

Commentary

As a group, actively-managed funds have had a difficult time outperforming the market lately, leading many to debate their merits as compared to passive approaches. While indexing has performed particularly well in the low-quality rally off the 2009 lows, we continue to believe that active management should be an important component within an overall portfolio. That being said, an active/passive approach should be evaluated independently for each market segment, taking into consideration: (i) the inefficiencies within each space that may potentially allow for long-term outperformance by skilled managers; (ii) the costs (fees) associated with utilizing active versus passive vehicles; and (iii) investor sensitivity to taxes and the tax impact of active versus passive management within each market segment.

In relatively efficient market segments such as U.S. large cap, a wide amount of analyst coverage and availability of information have historically made it difficult for active managers to add value on a net basis. This is particularly true for taxable investors, as large cap passive index funds/ETFs have very low levels of turnover and high levels of tax efficiency. In other segments, such as small cap and international, market inefficiencies should more easily allow managers to use their knowledge and skill to create a superior portfolio of companies. Indices in these segments also tend to have higher levels of security turnover, making the tax benefits of passive management much less beneficial than what is seen in the U.S. large cap space. Returns are only part of the story, however. The ability to better control risk and protect on the downside can also be justification for active management, especially in more volatile market segments. Long-term investors, especially those with spending needs, can benefit from lower levels of volatility and drawdowns over full market cycles that certain managers exhibit as it allows for faster compounding and higher long-term returns.

CONVERGENT TACTICAL POSITIONING

Given an intermediate-term increasing risk in the ability of bonds to preserve purchasing power, we are underweight our strategic core fixed income target. This risk comes both if rates stay at historically low levels or if prices are hurt by a further rise in yields. The underweight, along with a slight reduction to equities, accommodates our shift to opportunistic credit segments (such as multi-sector, emerging market currencies/debt, and international bonds) where we can collect a current yield while addressing inflation, currency, and U.S. interest rate risks. Within the real assets bucket, we remain underweight REITs and pooled commodities in favor of gold, which serves as a paper currency hedge and safe-haven asset.

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EQUITY	slight underweight	
U.S. Equity	neutral	
Developed Non-U.S.	underweight	
Emerging Markets	overweight	
Private Equity	neutral	
Directional Hedge	slight underweight	
REAL ASSETS	slight underweight	
Real Estate	underweight	
Commodities	overweight	
ARBITRAGE/CREDIT	overweight	
Multi-Strategy Hedge	neutral	
Opportunistic Credit	overweight	
CORE FIXED INCOME	underweight	
Core Fixed Income	underweight	
Cash Equivalents	overweight	

THE EQUITY AND FIXED INCOME MARKETS

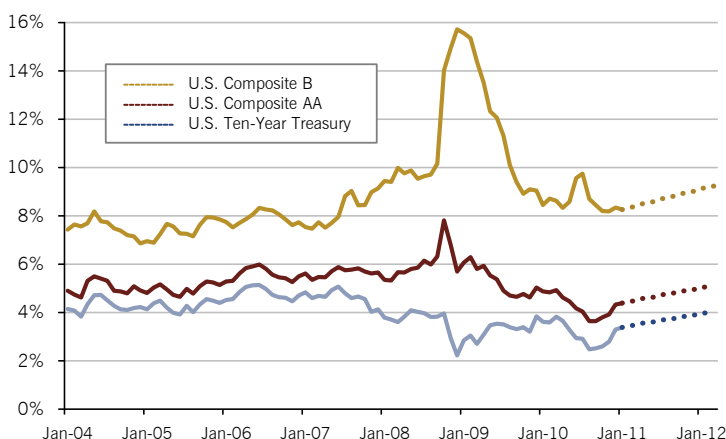
S&P 500 PRICE

Led by the energy sector and overcoming worries about unrest in Egypt, large cap U.S. stocks started the year out on a positive note with the S&P 500 gaining over 2% in the month of January. Small cap stocks did not fare as well, however, as the Russell 2000 index posted a modest loss for the month.



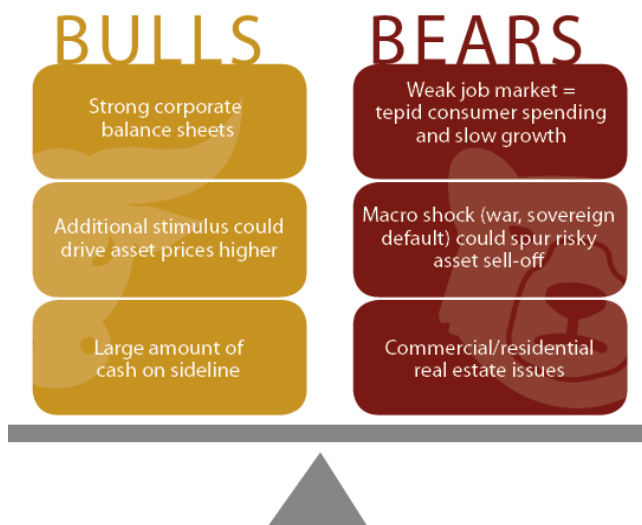
CREDIT YIELDS

Yields of U.S. Treasuries continued to move higher -- the fifth consecutive month of a bond market sell-off. Some fear the Federal Reserve, which has been focused on stimulating the economy for the past two years, might not be able to react quickly enough to squash any future overheating/inflationary pressures.



