



DEIGHAN

ASSOCIATES

INVESTMENT QUARTERLY

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Second Quarter 2010

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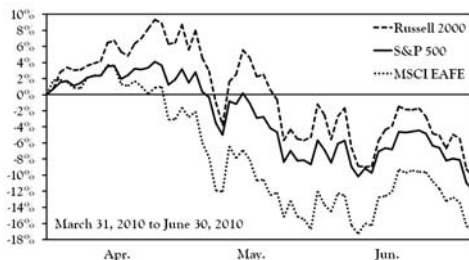
MARKET COMMENTARY

Last quarter, we closed our Market Commentary with a timely piece of advice: don't let a rising market lull you into complacency. Since then, we've seen a sharp spike in price volatility. No longer groggy from their winter naps, market bears are alive and hungry. The meal du jour has been the euro, which has fallen nearly 10% since the end of March. European sovereign debt woes have weighed heavily on most asset classes, prompting broad indiscriminate risk reduction worldwide. The S&P 500 Index finished the quarter down -11.43%, its first negative quarterly return since the first quarter of 2009. The MSCI EAFE Index finished down -13.97%, and the Dow Jones/UBS Commodity Index lost -4.81%. By contrast, U.S. Treasuries have rallied. Yields on the 2-year note recently reached record lows (yields fall when prices rise), and the yield on

Though the "flash crash" was caused in error and most of the trades were busted, it set the tone for the rest of the quarter. Investors began to realize that, regardless of the true cause of the crash, markets had the potential for a drop. The rose-colored glasses had been removed.

The flash crash put investors on notice, but it was the sovereign debt crisis in Greece and the rest of Europe that precipitated declines in May and June. Markets initially rejoiced at the \$1 trillion bailout package jointly hammered out by the European Union and the International Monetary Fund. However, as reality set in, it became apparent that even a bailout of this magnitude might not be able to address the structural issues facing Europe and indeed the entire Western world. The debt burden has simply become too large. Austerity is the new game in town, but its acceptance has been far from widespread. Rioting in Greece over severe spending cuts has demonstrated that it is often difficult for societies to tolerate pain in the short term in order to correct long-term problems. What makes the austerity argument even more difficult at the present time is the fact that the global economic recovery has shown signs of particular weakness over the past few months. There is debate as to whether more spending is needed, rather than less, despite already untenable debt loads, because to pull back now could be to pull the plug on a patient still in need of the respirator. Many believe that, while austerity might be an eventual necessity, it is not the right solution in the very near term.

In the U.S., May home sales dropped 30% to the lowest level on record dating back to 2001. This is a sign that the housing recovery is not yet strong enough to survive without government stimulus, and is but one of several negative readings released within the past few days. Last week, new claims for state unemployment aid rose unexpectedly. Meanwhile, the Conference Board's index of consumer confidence fell to 52.9 in June from a downwardly revised 62.7 in May. The drop put the reading sharply below analyst forecasts. Manufacturing growth has also slowed more than forecast.



the 10-year note dipped below 3% for the first time since April 2009.

It would be an understatement to say investors were complacent going into the second quarter of 2010. We heard from a number of analysts who largely opined that stocks could only continue to increase in value. Meanwhile, we were left scratching our heads, because we just didn't see it. The Dow Jones Industrial Average had already increased 71% trough-to-peak, and economic indicators were increasingly mixed. You can only fly so far so fast. It is unfortunate that we were correct. Markets began to correct in early May.

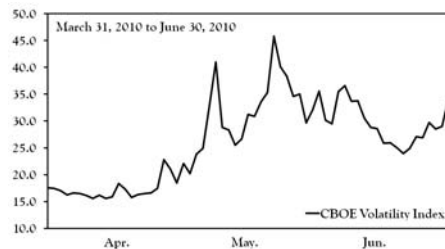
On May 6th, markets experienced a brief, albeit telling, moment of panic when the Dow lost over 1,000 points in a matter of minutes.

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MARKET COMMENTARY *continued from page 1*

Surveys show that manufacturing growth in both China and the 16-member euro region has weakened, and the U.S. Institute for Supply Management's manufacturing index fell to 56.2 in June from 59.7 in May. Combine all this with the ongoing tragedy in the Gulf of Mexico, and investors have had little positive news of late. What seemed like a stable, trudging recovery in the first few months of the year now appears to be much less certain.

