



**Investment Advisors, Inc.**

SGL Investment Advisors, Inc. is a Registered Investment Advisory firm headquartered in Missoula, MT. SGL Investment Advisors, Inc.'s professional money managers, backed by 45+ years of collective experience, personally work with clients to individually structure their portfolios to fit their risk tolerance profiles. We maintain an open door policy towards personal meetings throughout the money management process. Our in-house research department focuses on constructing portfolios that limit downside risk while maintaining an eye for capturing market upside. Our clients include institutions, pension plans, trusts, non-profit endowments, 401K & profit sharing plans and high net worth individuals.



## Systemic Crises, Mounting Deficits and Inflationary Concerns

Authored by Ather Bajwa, C.F.A

Alan Greenspan called the recent financial crisis a "once in a century" event. Although it is difficult to know how Mr. Greenspan reached such a conclusion, recent history suggests that in the current environment of floating currencies and fiat money economic crisis are all too common (Figure 1). Sovereign debt (e.g. the Greece 2010), currency (South-East Asia 1997) and banking (US 2008) crises have been a feature of global

Systemic Crisis	Cost of Rescue % of GDP
Finland 1992	12.8%
Sweden 1992	3.6%
Mexico 1994	19.3%
Japan 1997	14.0%
S. Korea 1997	31.2%
US 1988	3.6%

Figure 1 Source : IMF

economic growth over the past several decades. During the recent crisis both fiscal (government spending) and monetary (interest rate) policy were used in tandem to successfully limit the scale and scope of the downturn. However, as concerns of another depression have receded, the cost of running large unsustainable fiscal deficits and abnormally loose monetary policy have started to appear in many economies such as that of the United States. The US, along with many other developed economies, is running unprecedented budget deficits (Figure 2). According to the IMF, the world's twenty largest economies (the G20) had a combined budget deficit of 1.1% in 2007, which expanded to 8.1% in 2009. The consequence of continually running such large deficits has historically manifested itself into a higher cost of financing debt, rising inflation and a falling standard of living.

Positioning investments in times of large deficits, rising inflation and increasing interest rates becomes increasingly more complex. Over the past three decades a combination of low inflation, falling interest rates and manageable deficits helped the US economy grow. Additionally, fixed income securities experienced some of the best returns in history, averaging nearly six percent per year. Higher future inflation is a primary concern to both fixed income investors and issuers of such securities. Inflation not only reverses productivity gains but also imperils economic growth potential and reduces the consumption and investment ability of citizens. Large fiscal deficits post World War II and during the 1970's caused substantially higher inflation, resulting in rising interest rates and bond returns that turned strongly negative. Average annual bond returns from 1946 to 1951 were -4.98% (stocks 5.25%), and from 1977 to 1980 were -7.33% (stocks 4.75%).

	Budget Balance as % of GDP (2010)	Budget Balance as % of GDP (2007)
USA	-11.1	-1.2
Euro Area	-7.2	-0.9
UK	-13.5	-3.0
Japan	-7.6	-2.6
China	-3.3	0.2
India	-6.4	-3.4
Russia	-4.0	3.0
Brazil	-3.0	-1.8
Canada	-3.6	1.0
South Africa	-6.6	1.0

Source : Country Statistics Figure 2

High rates of inflation have historically placed great pressure on domestic currencies as well. The US dollar fell in value against the German Mark throughout the 1970s. As inflation was curtailed later in that decade, the dollar started to gain strength once again (Figure 3). If history is any guide, many western economies are likely going into a difficult next few years.

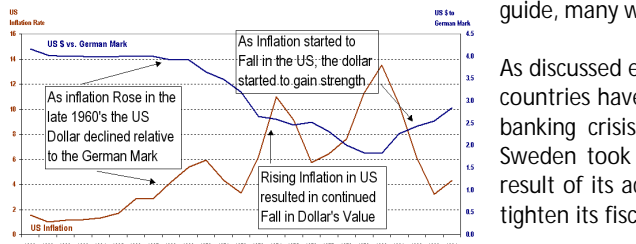


Figure 3 Source : Federal Reserve

As discussed earlier, economic crisis and the large budget deficits that follow are not new. Many countries have experienced similar conditions throughout history. Sweden experienced a similar banking crisis in the early 1990's when most of its financial institutions became insolvent. Sweden took over its largest banks, wrote-down all bad assets and recapitalized them. As a result of its actions in 1994, the budget deficit had swelled to 9.3% of GDP. Sweden started to tighten its fiscal belt by trimming its expenditures, reducing government's wage bills and cutting

