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## THE BIG PICTURE

Our big picture view of the investment landscape did not change materially over the last quarter. Specifically, we continue to see sustainable, albeit weak, economic growth in the coming quarters. Towards the end of the 2<sup>nd</sup> quarter, market volatility increased on fears related to the European “debt crisis”, the end of the Fed’s 2<sup>nd</sup> round of money printing (QE2), the debt ceiling debate, and a spate of economic data suggesting the economy may be weaker than many had anticipated earlier in the year. Nevertheless, as of this writing, the U.S. stock market (S&P 500) is only down approximately 4.5% from its May highs. While the weeks and months ahead will provide more clarity on the direction of the global economy, we view the resilience of the equity markets thus far as a generally positive sign that the economy is undergoing a soft patch and not on the precipice of another recession.

## ASSESSMENT OF CURRENT RISKS

European “Debt Crisis”: In late June, the European Union, the European Central Bank, and the International Monetary Fund agreed to provide Greece with additional financial assistance in exchange for promises of more fiscal austerity. The news was met with riots in the streets of Athens and rally in global stock markets. While the stock market “liked” the idea of a short-term resolution, the reality is that the debt problems of PIIGS countries (Portugal, Ireland, Italy, Greece and Spain) are long-term in nature, and the most recent Greek “bailout” was akin to kicking the can down the road. Due to the ongoing issues in the Euro zone, we significantly reduced our weighting in developed foreign economies in the 2<sup>nd</sup> quarter.

The End of QE2: The Fed’s most recent monetary policy initiative ended in June. Since the onset of the financial crisis, the Fed has tripled the size of its balance sheet to more than \$2.8 trillion. While the Fed will no longer be pumping money into the economy via large scale asset purchases, they will continue to reinvest the maturing debt on their books which will maintain the size of the balance sheet at its current level. The major risk is that the economy will not be able to sustain growth without some degree of artificial stimulus. The Fed seems to be taking a wait and see approach, maintaining “exceptionally low” interest rates for an “extended period” of time while reserving the right to embark on additional stimulus if conditions warrant.

The Debt Ceiling Debate: Up until the early 20<sup>th</sup> century, the federal government followed a pay as you go system, requiring congress approval each time it borrowed money. Congressional members complained about having to approve each bill and payment that had to be made with debt instead of cash; so, a “debt limit” was approved in 1917. Since then, the U.S. debt limit has been raised over 100 times. Currently, the U.S. treasury estimates that without further borrowing, the government will run out of money around August 2<sup>nd</sup>, 2011 and has given this date as a deadline for Congress to raise the debt ceiling. This is clearly a very short-term source of uncertainty for the markets. While we believe the most likely outcome is a political agreement that avoids a near term market upheaval, it will, like the Euro zone problems, simply be kicking the can down the road. There is additional risk that the two sides do not come to an agreement and the debt ceiling is not raised by August 2<sup>nd</sup>. If this happens, we would expect a sharp negative market reaction until an agreement is reached (which we would expect to be quickly forthcoming).

(Assessment of Current Risks continued)

**Economic Data:** Recent U.S. economic news has been disappointing, with sluggish GDP growth and continued weakness in employment and housing (which are important drivers of consumer confidence, income, and spending). Despite massive fiscal and monetary stimulus, in the seven quarters since the recession officially ended in June 2009, real GDP growth has averaged only 2.8%. This compares to an average growth rate of 5.3% for the same period after the prior 10 recessions, according to David Rosenberg, chief economist and strategist at Gluskin Sheff. While it is clear that this has been a subpar recovery relative to historical standards, we do not believe another recession is imminent and expect the economy to continue its slow growth course in the quarters ahead.

