

Quarterly Report and Commentary July 2010

In this report, we take a different look at the world of investments, markets, and the economy for the past quarter, five years and the decade. In some ways, it is not a pretty picture. From another perspective, it could be like D-Day in 1944, a future fraught with both risk and tremendous reward.

The Roth IRA Again

During this quarter, we will be finishing our calculations on converting all or some, even a small portion, of your IRA to a Roth IRA.

Everyone may convert this year, regardless of income. There is no maximum income limit. If you convert \$100,000 of regular IRA to a Roth, the \$100,000 is treated on your 2010 return as ordinary income. Your tax on that conversion will depend on your tax bracket but could approach as much as \$30,000, perhaps more. This tax should be paid from your other assets, rather than from the IRA account, so as not to deplete the Roth account.

The Roth account will grow tax free, and withdrawals are tax free. There is no age distribution requirement for the owner of a Roth account or their spouse, unlike the 70 ½ minimum required distribution for a regular IRA. There is a distribution requirement for non-spousal beneficiaries.

Your children or grandchildren may be your Roth beneficiaries and take their distributions over their life expectancy. If you have a 15 year old grandchild he or she could withdraw funds tax free for more than 60 years from the Roth they inherited from you. In theory, the \$100,000 Roth account could pay out millions of dollars over the next six decades.

One long time client and an astute observer of the Washington political scene does not buy into the Roth conversion. He believes that eventually the government will look at all that money growing and being distributed tax free, and find a way to tax us again. Perhaps he is right. Time will tell.

We will be communicating with you individually about some portion of conversion. For example, I have a retired client that uses his taxable asset base to generate income for current living needs. His wife, who worked outside the home early in her career, has about \$40,000 in her IRA, and she must take a minimum distribution each year. These are funds we cannot imagine they would ever need for living expenses. By converting this account to a Roth and naming their four grandchildren as separate beneficiaries, the adult children could reap meaningful payouts over the next fifty years.

Returns Analysis

Index	(Three Months) March 31, 2010 to June 30, 2010	(Five Years) June 30, 2005 to June 30, 2010	(Ten Years) June 30, 2000 to June 30, 2010)
Dow 30	-10%	-5%	-6%
S&P 500	-12%	-13%	-28%
<i>S&P Small Cap</i>	-9%	0%	55%
Tokyo Nikkei	-15%	-19%	-46%
European Top 100	-9%	-16%	-43%
<i>Mexico</i>	-10%	54%	58%
<i>Emerging Markets</i>	-11%	56%	no data
S&P Bank	-13%	-65%	-50%
Nasdaq Telecomm	-18%	0%	-79%
<i>Natural Gas</i>	-10%	37%	145%
<i>CBOE Oil</i>	-20%	13%	87%
<i>CBOE Gold</i>	-9%	154%	470%
CBOE 5 Yr Treas Yld Index	-30%	-52%	-71%

The above chart shows the price performance of 13 major indices over three separate periods; the most recent quarter, the five year period and the ten year period all ending June 30, 2010.

Ten years ago, the S&P 500 reached its zenith, capping off a 25 year Bull market. Others, such as the Nikkei, had peaked five years earlier.

The returns are broken down into six groups. The first includes three domestic indices, which are the Dow, the S&P, and small cap stocks index. You will observe that in each of the periods, the returns were negative *except* for the ten year 55% positive return for small cap stocks. Those are terrible returns, aren't they?

The next group fairs only slightly better. Tokyo and Europe went down a whopping 40% or more during the past ten years. The emerging markets, with less than ten years of data, did well for the past five years, and look to our southern neighbor. Who would have believed that Mexico would have turned in such stellar returns?

The bank and telecom industries headed south in a big way, down an average 65% during the past decade and continuing to stumble further in the most recent quarter.

However, there were winners, and you know the answers are oil, natural gas, and gold. If that was all anyone owned, three natural resources, they would be golden themselves. Look at those ten year average returns. It reminds one of bull market returns.

The interest rate outlook points to continued poor Treasury yields. The return on a hundred dollar Treasury would not even get you the cheapest cup of Starbucks coffee.

What this exercise points out is that returns have been really quite unpleasant for some time. Individuals who put their money in GE ten years ago would have lost half of the money. Some mutual funds, such as the Legg Mason Value Trust, headed by the likes of legendary manager, Bill Miller, are down 50% in ten years and 40% for the past five years. I have heard some investment managers say that just staying even is their goal.

The past quarter was miserable for all asset classes. Gold, energy, domestic, international stocks, and bond returns were all negative. It was the perfect bleak financial return storm.

For the year, our accounts were even or slightly up or down depending on your specific allocations and long-term goals. Our core Dimensional and index fund investments have performed well relative to the markets.