its spending by five percent - helping the economy generate a 1.2% budget surplus in 1998. As economic conditions improved Sweden sold off its stakes at a profit. By 1998 the unemployment rate was lower than at the start of the crisis. Japan after its economic crisis in 1987 took a different approach. Instead of recognizing losses it tried to prop up its financial sector and the economy by lowering interest-rates to near zero. Cash infusions into the financial sector and a series of modest stimuli over the following decade resulted in a prolonged downturn from which the Japanese economy has still not completely recovered. Tax increases (even targeted ones) work as a double-edged sword; on the one hand they can potentially reduce deficits, but higher taxes in times of financial strife can stifle growth potential. Japan raised consumption taxes in 1997 and the economy promptly fell back into a recession. On the other hand, Ireland (along with substantive austerity measures) raised taxes in 2009 to successfully reduce its projected deficit with no discernable consequent negative impact.

Emerging markets on the other hand had a remarkable financial crisis; many of them (e.g. China, India, South Africa and Colombia) averted a recession altogether. Learning from previous mistakes, pre-crisis, several emerging economies were running consistent budget and current account surpluses. According to the IMF, emerging economies will likely expand by about 6% in 2010 versus 2.1% in 2009, while advanced nations, after contracting 3.2% in 2009, will likely grow by 2.1%. Debt levels in emerging economies are currently around 40% of GDP, about the same as 2007. In developed nations debt levels increased from 78% to 107%. As a result of their prudence, the cost of borrowing for emerging countries has currently fallen to a little over 6%, the lowest on record, compared to approximately 12% in 2008 and roughly 18% ten years ago.





## Current Portfolio Strategies

Investment Advisors, Inc.

Released April 2010

### GROWTH + PORTFOLIO

Designed for the risk tolerant investor with a mid to long-term investment time horizon

Targeted Performance in a Market Cycle: greater than 100% of S & P 500 upside performance with 100% market risk

Approximate Average Equity Beta ( $\beta$ ) > 1

Current Allocations (appx.); 89% stocks, 7% fixed income, 4% cash

Strategic Outlook; The Growth + portfolios continue to focus on infrastructure orientated cyclical companies. A recent focus has been on information technology companies that should benefit from Obama's \$40 billion broadband buildout program – a vital and yet to be deployed component of his stimulus plan. More and more data continues to flood the world's information networks as smart phones continue to come online, internet delivery technologies accelerate, GPS navigation devices become as common as wristwatches, etc. That amount of information travelling at those sorts of speeds ultimately will require the hardware, software and expertise of companies like Cisco (CSCO), Juniper Networks (JNPR) and F5 Networks (FFIV).

Recent Purchases; F5 Networks, Inc (FFIV) manufactures, sells and services a wide variety of products that enhance the performance of network based hardware and software applications. In essence, FFIV's products accelerate and streamline data communication between and within commercial and public sector institutions. As more and more data is flooded into various network pipelines, processing and routing that data extremely quickly will become increasingly vital. That's FFIV's niche.

### GROWTH PORTFOLIO

Designed for the risk tolerant investor with a mid to long term investment time horizon or a risk neutral investor with a long-term outlook

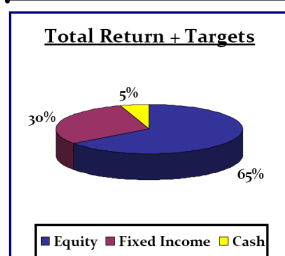
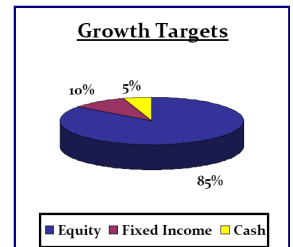
Targeted Performance in a Market Cycle: 100% of S & P 500 upside performance with 85% downside risk

Approximate Average Equity Beta ( $\beta$ ) >= 1

Current Allocations (appx.); 87% stocks (E/W), 9% fixed income (E/W), 4% cash

Strategic Outlook; Attributable largely to organic growth, we have allowed our equity allocations in the Growth Portfolios to drift upwards with market momentum. Our equity mix continues to capture market like performance with small but relevant positions in fixed income. We have also been able to find attractive pricing in some convertible bonds issued by companies with good long-term prospects. Convertible bonds allow our Growth Portfolios to participate in some capital appreciation potential while limiting some of the volatility in the stock market.

