ISLAND LIGHT CAPITAL
ENLIGHTENED INVESTING

Island Light Investment Commentary – June 2012

Investors were buoyed by a return to positive territory for the month of June in the major US and foreign stock markets. The returns for the month contributed to the continuing positive year for the broad equity and fixed income markets and salvaged an overall disappointing quarter. In June, US equities (Russell 1000) rose 3.8% and are up 9.4% for the year. European and Emerging market equities increased by 5.9% but are up only 2.8% for the year.

Investors are not sure what to think about this Goldilocks economy. Running neither too hot, nor too cold, the US equity markets reflect this slow growth. Good news can be found; manufacturing orders grew this quarter, housing starts are higher, modest inflation provides cover for companies to increase prices and margins, leading economic indicators are positive. Bad news can also be found; the first quarter revision downward of US GDP, large increases in US debt to GDP (now at more than 100%), weakness in overseas economies and falling consumer confidence. So what does an investor do?

In a word, diversify. Stay invested globally. A long time ago, I learned not to bet against the US economy. The US remains the world's primary engine of economic growth, with an educated and industrious workforce and an ethic of business innovation and competition. Somehow, the US economy muddles through and US equity investors benefit. Small companies are the primary drivers of job growth and, so long as policies do not interfere with the ability of these companies to grow, the US economy should remain in its current state.

What concerns this investor is not the economy as much as the uncertainty presented by US political theatrics. Political uncertainty has a negative effect on corporate decision making and investment. Major causes of this uncertainty include: continuing political stalemate in Washington leading to a debt to GDP ratio in excess of 100%; worries about the 2013 "Tax Cliff" and its impact on the taxation of investment income; the decision of the Supreme Court on the Affordable Care Act; and the upcoming presidential election. The combination of political stalemate and policy making through inaction is a drag on economic growth.

The factors that continue to drive international equity prices include the continued strength of the US Dollar, the not-yet-announced European recession, and declining growth prospects in China and other export economies. While there was a short-lived weakness in the dollar (to the euro) in June, contributing to better returns for US investors investing overseas, it appears that the direction of the US dollar is still strong, mostly due to overseas policies instead of our own, and the dollar remains the world's reserve currency.

In Europe, the most important news of the quarter, and perhaps the year, was the announcement that European finance ministers and the ECB will contribute to and manage an expansion of the European Stability Fund and also begin more federalist management of the European banking system. This is good news for the stability of the Euro. We cannot forecast what the long term prospects of the Euro will be, but the events of the last week of June and first week of July indicate a direction towards increased European fiscal unity, a necessary condition for the long term stability of the Euro.

In Asian markets, Japan continues its decades-long retreat into economic irrelevance. Innovation in Japan is lower than that of most Asian markets. Debt to GDP is now 225%, more than double the next G7 economy. The demographics of an aging population, low immigration and slow or no economic growth contributes to long term weakness. Discussion of a new consumption tax dominates the airwaves, which will be a further drag on economic growth. There do not appear to be any acceptable answers, let alone easy answers.

Emerging market economies are weakening as well, particularly in China, where domestic demand has not increased sufficiently to offset reduced overseas demand. Those emerging economies with low debt and high growth rates (India, Indonesia, Philippines, for example) have the best long term prospects for economic growth and investment gain, relative to their more developed neighbors.

Longer duration fixed income investments were modestly down in June and the overall fixed income market remained unchanged. For the year, the aggregate fixed income market is up 2.6%. Bond investments continue to act as a stabilizing force on the more volatile equity portion of our portfolios. US Treasuries, while yielding all-time lows in the intermediate term, are favored by a flight to quality. Investors' fears of stagnant economic growth, combined with uncertainty about the Euro and worries about credit quality and government support of European bonds offset continued expansive monetary policies in the US and abroad.

US Fixed Income investments are at historically low yield rates. With 10-year Treasuries yielding 1.6% and 20-year Treasuries at 2.3%, there is little room for gain. Unless we expect Japan-style deflation and negative growth in the next decade, the long term outlook for fixed income is anything but positive. Any yield from fixed income in the short term will likely come from investment grade and below fixed income instruments. This quarter, we introduce an improved methodology for incorporating relative risk measures in the portfolio construction and security market estimation process for fixed income asset categories.

Because it is quarter end, and a half year, we take a long look at our investment positions, particularly in light of the volatility of the past quarter and year. We also examined our overall risk allocations to determine if there are any major asset classes that we have not included in the portfolio. Finally, we considered the current state of the investment world from a macro-economic perspective and the overall uncertainty in the markets. Overall, we remain modestly positive in our equity outlook, particularly for US equities, and are neutral to pessimistic on fixed income securities, particularly those with long duration. We remain convinced that effective optimal diversification among growth assets is the correct way to address issues related to investment uncertainty and our portfolios reflect our belief in the benefits of diversification.

In our half year rebalance, we have introduced two new asset categories, US MidCap equities and short term US Treasury Inflation Protected Securities, and reintroduced US REITs to the portfolio mix. The

Midcap market include some of the most interesting growth stocks in the US and, while the correlation to Large Cap US stocks is relatively high, we think that the addition of the asset class will benefit our diversification and risk profiles. The introduction of short term TIPS, replacing the long duration TIPs in our portfolios, reflect our concerns about the flat yield curve. The re-introduction of US REITs is also a risk-diversifying strategy with the potential for higher yields than other US stock investments. We retain our relative underweight to European and international markets overall and our relative overweight in riskier assets, including emerging market and smaller capitalization equities, offset by an increased exposure to US value stocks. We retain a large exposure to gold and short term treasury inflation protected bonds which we consider good diversifying assets.

The table below reflects our composite portfolio performance for the month and quarter ended June 29, 2012 and since December 31, 2011. Returns are net of investment management fees and transaction costs.

Island Light Portfolio Global ETF	June 2012 Portfolio	June 2012 Index	Q2 2012 Portfolio	Q2 2012 Index	YTD Portfolio	YTD Index
Income	2.0%	1.8%	-0.2%	-0.6%	4.9%	4.3%
Balanced	3.0%	2.6%	-2.0%	-2.3%	5.6%	4.9%
Growth	3.7%	3.3%	-3.4%	-3.5%	6.1%	5.4%

We measure our portfolios against an index of US fixed income investments (the BarCap Govt/Credit Index) and an equal-weighted index of Large US Stocks (Russell 1000 value) and non-US stocks (MSCI ACWI ex US).

Island Light's investment methodology is designed on a process called "Enlightened Investing". Enlightened Investing is a stable approach to portfolio management, emphasizing quantitative principles and proven investment practices, while accentuating asset allocation as the most important determinant of long term success in investment planning. This approach is designed for the long term investor.

For more information about Island Light's Enlightened Investing methodology, or for further information regarding our methods in applying valuation factors to fixed income, please contact us at 508 687 0061 or email us at info@islandlightcapital.com