



Second Quarter 2010 Review and Outlook

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At the halfway point of 2010, most equity markets are slightly down from where they started the year. While it sounds uneventful, the markets have been anything but tranquil recently. After the equity markets climbed to double digit highs for the year in April, the markets gave up those gains and more during May and June. In fact, the equity markets experienced an official correction, falling over 10% from their highs. The Dow Jones Industrial Average ended the quarter down 10.0% while the S&P 500 Index lost 11.9% for the period.

The markets were cruising along in April, moving higher with little gyrations. From there, several negative events caused the markets to plunge. First, debt problems that were initially concentrated in Greece began deteriorating and spreading to other European countries. “Contagion” risk, the idea that Greece’s problems would spread to the broader European Union, worried investors. Around the same time, China announced aggressive plans to slow growth in their economy, worrying investors that a key figure in the emerging markets economy may contribute less to global growth than expected. Then, on May 6, what’s being called the “flash crash” occurred; multiple stock prices dropped, essentially, to zero at 2:45 pm, followed by an almost immediate rebound. Several explanations of this anomaly have been theorized, and it is still being investigated. The Dow Jones dropped over 700 points within eight minutes. This caused fears that the systems and technology supporting US stock markets may not be able to effectively handle such volatile trading environments. These events, along with lower expectations for global growth, weighed heavily on equity markets, pushing markets lower through the end of June.

Government policy has recently centered on Wall Street reform measures aimed at preventing a reoccurrence of the credit crisis of 2008. A proposed bill would give the government new powers to “unwind” financial firms deemed “too big to fail” and the ability to break up banks that are big enough to threaten market stability. In addition, the bill would create a consumer protection bureau aimed at curbing unfair lending practices and would look to regulate the derivatives market. It appears that when this Wall Street reform bill is finalized, it will give the government sweeping oversight over a number of facets within the banking and financial system.

International markets felt the pain of the European debt crisis more directly than the US during the quarter and their broad stock market index reflected it. The MSCI EAFE index dropped 14.9% for the second quarter, led by European Union countries. A 110 billion euro (\$140 billion) bailout was put together by the International Monetary Fund (IMF) to help contain the crisis. Governments in Europe were slow to approve the bailout, causing the crisis to worsen. There is speculation that Greece may still default, even with the bailout, dragging down other debt laden countries like Portugal and Spain with it. Many European governments (particularly Germany and France) have large exposure to the sovereign debt of these three countries. While the new loan package is a positive step toward containing the sovereign debt problems in Europe, the need for a package has raised tensions within the regions. Germany, for example, who has been careful to manage their country’s debt, is upset that their government (and taxpayers) will need to bail out fellow member countries who have not been disciplined in containing costs.

For the most part, the fixed income markets followed a similar path as the equity markets in the second quarter. Corporate bonds rallied until late April until the European debt crisis pulled them back. The safest areas of the bond market, particularly Treasuries, held up the best during the quarter, as the Barclay's Treasury index gained 4.7%.

Outlook

As we move into the second half of the year, the short term economic data may look promising; but, longer term, there are still significant headwinds to overcome. This recent market correction has brought stock market prices down and valuations are more attractive than a few months ago. Interest rates remain low, corporate earnings have generally been meeting or exceeding expectations and improved manufacturing and low inventories are positive signs. Longer term, the growing federal deficit in the US is looming over the economy, and steps need to be taken to avoid our own debt crisis. The housing market and persistent high unemployment have also been a drag on the economy and will need to show signs of improvement for longer term prospects to improve.

While the summer months are generally slower from a trading and volume standpoint, volatility can still be high. Investors have been less patient with bad news and quicker to sell first and ask questions later. In light of this reactive environment, a long-term strategy that is positioned to reduce risk in both down and up markets can help make the journey more comfortable. Diversification through a proper asset allocation plan allows you to reduce risk while still giving you the potential for exposure to the leading sectors of the market at any point in time.

An individual investor's situation can vary; therefore the information presented above should be relied upon only when coordinated with individual advice.

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Current and future portfolio holdings are subject to risk.

The Dow Jones Industrial Average is a price weighted index of 30 of the largest, most widely held stocks traded on the New York Stock Exchange. The S&P 500 Index is an unmanaged index comprised of 500 widely held securities considered to be representative of the US stock market in general. The MSCI EAFE Index is an index created by Morgan Stanley Capital International (MSCI) that serves as a benchmark of the performance in major international equity markets as represented by 21 major MSCI indexes from Europe, Australia and Southeast Asia. The Barclays Treasury Index is an unmanaged index of public debt obligations of the U.S. Treasury with a remaining maturity of one year or more. The index does not include t-bills (due to the maturity constraint), zero coupon bonds (Strips), or Treasury Inflation Protected Securities (TIPS).

The ActivePassive Funds investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and it may be obtained by calling 1-877-273-8635, or visiting www.activepassivefunds.com. Read it carefully before investing.

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Tim Clift is FundQuest's Chief Investment Officer and is the lead portfolio manager of all of the ActivePassive Funds. He joined FundQuest in 1994. Tim has overall responsibility for the Firm's investment management programs for separately managed accounts, mutual funds, alternative investments, ETFs and annuities. As Chairman of the Investment Committee, Tim leads a team of analysts and portfolio managers that produce the research and portfolio recommendations for all client programs. He has over 18 years of industry and investment management experience. Tim earned his BA in Economics from Allegheny College and his MBA from Boston University.