable caregivers in facilities because the problem is *structural*, not personal. Add to that the likelihood that at least some of the staff in even the best homes are less-than-wonderful, and you have a recipe for disaster.

You Can Go Home Again. After my Dad's last major stroke landed him in a nursing home, we debated whether or not we could move him and my Mom back to their home with personal, full-time, care. I was surprised – though I supposed I shouldn't have been – at the number of professionals who told us that we were crazy to even consider such a move. Luckily for both my parents and me, I have seldom been deterred by folks who tried to convince me that I couldn't do something that I had decided was the right thing to do.



The complete story of our quest to move our parents back to their home is too long a telling for the *Update*. Suffice it to say that, after months of planning and home renovation and staffing – in-

cluding our share of false starts and hiccups – we succeeded in bringing them back to their beloved home, where they will stay until the end.

I can't begin to express how different and how wonderful it is to see them back in their own surroundings. I often wondered during the months of planning and construction and outfitting whether it was all going to be worthwhile. But I know now that the answer is a resounding "yes."

Old People Need Young People, But Young People Need Old People Too

One of the reasons my mother always hated the nursing home is that there were too many "old people" there. At 92, you see, she just doesn't identify with those other, slightly loopy, individuals who sit at the dinner table and simply stare into their food. Even though she is slightly loopy herself at this point, she doesn't want to be around other people who are – and come to think of it I can't blame her for that. She wants to be around life, not constant reminders of death.

As for my sister and me, I think I speak for both of us when I confess that, despite the frustration and stress and work involved, it has been a privilege to interact again so frequently and so purposefully with our parents. In a very strange way it has actually been a good time. (I admit, this is somewhat

like remembering the endlessly sleepless nights after one's first baby is born as a 'good time.')

It has not been 'fun,' but it has been deeply satisfying. Neither of us will ever regret having done it, not just because we believe it was the right thing to do but because we actually got something out of it ourselves. We gained a deeper appreciation of and love for our parents, learning more about ourselves in the process. We consolidated much of our memory of early family life, something that will stay with us from this time forward. And as siblings we now have a deeper and more robust relationship. All told, I think we got a fair shake.

