TEMPO
Financial Advisors, LLC

550 Cochituate Road, Suite 25 ■ Framingham, MA 01701
Tel 508.655.7827 ■ Fax 508.655.7829
www.TempoAdvisors.com

THE TEMPO VANTAGE

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Uncertainty is a Fact of Life

The fourth quarter of 2010 turned out to be a great time for equity investors with benchmarks rising in excess of 10%. In fact, 2010 as a whole was quite profitable. Despite a significant decline in the second quarter (when the S&P 500 lost -11.3%), stocks gained 15% for the full year.

The fourth quarter for bonds was not as successful, with many categories experiencing declines of between -1% and -4%. Even including the fourth quarter set-back the year as a whole for bonds was reasonable, with most categories gaining between 3% and 8%.

At the risk of sounding like a broken record (or should I say broken CD these days?) it seems that the state of the economy today is much the same as it has been for the past year. Numerous intelligent, well reasoned market experts believe we are in a sustained recovery, that we will experience inflation, and that interest rates will rise, while others believe we will fall back into a recession, that we will experience deflation, and that interest rates will stay low or perhaps even go lower. They can't all be right!

Experts disagree. So, what else is new?

The past is always crystal clear and the future is always murky, at best.

Let's accept that uncertainty is constant and normal. The particularly difficult part of the uncertainty that we face today is that the potential outcomes are disparate. It is one thing when economists disagree on whether we'll see GDP growth of 3%, 4%, or 5%. The risks of being wrong in that environment are minimal. But when the difference is between growth and contraction the potential outcomes are extreme.

Unless you are willing to bet the farm and risk being very wrong the answer is, of course, to remain diversified.

What we can do is tilt our portfolios according to our best thinking, as I will do for you. So, what is my current thinking?

- We will continue to have a recovery, albeit a slow one.
- Interest rates will eventually rise, though perhaps not as quickly as some are predicting.
- The third year of a presidential cycle has historically been the strongest year for stock market performance, gaining more than any other year and rising nearly 80% of the time.

- The market is fairly valued with a price/earnings ratio for the S&P 500 of 18. With earnings still rebounding off lows from the recession companies should be able to surprise (i.e. beat analyst estimates) to the upside.

These thoughts lead me to believe that equities will outperform other types of investments as we move forward, but it will not be a straight line progression - it never is.

I will not shun bonds altogether (remember that whole spiel about diversification?), but I will certainly favor certain types of bonds over others. For example I prefer corporate bonds to government bonds and short/intermediate-term bonds to long-term bonds.

Tempo Financial Advisors' Investment Performance

The 4th quarter was particularly kind to those invested in a **Tempo Lifestyle Portfolio**. Returns ranged from 7% for conservative clients to 12% for aggressive clients. For 2010 as a whole returns ranged from 14% to 18%. A complete success from any standpoint. As was the case with 2009, in 2010 returns were about 4% higher than relevant benchmarks (portfolios with comparable risk profiles).

Our returns were bolstered as much by what we didn't own as by what we did. Overweights included technology, real estate, small cap equities, and corporate bonds. Underweights included government bonds, utilities and commodities.

The ideal investment today is one that could flourish regardless of whether the economy grows or not. Commodities may be such an investment. If the economy grows there will be increased demand for commodities. If the economy doesn't grow the governments will surely continue printing money, in which case commodities will hold value better than most other investments.

Some of you may recall that I have been contemplating adding a commodity position to Lifestyle portfolios for about a year. To this point I felt it was too early to invest. I was right not to buy for the first half of 2010 as commodities fell quite a bit. In the second half of the year commodities firmed up and rose in line with the overall market. I'm getting closer!

Tempo's Multi-Asset Dynamic Income Strategy had a very successful quarter and year. In the fourth quarter we were able to generate a gain of close to +1%. This may not sound great until you recall that many bond categories lost money during the quarter. For the year our return was over 11%. Any time we generate a double digit return in either of our dynamic strategies we are thrilled.

Some have wondered how the Dynamic Income Strategy will be able to make money in the future if, as many think, interest rates rise (higher rates means lower prices and possibly negative returns).

First you must realize that not every bond category will lose if interest rates rise. Inflation linked bonds, floating rate bonds, corporate bonds, and international bonds (depending on the movement of the dollar) could all hold up quite well in such an environment. Second, the Dynamic Income Strategy does not invest only in bonds. We also can invest in convertible securities, utilities, real estate, and a host of alternative (i.e. long/short, market neutral, global macro) funds. Our research indicates that

the last two times bonds had a negative return for a 12 month period (December 1999 and June 2006) the Dynamic Income Strategy did just fine (gains of 5% and 10%, respectively).

If you've been reading the Vantage for more than a few issues you know by now that we are not afraid to toot our own horn when called for. After all, if we don't toot, who will? The flip side is that we are also not shy to indicate when we are less than thrilled with our performance.

2010 will not be remembered as the shining moment for the **Tempo Multi Asset Dynamic Growth Strategy**. Although the Dynamic Growth Strategy was able to make money in the 4th quarter (+1.5%) and for 2010 as a whole (+4.0%) we are not particularly pleased. On the plus side, earning +4% can hardly be considered a disaster (would anyone like to revisit the 50% decline in the S&P 500 from 2007 to 2008?). Yet, when bonds gain in the mid single digits and stocks in the mid-teens I expect the Dynamic Growth Strategy to capture more of the upside. Unfortunately, the volatility in the stock market in the second quarter provided enough of a deterrent for our strategy to fully embrace equities in the second half of the year when the gains were there for the taking.

As of this writing we are completing the first quarter rebalance for the Dynamic Growth Strategy and can report that although equities are starting to filter their way into accounts, overall the strategy is still relatively conservatively positioned. Should the markets remain stable for a few more months, I expect that we will increase our exposure to equities even further.

Reminder

Please contact us if there has been a change in your financial circumstances that would warrant a fresh perspective on your portfolio.

Daniel J. Traub