SUMMARY OF CURRENT EQUITY MARKET LEANINGS

We are slightly underweight our strategic equity targets. U.S. equity is at a neutral allocation, while we remain underweight to developed international equity markets. An overweight to emerging market equity remains in place. The overall equity underweight accommodates ongoing shifts to other growth asset categories (such as emerging market debt) where we can mitigate some equity risk.

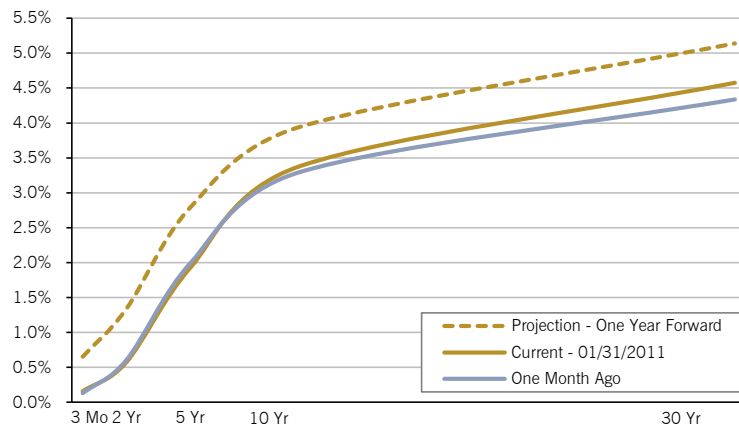


THE EQUITY AND FIXED INCOME MARKETS

U.S. TREASURY YIELD CURVE

The Treasury yield curve shifted slightly higher in January -- particularly on the long end -- as investors demanded higher compensation for future inflation concerns. As short-term rates remain low, the curve is near the steepest level on record. The muni market was also weak in January (after a rough December) and saw large cash outflows.

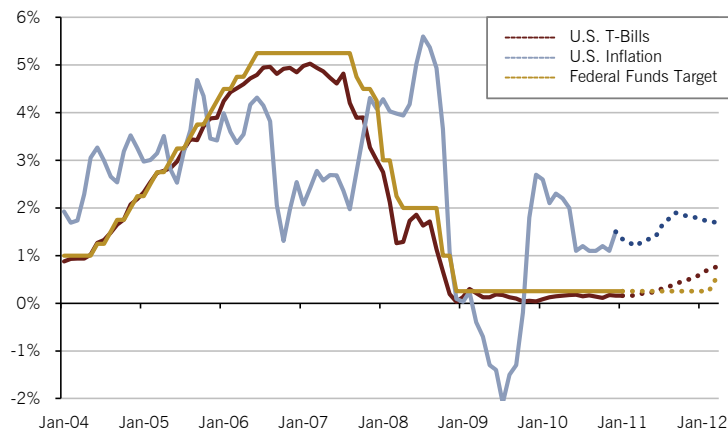
Advantage: Neutral



T-BILLS, FEDERAL FUNDS, AND INFLATION

Given risks to the economy, the Federal Reserve has indicated that it will keep in place its program to buy \$600 billion of Treasury bonds as well as maintain short-term interest rates near zero. Longer-term, however, many fear aggressive easing measures by the Fed may lead to some form of inflation.

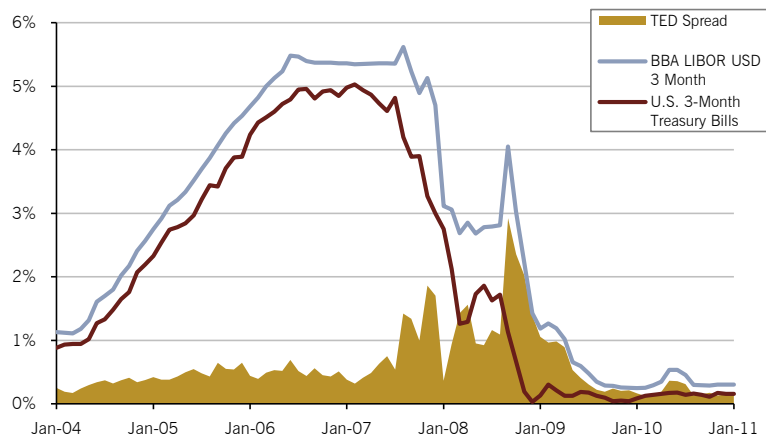
Advantage: Neutral to Bullish



LIBOR/T-BILL RATES AND TED SPREAD

The TED spread is a measure of how tight the credit markets are, as illustrated by the difference between T-Bill yields (a risk-free loan) and LIBOR yields (the rate at which banks lend to one another). Current low spreads illustrate credit markets are operating with little anxiety.

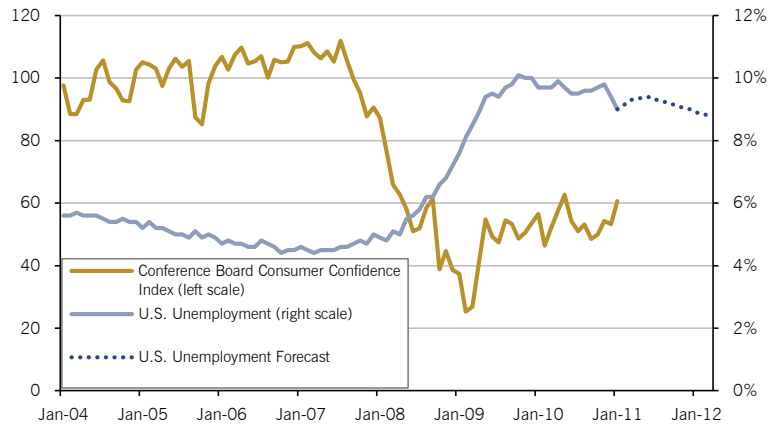
Advantage: Bulls



CONSUMER CONFIDENCE AND UNEMPLOYMENT

Thanks to modest improvements in the jobs market and some signs of sustained economic strength, consumer confidence has risen to its highest level in eight months. However, confidence remains well below the 90 level that signals healthy consumer attitudes, as the U.S. still has far fewer jobs than it did before the recession began.