Recent Purchases; In order to diversify the portfolios, we have recently taken positions in a couple of small companies with well established product lines - including Synaptics Inc (SYNA). Since 2002, SYNA has been one of the world's leaders in producing touch screen interfaces for a variety of consumer and household electronic devices. As the touch screen method of user interface continues to spread through phones, televisions, and more household appliances - SYNA stands to benefit. Touch screens aren't merely a futuristic pipedream – SYNA recently contracted with Samsung to provide interfaces for A/C units.



### TOTAL RETURN + PORTFOLIO

Designed for the risk tolerant investor with a mid term investment time horizon or a risk neutral investor with a mid to long-term outlook

Targeted Performance in a Market Cycle: 80% of S & P 500 performance with 60% downside risk

Approximate Average Equity Beta ( $\beta$ ) = 1

Current Allocations (appx.); 66% stocks (E/W), 31% fixed income (E/W), 3% cash

Strategic Outlook; Similar to the Growth category, we have allowed market momentum to carry our equity allocations to a slightly higher level. We continue to harvest significant premiums on appreciated bonds and reinvest in both stock and fixed income opportunities as they become available.

As money market rates continue to stay historically low, we are carrying as little cash as is possible in all portfolio classes.

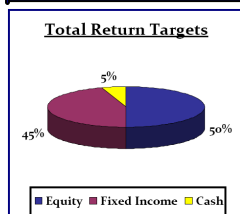
Recent Purchases; CPFL Energia SA (CPL) is the largest privately owned utility (as measured by distribution) in Brazil. CPL services over 6 million customers in 234 municipalities including the greater Sao Paulo region. In contrast to US utilities, there are significant growth opportunities for foreign utilities from a demand growth perspective. As Brazilian industrial complexes come online and individual consumers buy more electricity hungry devices – a utility like CPL enjoys expanding usage of their product. CPL also publicly states that they are committed to paying out at least 50% of their net income in dividends. This shareholder friendly methodology has resulted in a trailing one-year dividend yield in the neighborhood of 7%. In an environment where the US\$ weakens against 'risk' currencies like the Brazilian Real, a company like CPL should do well. Utilities are often compared to bonds because they provide high levels of current income. If CPL was a bond, it would be a foreign currency denominated bond which provides a natural hedge against a weakening US\$.

# Current Portfolio Strategies



Released April 2010

Investment Advisors, Inc.



## TOTAL RETURN PORTFOLIO

Designed for the risk tolerant investor with a limited investment time horizon, or a risk averse/neutral investor with a mid to long term outlook

Targeted Performance in a Market Cycle: 65% of S & P 500 upside performance with 50% downside risk

Approximate Average Equity Beta ( $\beta$ )  $\leq 1$

Current Allocations (appx.); 55% stocks (E/W), 42% fixed income (E/W), 3% cash

Strategic Outlook; Continued strength in world stock markets has pushed up the equity allocations in the

Total Return category as well. We have been somewhat more cautious in the more conservative portfolio classes – and have been incrementally harvesting gains where appropriate in order to limit some of our client’s exposure to a potentially volatile stock market.

Recent Purchases; Family Dollar Stores Inc (FDO) operates over 6,600 retail discount stores in 44 states across the United States. 99% of FDO’s products are priced at \$9.99 or less, but many of their products are brand name items that were simply overstocked or overproduced. In this environment where the US consumer continues to struggle due to high unemployment and battered personal balance sheets – a company that capitalizes on a downshifting consumer should benefit. FDO is a tightly run midcap company on an impressive growth curve – FDO’s sales have grown at a 14% annualized rate over the last ten years.

## CAPITAL PRESERVATION PORTFOLIO

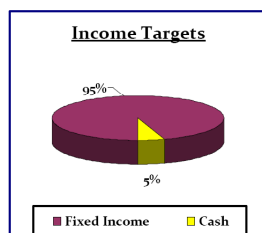
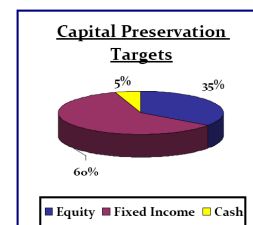
Designed for the risk averse/neutral investor with a limited to mid-term investment time horizon  
Targeted Performance in a Market Cycle: 50% of S & P 500 performance with 35% downside risk

Approximate Average Equity Beta ( $\beta$ )  $< 1$

Current Allocations (appx.); 35% stocks (E/W), 61% fixed income (E/W), 4% cash

Strategic Outlook; Similar to the Total Return portfolios, we have been harvesting some gains on the equity side as we limit our client’s exposure to volatility. As we continue to harvest significant gains in the fixed income portfolios – we have been reinvesting in callable CDs and high-grade corporates. A near term call tends to hold bond prices near par – offering longer term yield advantages if the bond isn’t called. If the bond is called, we hope to be able to reinvest at a more attractive interest rate.