With the return of uncertainty has come the return of volatility. Back in April, the CBOE Volatility Index (VIX), which tracks the implied volatility of S&P 500 Index options, was trending toward 5-year lows. However, by May 20th, the VIX had shot up to 45.79 from a low of just 15.58 (see chart):



In the second quarter, the Dow Jones Industrial Average experienced swings in value greater than 100 points on 29 out of 63 trading days. Looking only at May and June, 24 out of 42 trading days suffered such swings. We expect this level of volatility to contin-

hedge a portion of their portfolios against the risk of declining stock prices. As expected, these funds have held up better as a group than long-only stock investments.

With regard to the long-term, despite the economy's current woes and in large part because of them, we see both interest rates and inflation rising. The Federal Reserve will keep rates low for as long as necessary, but there will come a point when rates must rise. Initial estimates were for a rate hike by the end of this year, but if the economy continues to sputter then rates might not rise until sometime in 2011. It is important that rates eventually increase, because if they are kept too low for too long then we will again have the same speculative activity that led to the housing bubble. Already the ill effects of low interest rates are being felt. Cash and fixed income investments are offering little or no return, and this has forced investors into riskier assets, which, as we have recently seen, are susceptible to large swings in value. The same mom-and-pop retail investors who were most hurt by stock market declines in 2008 are the ones most at risk from this low interest rate phenomenon. Many of these investors only ventured back into stocks well after markets rallied, because they could no longer stand making nothing on their "safe" investments while stocks soared. The low return on their cash and bond holdings drove them back into stocks just in time for the current pullback.

Like ocean waves, asset prices rise and asset prices fall.

ue, as more readings come in negative or mixed. Therefore, we have been working to systematically position client portfolios so as to balance the short-term increase in volatility with certain other long-term risks, such as rising interest rates and inflation.

In mid-March, we adjusted our stock allocations, reducing more volatile small cap U.S. stocks in favor of larger companies. We also reduced foreign developed stocks in favor of foreign emerging stocks. In general these moves have helped, though stocks are down across the board. Counterintuitively, foreign emerging stocks have been less volatile than foreign developed stocks, because of the debt concerns embroiling the eurozone. We reduced foreign developed stocks a second time in early May. To further reduce exposure to stock market volatility, we increased our allocation to market neutral funds, which

To protect against rising interest rates, we have been keeping bond portfolios short in duration and overweighting cash. We have also increased allocations to international and high yield bonds. International bonds reflect the monetary policies of other countries, rather than just that of the United States. High yield bonds pay higher coupons, which tend to give them a bit more price protection as rates rise.

Along with higher interest rates, inflation is poised to make a comeback. Western countries will need to devalue their currencies in order to reduce the debts they have amassed. This will place upward pressure on the prices of goods and services even in the absence of a sustained economic recovery. Assuming that the global economy does recover, and accounting for continued growth in emerging countries and the inherent scarci-

European sovereign debt woes weighed heavily on most asset classes.

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ty of natural resources, there can be little doubt that prices will eventually be going up. We have therefore increased allocations to commodities and hard assets. These will help take some pain away at the pump, once gas prices start to rise.

The important thing to remember during volatile times like these is to maintain a steady hand. Like ocean waves, asset prices rise and asset prices fall; it's a natural part of investing. As investors, there are some storms you can predict and other storms you just have to ride out. But we're confident we've built your portfolio with strong rigging and that we've packed durable rain gear. We can't say with certainty whether markets are simply in short-term flash crash mode, or whether we're at the beginning of a longer downward trend. The next month or two will help determine that. But we can say that each investment

in your portfolio has a specific, intentional role to play; some will shine during times of market weakness, others will not. It is our job as managers to see that you have both investments that will get you through the rough patches, and investments that will propel you forward once the waves subside.

As always, we ask that you call us should questions arise or should you simply need someone to talk to. We also ask that you tell us about any upcoming large cash needs you might be anticipating, so we can properly account for them in your portfolio. We understand how difficult it is to see the market lose value. But we encourage you to take some solace in the fact that we weren't surprised it happened. We're here, working a game plan that balances these short-term setbacks with your long-term goals. Until next time, we hope that you enjoy your summer.

WASHINGTON WEEK: AS REFORM UNFOLDS

At long last it appears that financial reform is on the horizon. On the last day of the quarter, the House passed reform legislation 237-192. While it is not a sure thing that the House version will pass the Senate, it is highly likely that the Senate will pass some version of the bill this summer.