## WHERE WE ARE INVESTING CAPITAL NOW

- **Alternative Assets:** In the second quarter, we significantly increased our exposure to merger arbitrage strategies. Merger arbitrage is a specialty strategy whereby one invests in the stock of an acquisition target at a level below the publicly announced buyout price. The goal is to hold the investment until the completion of the merger at which point the investor makes the “spread” between the purchase price and buyout price. While merger arbitrage is not without risks (mainly that the announced deal may not close), the strategy has historically exhibited low volatility and a low correlation with the stock and bond markets. For example, during the 2008 financial crisis, two of the funds we utilize in this space were down .55% and 2.26% respectively while the broad stock market (S&P 500) lost over 36%. Our return objective for these funds remains in the mid to high single digits. We believe an overweighting in this strategy makes sense in the current environment given the myriad of potential threats facing both stocks and bonds. In addition to merger arbitrage, we continue to maintain our holdings in commodities and real estate as longer term inflation hedges.
- **Bonds:** Depending on client objective, we continue to maintain exposure to inflation hedged bonds, emerging market bonds, floating rate notes, and unconstrained (“go anywhere”) funds. Long-term rates remain depressed as evidenced by the move in the 10 year treasury yield from 3.75% to below 3% over the last quarter. While a good amount of our current bond exposure is structured to withstand (and in some cases profit in) a period of rising rates, most of our bond holdings performed reasonably well in the 2<sup>nd</sup> quarter as rates came down. The only significant bond holding change during Q2 was the elimination of our high yield bond exposure. High yield bonds tend to be more economically sensitive and also have a fairly high correlation to stocks. Given our underlying economic concerns, we felt that it would be prudent to sell the majority of our holdings.
- **Stocks:** We continue to maintain an underweight allocation to equities in our asset allocation portfolios. Over the last quarter, we reduced stock exposure in emerging markets, foreign developed markets (Europe), and domestically. While we are not explicitly bearish or of the belief that we are entering another financial crisis, the reality is that markets have rallied significantly from their 2009 lows and, given the high degree of headline risks, it seems prudent to maintain a lower than normal equity weighting in the current environment. Two scenarios would likely make us more positive on increasing stock exposure. First, if our assessment of the economy and corporate profit growth improves while stocks remain relatively flat, that could lead us to increase our stock holdings based on higher expected returns. The second scenario is a pullback in stocks of 5-10% from current levels without any serious threat to the status quo (i.e. economy remains stuck in slow growth mode, jobs growth is anemic, etc). This would offer us a more compelling valuation entry point of which we would seek to take advantage.

We manage several different portfolio strategies, so not every client has exposure to the securities listed above. In addition to asset allocation strategies, we also manage more concentrated equity portfolios that generally carry a higher degree of risk and volatility. Please contact us if you want to discuss your portfolio strategy, or any of your investments in greater detail.

## WHAT'S NEW AT AMM

**Websites:** We have launched two new websites: [www.amminvest.com](http://www.amminvest.com) and [www.valueinvestingcenter.com](http://www.valueinvestingcenter.com). Amminvest.com is our new corporate website, providing information to current and prospective clients about our company, people, investment philosophy, archived newsletters, press information and more. Valueinvestingcenter.com is a financial markets blog with regular posts written by American Money Management's portfolio management team. Typical posts include information on the current economic environment, investment strategy, personal finance and more. While accessible to the public, we believe that valueinvestingcenter.com will be a valuable educational/informational resource for all of our clients.

**Retirement Income Solutions:** We have received significant feedback from clients who have reached or are approaching retirement regarding their need for a sustainable income stream from their investments. With interest rates on risk free assets like CDs and treasury bills at historic lows, income-oriented investors are finding it more and more difficult to fund their retirement years. Depending on income level, risk tolerance and time horizon, we have several strategies to help our clients achieve a good yield in a low yield environment. If you are at or near retirement, or if you are simply seeking more income from your portfolio investments, please contact us so we can review your situation.

**Client Survey:** Beginning in August, we will be mailing surveys to all of our clients. We want to know how we may better serve you going forward. Your candid and timely response is greatly appreciated. Surveys will include a prepaid return envelope for your convenience.

## 2ND QUARTER IN REVIEW

Year to date through June 30th, the S&P 500 gained 6.02%, International stocks (EAFE) gained 4.98%, and bonds (BarCap US Aggregate Index) gained 2.72%. Should you have any questions regarding your investment accounts, or if there have been any recent changes to your investment and/or retirement objectives, please do not hesitate to contact our office.

As always, we thank you for entrusting AMM to help you achieve your investment and retirement objectives.

## AMERICAN MONEY MANAGEMENT, LLC

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