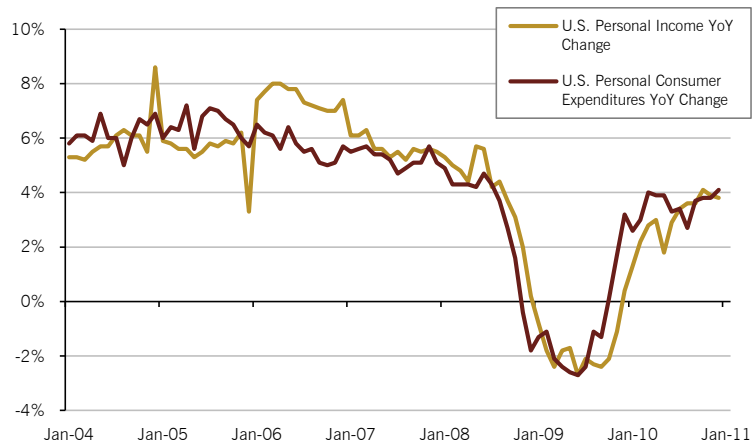
Advantage: Bears



U.S. CONSUMER INCOME AND SPENDING

The primary concern with high, lingering unemployment and low confidence is that consumers will not spend enough to rejuvenate the economy. However, consumer spending has shown surprising strength recently while savings have dropped.

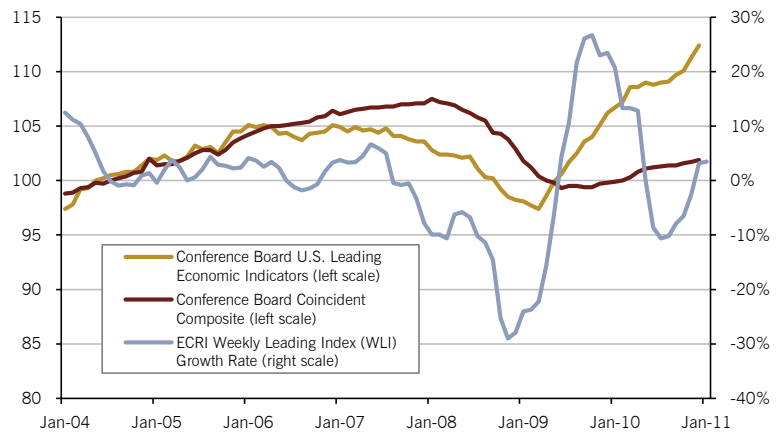
Advantage: Neutral



LEI AND ECRI

Thanks to rising stock prices and improved consumer expectations, the U.S. leading economic index (LEI) continues to trend upward, suggesting the economic expansion will carry on in the near term. Meanwhile, the index of coincident indicators has been mostly flat, illustrating the tepidness of the recovery thus far.

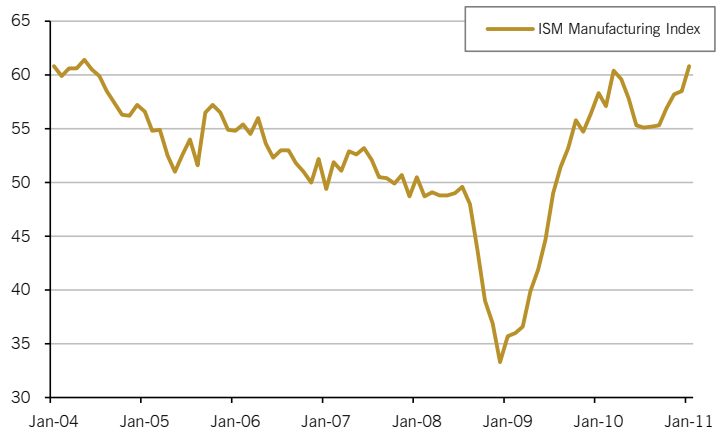
Advantage: Neutral



ISM MANUFACTURING INDEX

The ISM report is a national survey of purchasing managers covering such indicators as new orders, production, employment, inventories, prices, and export/import orders. A reading over 50% indicates expansion relative to the prior month, while a reading under 50% indicates contraction. The latest reading was the 18th consecutive month of expansion and the highest level since May 2004.

Advantage: Bulls



BALTIC DRY INDEX

The Baltic Dry Index (BDI) measures shipping costs for commodities and is used to evaluate world trade. Copper, a plentiful and heavily used metal in construction and manufacturing, can reflect trends in global economic growth. Recently there has been a huge divergence between the BDI and the price of copper, and many feel the BDI says more about the oversupply of ships than demand for cargo.