What is the outlook? If the markets revert to their 200 year growth trend, we should see significant returns over the next 3-5 years. We don't know exactly when this uptrend will resume, but at some point, it will if history is our guide.

The Effects of Timing

When reviewing your accounts' specific performance for this quarter, it is important to recognize that both the valuations and performance calculations are based on market values as of June 30, 2010. June 30th was a poor day in the market, closing down 4% versus the close just two days before on June 28th. Equally important is that, as of July 22, 2010, **the S&P500 has advanced a full 6.1%** from the June 30th close date, meaning that, in all likelihood, your accounts are ahead of what the enclosed quarterly reports indicate.

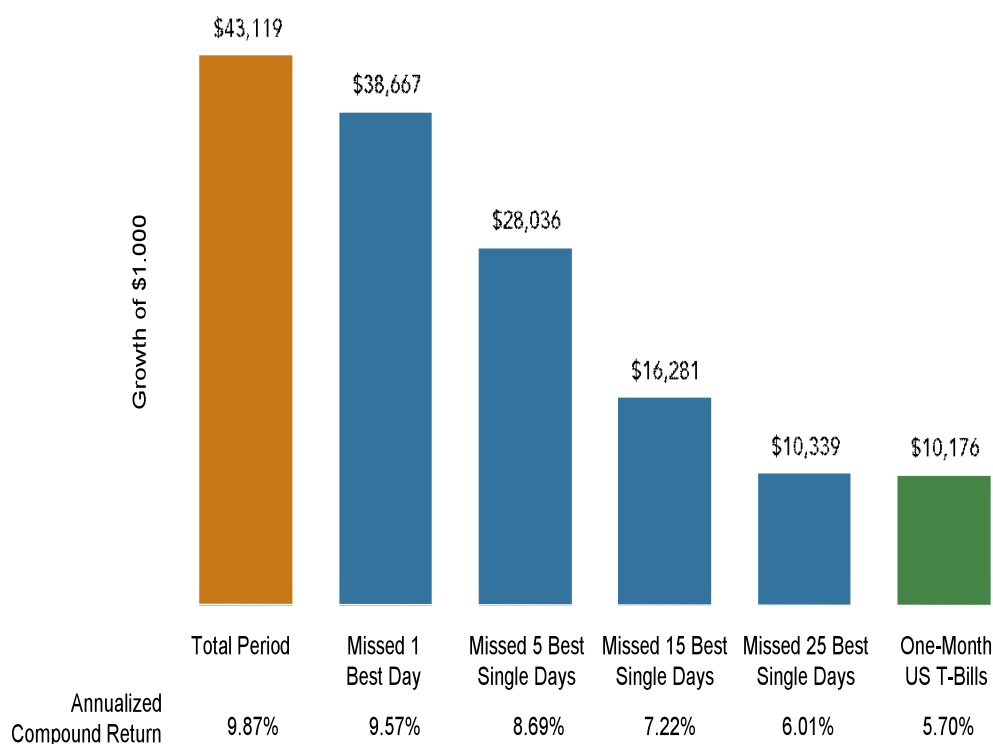
Another comment regarding timing...included is a chart showing the harsh reality of market timing. On paper, market timing offers a seductive prospect: By predicting market direction ahead of time, a trader might capture only the best-performing days and avoid the worst. The chart tells the other side of that story. Large gains may come in quick, unpredictable surges. A trader who misinterprets events may leave the market at the wrong time. Missing only a small fraction of days—especially the best days—can defeat a timer's strategy. For example, since 1970, missing the best 25 trading days would have cut the S&P 500 Index annualized compound return from 9.87% to 6.01%. Trying to forecast which days or weeks will yield good or bad returns is a guessing game that can prove costly for investors.

Succession Planning

Last evening, the temperature had dropped to 86 degrees; I had an aggressive one hour bike ride on the C&O canal. Still, I won't live for ever. We are in the process of succession planning with Derek and Dawn becoming part owners in the firm. I am off to California the week of July 26 for several business meetings, including a conference on succession planning. I expect to be here for a number of years, as this is what I have done since the 1960s, and it just keeps getting better and more interesting each year.

Performance of the S&P 500 Index

Daily: January 1, 1970-December 31, 2009



Performance data for January 1970-August 2008 provided by CRSP; performance data for September 2008-December 2009 provided by Bloomberg. The S&P data are provided by Standard & Poor's Index Services Group. US bonds and bills data © Stocks, Bonds, Bills, and Inflation Yearbook™, Ibbotson Associates, Chicago (annually updated work by Roger G. Ibbotson and Rex A. Sinquefeld).

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