Much of the bill involves oversight designed to prevent the financial free-for-all that lead to the structural challenges we are now experiencing. Time will tell whether the blunt instrument of regulation will help or hinder our worldwide financial health. However, there are some specific measures that will have a direct impact on individual investors, and we have listed a few that might interest you:

Expansion of a Fiduciary Duty Standard: Independent Investment Advisors, like our firm, have long been held to higher fiduciary standards than many other providers of investment advice. *Investment News* reports "Fiduciary duty advocates knew that the landmark financial reform bill offered their best chance to get Congressional approval for a universal standard of care for retail investors. After a pitched battle with the broker-dealer and insurance lobbies,

fiduciary proponents carried the day." The House bill gives the Securities and Exchange Commission (SEC) authority to expand this higher standard of care to broker-dealers, but only after a six month study analyzing the differences in the application of fiduciary duty standards and suitability standards. In short, true victory is uncertain as the debate continues. We will let you know the outcome.

Regulation of Smaller Firms: The SEC has traditionally overseen Investment Advisors with assets under management of \$25 Million or more. However, like the "Old Woman Who Lived in a Shoe" this left them with far too many firms to oversee effectively. The House bill raises the SEC asset trigger to \$100 Million, leaving the regulation of smaller advisors to the state securities divisions. Deighan Associates expects to continue to be under SEC review as our assets under management exceed \$100 Million. Undoubtedly this will shift a heavy burden to the states, but it should improve regulatory oversight to the benefit individual investors.

Soundbytes

In mid-May, Jenifer Wilson attended CFA Institute's 2010 Annual Conference in Boston. There she was exposed to a wealth of information surrounding such topics as alternative investments, behavioral finance, and private wealth management. Speakers included John Bogle, Daniel Fuss, and Niall Ferguson, among many others.

On May 5th, Jean Deighan attended the 2010 Trust & Wealth Management Conference hosted by the Maine Association of Community Banks in Freeport. Among the speakers were Dr. Nariman Behraves, chief economist of IHS Global Insight, and Donald Moore of Bearmoor, LLC.

WASHINGTON WEEK, *continued from page 3*

Equity Indexed Annuities: The debate over whether the SEC should regulate these controversial and often misunderstood/misapplied products has centered on whether they are securities or insurance products. The bill has been amended to bar these products from SEC oversight. Thus, it appears that these hybrid instruments, which many believe lead to significant sales

abuses, will remain under the jurisdiction of the states.

We will continue to monitor the financial reform debate as it winds to an eventual conclusion. The end result is sure to be a mixed bag of both good and bad legislation, but we are encouraged that Congress is finally starting to look out for the individual investor.

SEASONS OF MAINE

On June 10th, we hosted our second annual Seasons of Maine art show. The show featured impressive works from the many Maine artists who have appeared on our holiday cards over the years. We were blessed with clear skies and hearty attendance, and a wonderful time was had by all.

It is one of our firm's core values to support the communities in which we live and work. To that end, one of our goals in hosting Seasons of Maine was to support the

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Seasons of Maine
ART EXHIBIT AND RECEPTION

good work of the Penobscot County Fund at the Maine Community Foundation. Penobscot County is one of eleven Maine counties that have raised funds to generate income for local community projects. As a firm, we pledged to make a donation to the Penobscot County Fund in an amount equal to 10% of the total value of art sold at the event. We are pleased to report that artists sold over \$15,000 worth of art, and artists themselves donated a total of \$420 to the Fund. This means that \$2,000 will be donated in all, and it is our hope that the money will be used to support the arts within Penobscot County.

This is such a fun event to host, because it is a win-win for all involved. The artists gain much deserved exposure, our guests get to enjoy all the wonderful art and food, and the local community receives a little something back. We would particularly like to thank Sheila Foley, our Schwab Institutional relationship manager, for coming all the way from Boston to attend. We hope you will join us next year!

PORTFOLIO CHANGES

Artisan International Fund (ARTIX) – Removed – Artisan International Fund was previously one of three actively managed mutual funds in our international stock allocation. However, due to intensifying concerns over Europe's sovereign debt problems, we decided to reduce our foreign developed exposure. In our opinion, Artisan was the weakest of our three active international managers, and so we exited the fund in all client accounts.

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