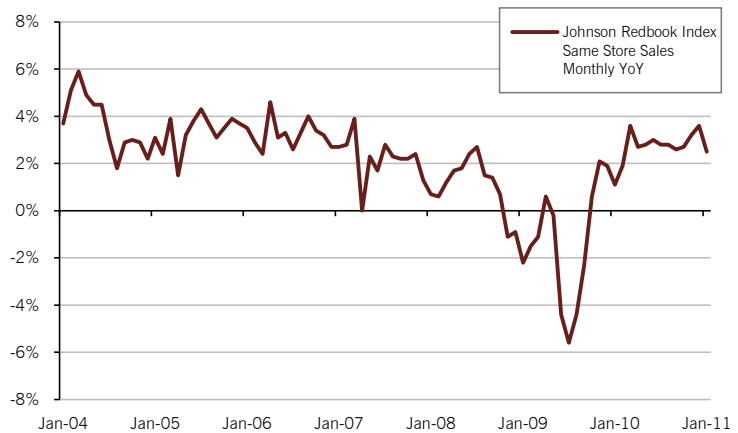
Advantage: Neutral



RETAIL SALES

Retail sales figures track the dollar value of merchandise sold to consumers and are an indicator of economic recovery. Snowstorms may have hindered January gains, though the month is typically considered the least important of the year for retailers as they make room for spring merchandise.

Advantage: Neutral

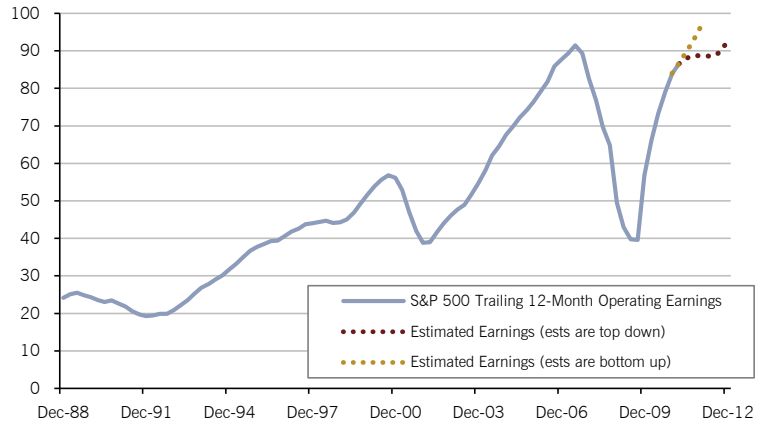


U.S. CORPORATIONS

CORPORATE EARNINGS

Earnings growth, which benefited in the past two years from significant cost cutting, might taper off in 2011 as year-over-year comparisons to 2010 will be difficult. Still, earnings on an absolute basis are expected to remain healthy.

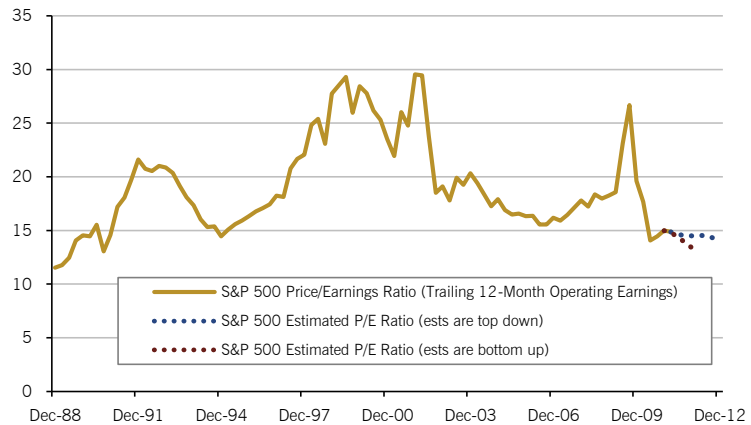
Advantage: Neutral to Bullish



STOCK MARKET VALUATIONS

Earnings growth over the past year has helped trailing 12-month P/E valuations look reasonable (slightly below historical norms) despite a run-up in stock prices. However, longer-term methods of measuring valuations, such as the ten-year real P/E pioneered by Yale economist Robert Shiller, remain a bit elevated (just over 23).

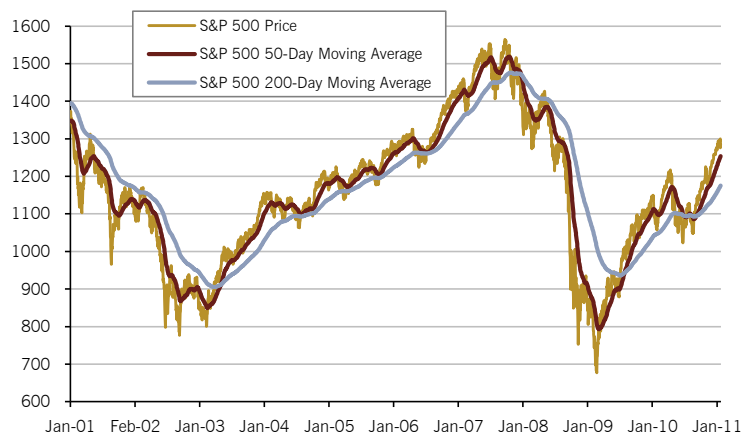
Advantage: Neutral to Bullish



STOCK MARKET TECHNICALS

The S&P 500 50-Day moving average is higher than the 200-Day moving average, interpreted by many as a bullish signal.