Recent Purchases; In order to insulate the portfolios against inflationary threats – we have purchased some bonds similar to an Allstate Life CPI (Consumer Price Index) bond due in 2016. The bond is life insurance trust paper – meaning the bondholder has the same claim to assets as do policy holders. As such, it is rated AA. It pays a monthly coupon at a rate of  $CPI \times 1.5$ . If inflation (most commonly measured by CPI) comes in at 3%, the bond pays 4.5% or 6%/9%, etc... The multiplicative factor enhances the beneficial spread as inflation accelerates. We’ve been finding these bonds at a significant discount, adding to the total return potential of the strategy.



## INCOME PORTFOLIO

Designed for the investor in search of current income and/or preservation of principal.

Targeted Performance: Customized income portfolios to meet a variety of income needs.

Approximate Average Equity Beta ( $\beta$ ) ~ n/a

Current Allocations (appx.); 85% fixed income, 15% cash

Strategic Outlook; As most debt spreads continue to incrementally grind down, a premium is placed on investing in corporate names and sectors with potential credit upgrades. The dramatic appreciation in fixed income in 2009 is unlikely to repeat itself in 2010. Colloquially – “the easy money has been made”.

We are still finding value in individual corporate names that haven’t yet appreciated with the broad market, convertible bonds and Build America Bonds in select geographic locales.

Recent Purchases; For our clients who prefer the safety of FDIC backed Certificates of Deposit, we have been focusing largely on callable CDs. For example, we would find a 3.5% CD due in 2012 attractive in spite of a 1.5% yield to call in 4 months. Assuming no call, our client would be pleased to receive a two-year return far above what is offered at local banks. Assuming a call in 4 months, our client would be equally pleased to earn a return above what is offered at retail banking branches and maintain the flexibility to reinvest at potentially higher rates in 4 months. A non-callable 3.5% 2012 CD might trade at a significant premium – while the call provision generally will hold the callable CD’s price near par (so as not to drive the yield to call below 0).

(U/W) – Underweight relative to targets, (O/W) – Overweight relative to targets, (E/W) - Equalweight relative to targets

Beta ( $\beta$ ) is a quantitative measure of a stock’s volatility relative to the market as a whole (eg – a Beta of 1 implies that a stock historically has performed in exactly as volatile a fashion as the entire market)

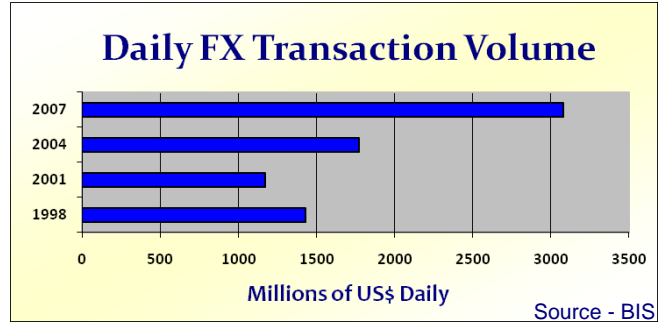


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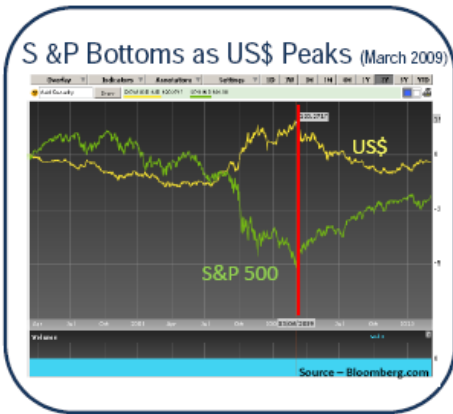
# The Three Trillion Dollar Gorilla in the Room

Authored by Joshua Denney

Although the world's stock markets often monopolize the headlines, there is another financial market that deserves more attention than it receives. It's not uncommon for over \$3 trillion to change hands in currency market transactions on a daily basis. Compare that with average daily trading volumes of \$60-\$80 billion for the world's largest stock market (NYSE) and the scale differential is obvious. Since 1971, when President Nixon was forced to pull the gold standard, most world currencies have 'floated' – meaning that the market forces of supply and demand have determined how 'weak' or 'strong' a currency was in relative terms. Increasing internationalization of trade has only fueled the expansion and relevance of the world's various currency markets.



