



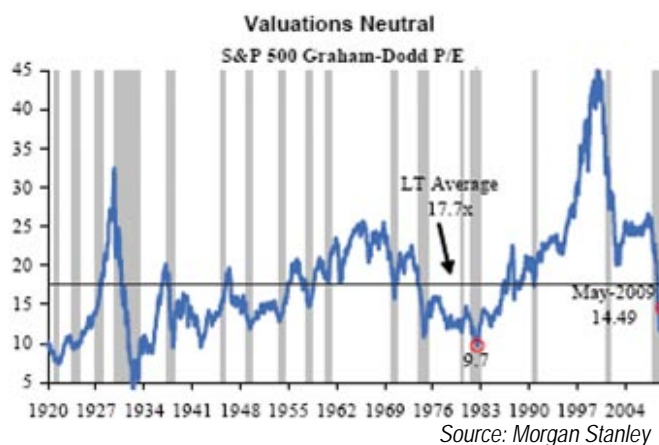
## AFTER AN EARTHQUAKE, EXPECT AFTERSHOCKS

After six consecutive quarters of negative results in the US equity markets (yes, that was an eighteen month negative stretch beginning September 30, 2007), it appears we may post a respectable positive quarter. Since early March, we have seen an explosive rally in all major indices *over a relatively short period of time*. The current rally has been very broad in nature, encompassing both US and foreign markets in an array of sectors and industries across the globe.

It is somewhat difficult to believe that in light of the financial meltdown that has occurred since the collapse of Lehman Brothers in September, and the incredible chaos that continued throughout the spring of this year, *most of the major indices are positive for the year*. Though we expected the equity markets to rebound after the severe sell-off, we are a little taken back by the speed and magnitude of this rally and are now getting a little concerned about too many investors mistaking green shoots for fully grown trees.

The S&P 500® is at roughly the same level as it was last October, but the time between has been historically volatile. Over this time frame, *there have been four large swings in the market (in excess of 20%), two up and two down*.

The extreme volatility reflects the financial earthquake incurred by our financial system and economy, and the subsequent aftershocks that will have long-term implications for national policy, consumer behavior and investors' perceptions and attitudes.



The recent stock rally has been fueled by a string of evidence that credit conditions are improving and the economy is stabilizing and is poised to recover; or at the very least, stop collapsing. According to GMO, a well respected institutional research firm, *the advance in the US stock market has taken us to a level where it is currently selling close to fair value*.

Though the market may be seen as fairly valued by some, the economy and banking system is far from operating under normal conditions.

*There are still many risks and headwinds that confront us. Forefront to our concerns is the expansion of credit*, which impacts the long-term growth rate of the economy. The growth in credit as measured by the money multiplier has collapsed and has yet to recover. This matters because the longer lending takes to return to historical norms, the longer it will take to put the economy back on its historical growth path.

*The economy stabilizing with less credit, infers the future growth rate will not be as impressive.*

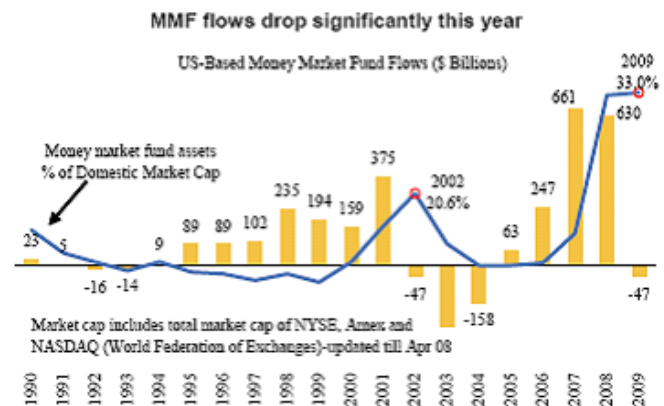
American consumers and businesses need credit to spend and grow. In the meantime, the government is printing money to offset this gap, which leads to a weakening dollar, higher interest rates and a higher risk of inflation. We mentioned all of these risks in our last market update so we will not rehash them, but if lending returns to normal levels, the government will need to act very quickly to shut down its supply of liquidity, otherwise inflation could become a very major problem by the end of this year.



*We believe that the stock market is taking on elements of frothiness* and has charged ahead of the underlying fundamentals of Corporate America and the economy. This is not unusual in the early stages of a recovery. However, these conditions are making the market very susceptible to a pause or even a decline. Given the price turbulence since last September, *the correction might be more than a minor price adjustment and could test the peace of mind we have been enjoying lately.*

*There has been a great deal of skepticism concerning this latest rally.* According to a recent Barclays

Capital survey, a vast majority of investment professionals do not believe this rise in stocks is for real and sustainable, and for the most part have been on the sidelines as equities continue to climb. This is reflected by the enormous amount of money still parked in cash (see chart to the right). We are beginning to see anecdotal evidence that investment managers that have been underinvested are succumbing to performance pressure and have begun to put money back into stocks. As the end of quarter approaches, more people will feel pressure to invest and thus potentially continue to drive stocks higher regardless of fundamentals.



Source: Morgan Stanley

In short, the market appears to be fairly priced due to the amazing adjustment that occurred very rapidly. This compares to the very attractive pricing we saw in March. Yet, as many professional and amateur investors contemplate getting back into the market, this could continue to push the market higher. *While we remain quite optimistic that the worst is behind us and the longer term outlook appears very promising, we are increasingly concerned that investors have factored in an overly optimistic viewpoint a little too quickly and this may create more turbulence over the next few months.*

As Californians have come to know, after a “big one”, there are often aftershocks that are just as frightening as the original earthquake. We are vigilantly overseeing your investments and are hoping for no more aftershocks. Unfortunately, history would suggest that we probably are not done rumbling just yet. Please make sure you speak with your adviser to discuss what adjustments, if any, should be made to your Master Plan given the nice respite we have received from the market.

Thank you for your ongoing trust and confidence,

Joe Duran & the Investment Committee

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The Standard & Poor’s S&P 500™ Index is a market value-weighted average of the performance of 500 stocks of the largest US companies as measured primarily by market capitalization.