Advantage: Bulls

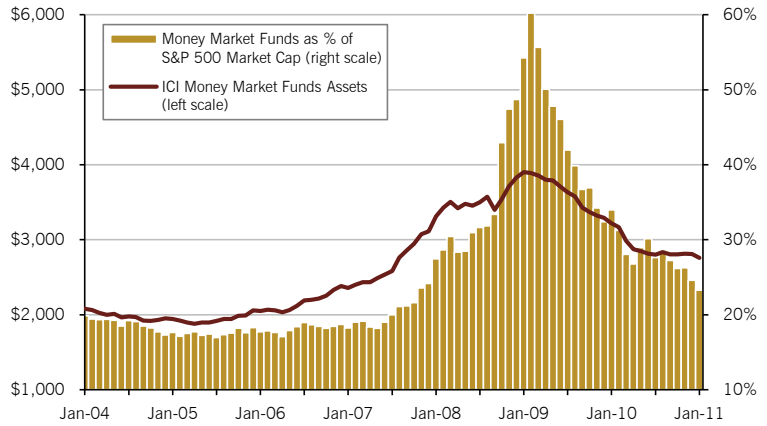


INVESTOR FLOWS AND LIQUIDITY

MONEY MARKET FUNDS ASSETS (\$ BILLIONS)

Money market fund assets declined to \$2.75 trillion at the end of January from \$2.81 trillion the previous month. Still, there remains plenty of dry powder on the sideline available to be deployed.

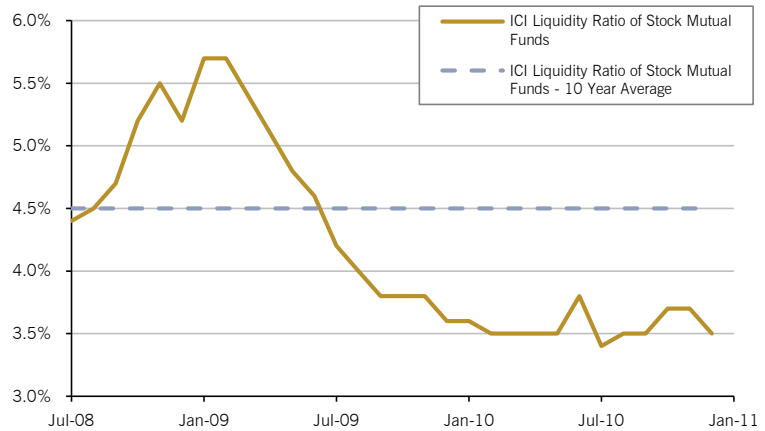
Advantage: Bulls



MUTUAL FUND LIQUIDITY RATIO

The liquidity ratio compares the amount of cash relative to total assets held by stock mutual funds. As stocks tumbled in 2009, mutual fund managers were bearish and sitting on a large amount of cash. Since then, managers have put most of that cash to work and, throughout 2010, held unusually low levels of cash (meaning little in additional cash to invest).

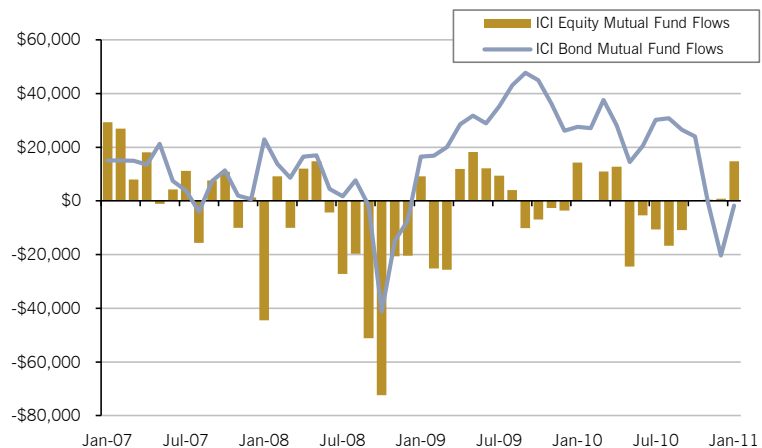
Advantage: Bears



MUTUAL FUND CASH FLOWS (\$ MILLIONS)

Withdrawals from municipal bond funds contributed to net negative cash flows for bonds for the third consecutive month. Stock funds, meanwhile, experienced their strongest cash inflows since May of 2009. Time will tell if this is a turning point for retail investor sentiment.

Advantage: Neutral

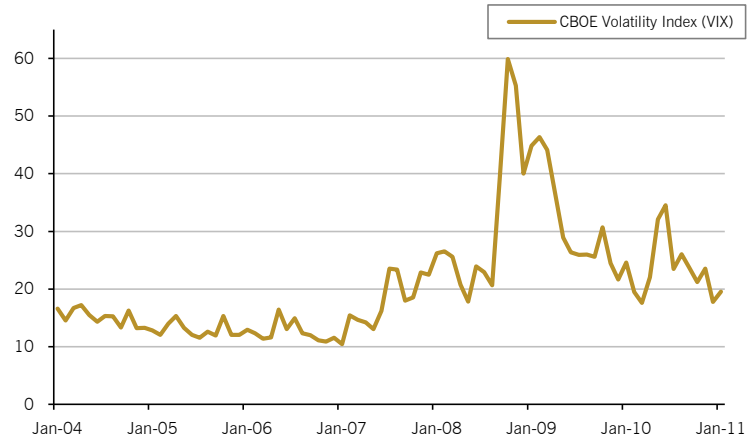


FEAR MEASURES

STOCK MARKET VOLATILITY

Volatility, as measured by the Chicago Board Options Exchange Volatility Index, ended January at 19.5 after holding at lower levels for most of the month. Readings in excess of 30 generally correspond with times of investor fear or uncertainty, while values below 20 are typically associated with less stressful (or even complacent) times in the markets.