For purposes of this analysis, there are a few things that are important to understand. First, currency markets are a zero-sum game. This means essentially that for one currency to strengthen (or go up), another must weaken (or go down). In theory, all stocks traded on the NYSE could go up at once – in fact the level of correlation between world equities has been atypically high as of late. Currencies strengthen or weaken against other currencies in a relative sense. The US dollar (US\$) doesn't go up or down in a vacuum. For example it is completely possible for the US\$ to strengthen against the Yen (¥), Brazilian Real and Australian Dollar (Aus\$) while simultaneously weakening against the Euro (€), New Zealand Dollar (NZ\$) and Canadian Dollar (Can\$).



Second, one can roughly break up the world's primary currencies into two generalized baskets – the 'safe' currencies and the 'risk' currencies. Currency traders put only the US\$, British Pound (£), € and ¥ in the safe basket. Together, these 4 currencies account for over 75% of trading volume in exchange markets. Everything else goes in the 'risk' basket, some favorites of traders include the Aus\$, NZ\$ and Can\$. Most of the 'risk' trading volume currently flows through relatively well-developed countries that are commodity focused. Thirdly, the world currently views the US\$ as the safest of the 'safe'. This was clearly evident in late 2008 and early 2009 as global investor monies flowed into the US\$ and US Treasuries. Additionally, the US\$ is the global reserve currency – a distinction it has maintained since 1971. This basically means that global commodities such as gold, oil, and copper trade, and are priced in, US\$. This reserve currency status has two primary impacts. First, it creates a built-in demand component for US\$. Secondly, it causes commodity prices to flex with US\$ movements. If all else was held equal, a barrel of oil at \$80 today would cost \$160 if the dollar devalued by 50%. Not due to the economic fundamentals of additional demand or restricted supply – merely as a result of the US\$ being worth half as much.

An interesting and telling scenario developed when the news of fiscal strain within Greece first broke. Predictably, the € sold off aggressively – and much of that money fled to safety in the US\$. The US\$ rallied, and oil fell in value as a result. Energy stocks suffered relatively dramatically as a result. Nothing structurally changed in their businesses; the currency that their product is priced in had simply adjusted. This scenario tells us a few things. First, there is currently no viable alternative to the US\$ for currency markets when safety is the objective. The € is clearly suffering from the strain of trying to maintain a singular monetary policy across a diverse set of countries and the debt levels as a % of GDP in Japan surpass even the United States. To presume a dramatic decoupling of the US\$ implies that currency traders have a better option, and recent events clearly indicate that they don't.

Second, global asset values tend to benefit to some extent from a weakened US\$. For example, oil drillers and copper mining companies benefit directly from higher relative prices for their products. Additionally, US based companies that pay most of their expenses in US\$ and earn their revenues in incrementally strengthening currencies will benefit. Simply put, a weak US\$ benefits domestic companies that export significant amounts of their products. Paying your expenses in a weakening (US\$) currency and earning your revenues in a strengthening currency incrementally benefits your bottom line over time.

It seems highly unlikely that the US\$ will dramatically decouple, a long slow erosion is a more likely scenario. Although the United States' debt as a % of GDP is reaching concerning levels due to increased government spending - a dramatic collapse of the US\$ would require a 'safer' alternative. Neither the € nor ¥ offers such a haven. Over time, a likely scenario involves a slow but steady blurring of the lines between what is now considered a 'safe' currency and what is considered a 'risk' currency. For example, incrementally more currency will probably be held in Aus\$ and Can\$ while less will reside in the US\$ or €. As currency traders and central banks presumably become more and more comfortable with historically riskier currencies, the net effect will be a grouped weakening of the 'safe' currency basket.

So how does SGL Investment Advisors position our portfolios to capitalize on this continued incremental weakening of the US\$? A weakening currency tends to correlate with higher rates of inflation. Based on a projection of ongoing incremental US\$ weakness, we are positioning portfolios in stocks and bonds that stand to benefit from an uncomfortably inflationary environment. Notice I didn't refer to a hyperinflationary scenario (or anything close for that matter). We are therefore not betting the proverbial farm on gold or any other myopically inflation focused asset. Energy and commodity companies and the companies that supply those industries are a focus of our research - as are domestically based companies that export a high percentage of their products to countries with 'risk currencies'. We are also actively pursuing high credit quality fixed income instruments that pay interest on a Consumer Price Index (CPI) linked basis. A bond that pays a coupon of CPI X 1.5 or CPI + 2% should provide a better inflation adjusted or "real" return relative to conventional fixed income instruments. Whether it be stocks in the Growth portfolios or fixed income in the more conservative portfolio classes, SGL Investment Advisors is actively structuring our portfolios to protect our clients from this important macroeconomic transition.

