Harmonic Investment Advisors

Equity Strategy Review

July 29, 2010

> "I violated the Noah rule: Predicting rain doesn't count; building arks does."
>
> Warren Buffet

So much for silent dogs and still waters – 2Q10 proved to be anything but silent and still. The quarter was much like 1Q09 in that most domestic equity indices experienced double-digit or near double-digit declines.

It never ceases to amaze me how quickly investor's attitudes can change. In the last three months investor sentiment swung from strongly bullish to bearish, even while earnings estimates rose. We noted with some interest that small-caps continued to outperform large-caps; in particular, small-cap financials, which typically show a relatively high beta, outperformed large-cap financials. We would argue that there is an underlying desire among market participants to add risk to portfolios.

Given our statements in last quarter's commentary it should come as no surprise that all three of our equity strategies outperformed their respective benchmarks, as our portfolios were positioned to reflect the concerns we expressed at that time. In contrast to 1Q10, during which our security selection generated underperformance, this quarter both sector positioning and security selection contributed to outperformance. In particular our underweights in consumer discretionary and financials, which contributed to our lagging in 1Q10, proved to be a benefit.

The second quarter did not see the influences of security selection in our portfolios concentrated in a few sectors, unlike the previous quarter. This characteristic is not a surprise given how broad-based the declines were across sectors. Given those broad-based declines, it is usually more difficult to highlight individual names in the portfolios. On the positive side was Inventiv Health (VTIV), a company that was the beneficiary of a private buyout offer and saw its share price rise by double digits for the quarter. One notably poor performer was Guess Inc ., which was negatively impacted by both the slowdown in Europe and the decline in the Euro; GES fell over 30% in the quarter.

We made no significant sector changes during the quarter. We did slightly increase our exposure to the consumer discretionary sector; however, we made only a small adjustment as we felt that the increases in consumer spending that we were seeing early in the year did not necessarily indicate a longer term propensity towards higher discretionary consumption. Macroeconomic data released during the last couple of months seem to indicate that this very well may be the case. Our sector positioning is driven by two primary factors, the economic environment surrounding a sector and the sector's valuation relative to other sectors and to historical levels. Given the recent significant declines in equity prices coupled with a changing economic environment, we anticipate that there very well may be more changes to sector weights in the coming months.

The recent quarter was obviously a challenging one for the equity markets. With a slowing economy and the potential for deceleration in corporate earnings growth, we expect the markets to remain volatile. Earnings reports, concentrated in the next four weeks, may further accentuate that volatility; however, we believe market participants will emerge from that period with a clearer view of the economic environment. Also, the absolute level of equity valuations is more appealing now than three months ago and by other historical standards, so we see opportunities available.

We look forward to talking with you further as the year progresses. As always, we are available for any additional questions you may have.

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