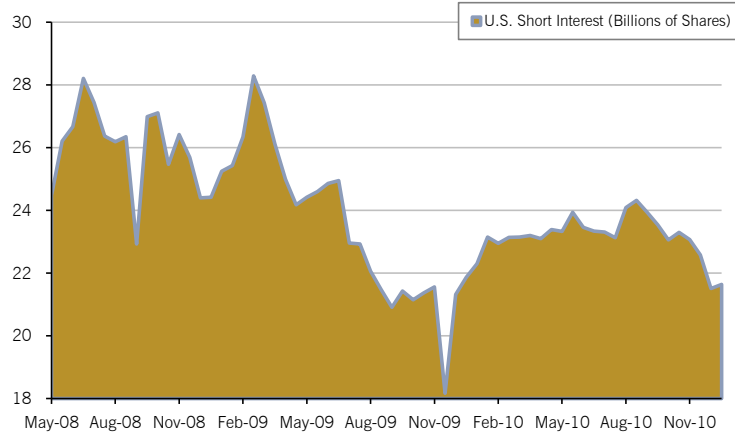
Advantage: Neutral



U.S. SHORT INTEREST

Short interest can be a measure of investor sentiment, though it is often viewed as a contrary indicator since high levels of short positions are eventually covered, providing upward pressure on stock prices.

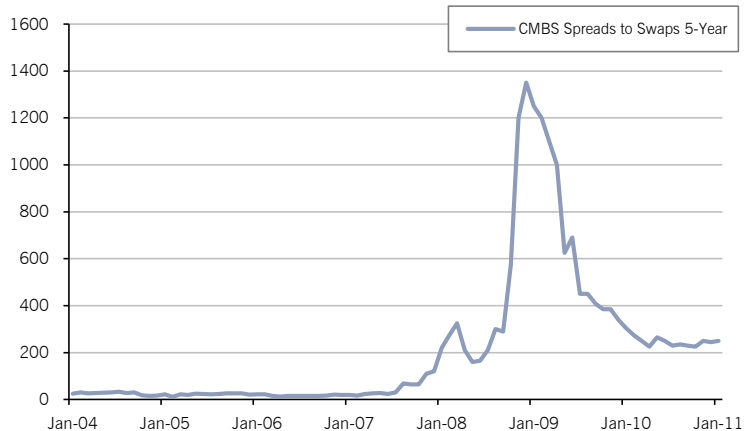
Advantage: Neutral



CMBS SPREADS

Even as delinquencies have risen to some of the highest readings in history, commercial mortgage-backed securities (CMBS) spreads have been stable and in a narrow range for some time, supported to some degree by government programs such as the Term Asset-Backed Securities Loan Facility (TALF) and the Public-Private Investment Program (PPIP).

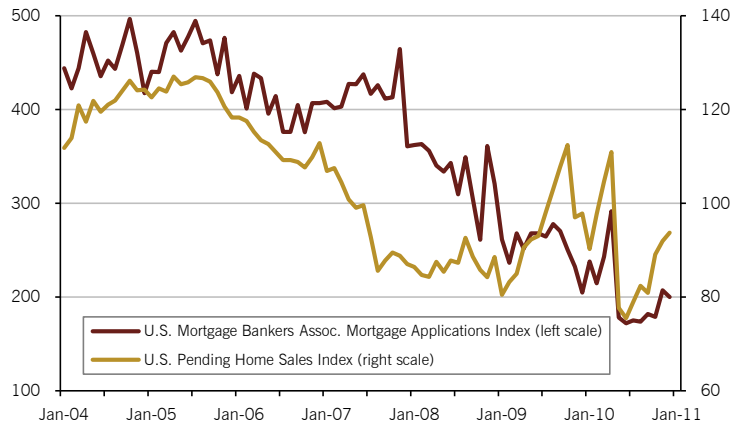
Advantage: Neutral



MORTGAGE APPLICATIONS AND PENDING HOME SALES

The volume of U.S. mortgage applications remains muted as the pace of refinancing and actual home purchases has slumped. Pending home sales, however, have seen a pick-up with gains in five of the past six months. Nevertheless, the housing recovery is expected to be uneven thanks to oversupply and as banks deal with foreclosure issues.

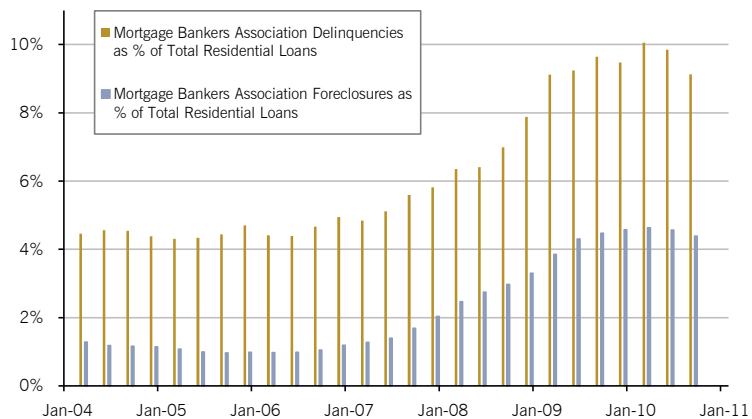
Advantage: Bears



RESIDENTIAL DELINQUENCIES AND DEFAULTS

Mortgage delinquencies and foreclosures remain near record levels. With unemployment stubbornly high and a large number of distressed properties that could reach the market in 2011, the housing market is expected to be a headwind to the economy for some time.

