



Dunn Warren Investment Advisors, LLC

The Portfolio Reporter

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Performance Attribution

Last month we tried a new format for the monthly conference call based on the suggestion of an Advisor. On the call, we answered five specific questions. Because of the positive feedback we received, we wanted to review the questions in this month's newsletter.

What caused the portfolios to lag the S&P 500?

The underperformance relative to the S&P 500, an index of 500 companies commonly used to trace the movements of the stock market, is due to two positions we have held. The first is in VXX, iPath S&P 500 VIX Short-Term Futures ETN. This is an investment in increase in volatility. When investors become concerned about future risks in the market, volatility increases. We began investing in VXX in February. While we found that when the S&P 500 was down about 6%, VXX increased just over 20%, conversely, when the S&P increased, VXX declined just over 50%. Consequently, the protection VXX provided did not offset the drag on the portfolio when the S&P increased. However, in the recent downturn, VXX has reclaimed a good portion of the loss.

The second difference in performance was a result of holding emerging markets. We invested in emerging markets because of the beneficial opportunity for these economies to grow faster than in developing markets. However, the economic slowdown seems to have hit the emerging markets sooner. As a result, the S&P 500 increased just over 9% while emerging markets declined by over 2%. As a result of the foregoing, the total drag to the Aggressive ETF portfolio model was just over 7%.

Why did we sell VXX?

While VXX performed as we intended when the S&P 500 declined, VXX declined more than we anticipated when the S&P 500 increased. Therefore we wanted a hedge to correlate more to the movements in the market, but in the opposite direction. Adding inverse funds which increase (decrease) in value when the market decreases (increases), was closer to accomplishing this.

What was the impact of Quantitative Easing to the S&P 500?

Quantitative easing is the name given to the Federal Reserve's actions of purchasing U. S. Government bonds. QE2 is the second round of such purchases. It was first announced in August 2010 that the Federal Reserve would reengage in this practice, and from the day of that announcement through June 30, 2011, the S&P 500 increased about 22%. However, upon the discontinuation of the first round in March 2010 and the announcement of the second round in August 2010, the S&P 500 declined over 16%. Besides increasing the government debt burden, the Federal Reserve is enticing investors to take more risk—risk that should not be taken given high valuations and a slowing growth cycle.

Why is matching an index not a goal in the near term?

We all want to see an increase in the value of our investments. However, we at Dunn Warren do not believe following the S&P 500 is a worthy goal just to expect higher portfolio values. Unfortunately history is littered with times that the S&P 500 increased, and at times very rapidly, only to give up those returns in short order. Our goal at Dunn Warren is to try to sustain most of the gains. To this end, we are trying to beat the S&P 500

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over the full cycle, from trough to trough. In this case the most recent cycle was from March 2003 to March 2009. During that time the S&P 500 was flat. So even though the S&P 500 has increased 22% in the past 12 months, the current value is still below where it was in October 2007.

How are you positioned now and if the market gets worse?

Broadly speaking, we look at the areas of the market, risk, and valuations, and where we are in the economic cycle to decide on the investment mix. Here we will address two of those components: valuations and where we are in the economic cycle. Valuations are high and historically such valuations lead to lower growth, if not decline, in the value of the market over the next 5 to 10 years. This risk of decline versus potential for increase causes us to be more conservative with our investments. Using a method popularized by Professor Robert Shiller of Yale, we cyclically adjust corporate earnings over the last ten years. This means we take the average of the last ten years of earnings and compare it to the current price of the S&P 500. At nearly 23 times earnings, this is one of the highest points in history except for 2007, 1999, and 1929. Consequently valuations are high.

Second, we are seeing that the growth rate of the economy is slowing down. When this happens investor's get skittish and begin selling shares. At times the market can rebound handsomely with good news. At other times, the situation could be dire when the economy begins to slow. Historically this has resulted in both good and poor returns. Specifically, if we look at the Institute of Supply Management monthly manufacturing index, we see that it has declined precipitously, from over 60 in April to 53 in May. This decline was not felt just in the US. The decline began in late 2010 in China and a few months later in Japan, well before the earthquake. As a result, risk increases as that growth rate moderates and investors realize that the opportunities to gain a larger return are diminishing. Consequently, we have increased the use of the inverse funds to try to offset the market risk from both high valuations and a slower growth rate in the economy.

Please let us know if you have questions you would like addressed on the next monthly conference call.

Please feel free to pass "The Portfolio Reporter" to interested friends and family members. For more information about your investments, please contact your financial professional.

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MONTHLY CONFERENCE CALL

Our next monthly conference call will occur Thursday, July 21st at 11 a.m. Mountain Time (1 p.m. EST).

Phone Number: 866-740-1260

Access Code: 4682824

To view slides on the internet during the call, go to www.readytalk.com and enter 4682824 under "Join a Meeting".