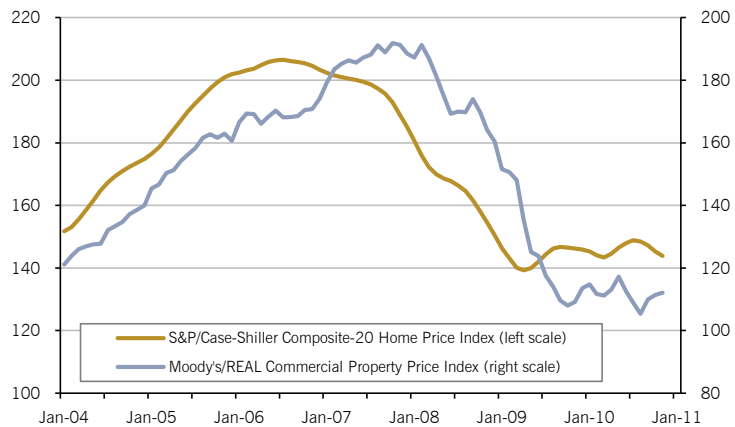
Advantage: Bears



RESIDENTIAL/COMMERCIAL PROPERTY PRICE INDICES

Some fear the housing market might be starting on a second wave of falling prices, thanks to oversupply, high unemployment, and rising foreclosures. Recent Case-Shiller data show prices declining in all but one of 20 major cities. Sales remain stagnant, as buyers purchased the fewest number of new homes in 2010 in nearly half a century.

Advantage: Bears

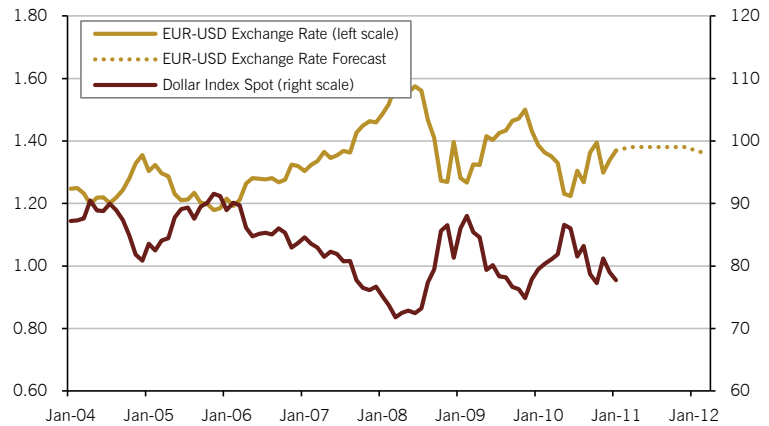


CURRENCY

U.S. DOLLAR

The U.S. Dollar Index was down 1.6% for January as worries about the government debt burden weighed on the greenback. The U.S. dollar could strengthen in 2011 against currencies with exposure to the European debt crisis, though many expect greater currency strength in other regions with stronger balance sheets.

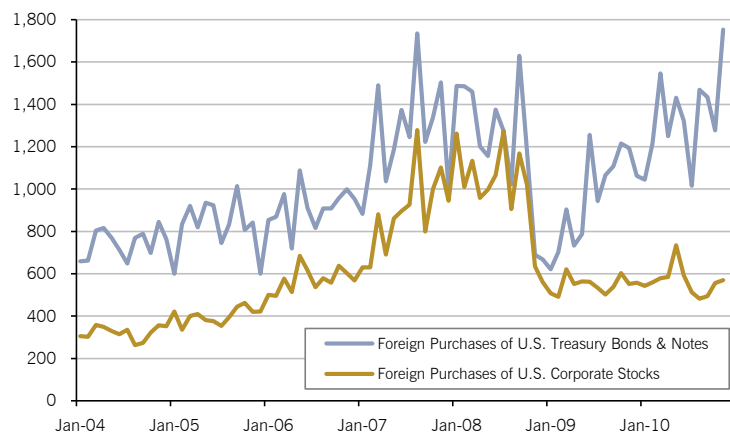
Advantage: Neutral



FOREIGN PURCHASES OF U.S. SECURITIES (\$ BILLIONS)

Global demand for U.S. bonds from foreign investors increased in November, despite selling by China, the largest foreign holder of U.S. Treasuries. Some worry that high government debt levels could cause foreign buyers to lose confidence and either demand higher U.S. interest rates or stop buying Treasuries altogether.

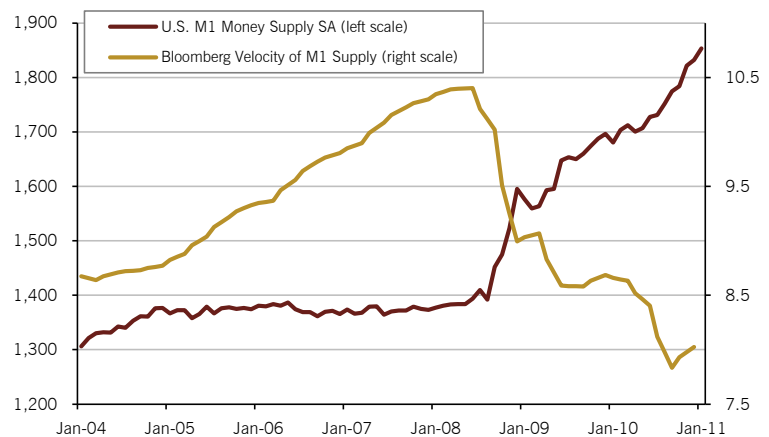
Advantage: Neutral



U.S. M1 MONEY SUPPLY AND VELOCITY

M1 consists of the most liquid forms of money, namely currency and checkable deposits. With the recent stimulus, M1 has spiked to unprecedented levels, causing fears of eventual inflation and dollar weakness. Velocity of money (the rate at which money changes hands), however, remains low as consumers and businesses are not spending or borrowing at high levels.

Advantage: Neutral to Bearish

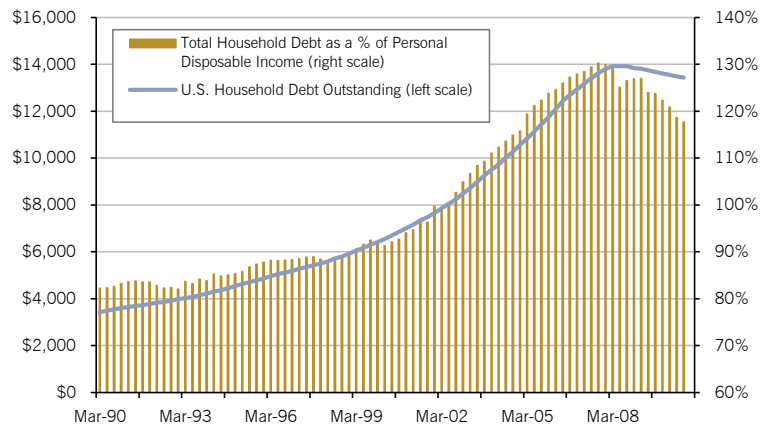


BORROWING

U.S. HOUSEHOLD DEBT AS A % OF DISPOSABLE INCOME

U.S. household debt (including mortgages and consumer credit) and the percentage it represents of disposable personal income have increased dramatically since the early 1990s. Despite talk of a deleveraging cycle, so far consumers have been decreasing debt slowly and still have a way to go.

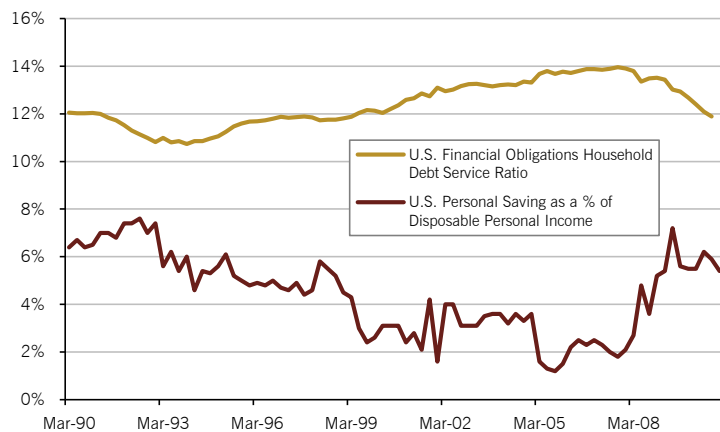
Advantage: Neutral to Bearish



U.S. SAVINGS AND HOUSEHOLD DEBT SERVICE RATIO

The debt service ratio measures the amount households spend on debt payments as a percentage of their earnings. Despite the remarkable increase in total debt over the past few decades, the rise in service ratios has been more muted due to the decline in interest rates. However, if rates spike, so too would debt payments, which would be problematic.

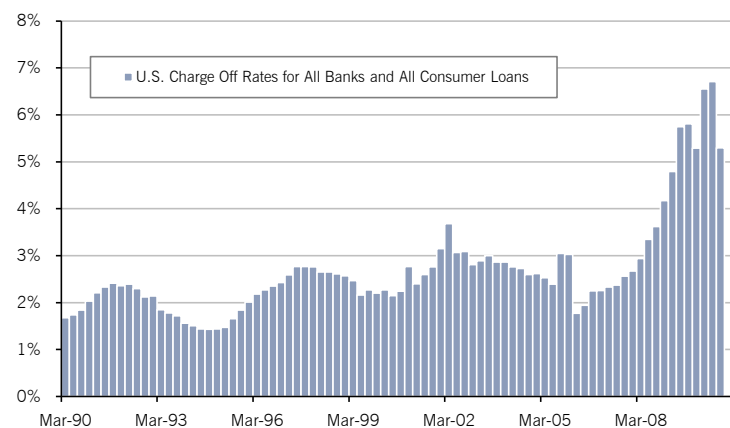
Advantage: Neutral to Bearish



U.S. CONSUMER LOAN CHARGE-OFF RATES

Despite low interest rates, U.S. consumer bank loans (including credit cards but excluding real estate) written off as unrecoverable remain near the highest levels on record. Personal bankruptcies were up as much as 25% in 2010 in states such as California and Arizona.

Advantage: Neutral to Bearish



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