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Dear Friends and Clients:

This letter gives a review of the quarter and briefly summarizes our current investment views.

Market Summary

Stocks surged in the first quarter, continuing the strong run that began in the fourth quarter of last year. In each of the past two quarters, domestic stocks gained about 12%, marking one the strongest runs over the October-March span since the 1920s. Developed foreign stocks increased nearly 12% in the quarter, emerging-markets stocks gained 14%, small-cap U.S. stocks were up 12%, high-yield bonds rose 5%, and emerging-markets local-currency bonds added 8%. In contrast, the core investment grade bond index is flat on the year, as interest rates have risen slightly, depressing investment grade bond prices.

March Benchmark Returns (Preliminary)

Large-Cap Benchmarks	Mar	1Q	YTD
Vanguard 500 Index	3.3%	12.5%	12.5%
Russell 1000 (iShares)	3.1%	12.8%	12.8%
Russell 1000 Growth (iShares)	3.3%	14.6%	14.6%
Russell 1000 Value (iShares)	2.9%	11.0%	11.0%
Mid-Cap Benchmarks			
Russell Midcap (iShares)	2.2%	12.9%	12.9%
Russell Midcap Growth (iShares)	2.2%	14.5%	14.5%
Russell Midcap Value (iShares)	2.2%	11.4%	11.4%
Small-Cap Benchmarks			
Russell 2000 (iShares)	2.6%	12.4%	12.4%
Russell 2000 Growth (iShares)	2.0%	13.3%	13.3%
Russell 2000 Value (iShares)	3.1%	11.5%	11.5%
Other Benchmarks			
Vanguard Total Int'l Stock Index	0.2%	11.5%	11.5%
MSCI World ex USA Index	-0.7%	10.5%	10.5%
Vanguard Emerging Mkt Stock Index	-2.8%	14.0%	14.0%
Vanguard REIT Index	5.1%	10.7%	10.7%
Vanguard Total Bond Mkt Index	-0.6%	0.2%	0.2%
BofA Merrill U.S. High Yield Cash Pay	-0.1%	5.0%	5.0%
Barclays 7 Yr Muni Bond Index	-0.9%	0.3%	0.3%
S&P/LSTA Leverage Loan Index	0.8%	3.7%	3.7%
Citigroup World Govt. Bond Index	-1.0%	-0.5%	-0.5%
JPMorgan GBI-EM Global Div. Index	-2.0%	8.3%	8.3%
DJ-UBSCI (Commodity Futures)	-4.1%	0.9%	0.9%

Key Takeaways

- The huge amount of debt in the developed world continues to drive our expectations about the years ahead.
- Among the drivers of the rally in risk assets are the receding fear of a European financial crisis (at least for the time being).
- These positive developments don't signal an "all clear" to us.
- There have not been material changes to our assessment of risks and returns across asset classes, and therefore our portfolio positioning has not changed.
- As always, across all of our portfolios we hope to add value by being opportunistic and investing more aggressively at lower prices if our research convinces us it is prudent to do so while still managing against our 12-month downside loss thresholds.

Additional Commentary

Clearly people feel better when things are going well, and we are no exception. It is interesting to consider, as objectively as possible, how the way people feel impacts the investment world. On one hand, it is good for the economy when people feel good, and the push by policymakers since the depths of the financial crisis has been to stimulate the economy and financial markets in the hope of spurring so-called "animal spirits" that get people spending and investing. And, in recent months, there have been things to feel good about, including positive data points on the job and housing markets, a slowdown in the rate of inflation in China, and a lessening of financial pressure in Europe.

On the other hand, it would be tempting to conclude that the recent strong stock market performance reflects the likelihood that the scariest risks are off the table and that we're out of the woods. Unfortunately, we don't believe that recent economic or market developments provide an "all clear" signal, particularly because our time horizon is not the next month or quarter, but the next five years.

For example, the eurozone's fundamental structural problems are not solved and continue to pose probably the most serious near-term economic and financial risk. While Greece garners more headlines, the broader problem is the level and sustainability of government debt in large and important European economies like Italy and Spain, and European banks' exposure to this debt. Late last year, the problem began to spiral rapidly downward, and the European Central Bank halted the spiral with the Long Term Refinancing Operations (LTRO) in which cheap loans were made to banks for three years, and where bonds of troubled countries could be used as collateral for these loans. While this program removed the near-term threat of a financial crisis, it does nothing to address the underlying structural problems in Europe beyond buying some time.

The recent news out of China is a positive, as the slowdown in the rate of inflation will allow the country's rulers to take additional measures to support growth, but longer-term problems (including a real estate bubble of their own) remain.

Finally, back home we have severe fiscal problems that will have to be addressed within our five-year time horizon. In his recent Congressional testimony, Fed Chairman Bernanke mentioned the "massive fiscal cliff of large spending cuts and tax increases" that (under current law) takes effect January 1, 2013. While it seems unlikely that this law will take effect without modifications, the risk of policy errors and political dysfunction, particularly in an election year, remains very high.

So How Are We Positioned In This Environment?

The reasons above are why we continue to position our portfolios with a conservative bias relative to our long-term, strategic allocations. In our balanced portfolios, we remain underweight to equities/equity-risk and underweight core bonds/interest-rate risk (by increasing quality and decreasing maturities). We continue to see relatively attractive tactical opportunities in emerging-markets local-currency bonds, flexible fixed-income funds, and alternative

strategies (such as Gateway). We continue to think that Gateway's covered call writing provides a prudent hedge against potential stock market weakness.

Of course, there are no "free lunches". And, our equity underweight means that if stock markets continue to rally in the near term, we do not expect to fully participate in that upside. Nonetheless, sticking to our long time mantra of "managing money for the downside as well as the upside", we are willing to give up near term upside in light of our big-picture concerns. Importantly, we think it will take many years to work through the huge buildup of debt that precipitated the 2008 financial crisis, and the result will be less spending and slower growth.

Looking out longer term, we expect to see more periods of heightened volatility. And, we welcome these environments because it is volatility that creates opportunities to increase our weightings to riskier asset classes when they are priced at levels likely to generate higher returns. Exploiting these opportunities via smart portfolio rebalancing activities can allow us to generate long-term returns that are better than just buying and holding for “what the market gives us.”

To recap, we believe we have created balanced and diversified portfolios that can:

- capture decent and acceptable five-year returns in our base-case, subpar growth scenario while at least matching our benchmarks
- participate in significant upside if the returns for stocks and other risk assets are much better than we expect (though we would likely trail our benchmarks)
- beat our benchmarks in the worst-case scenarios and protect (not lose) capital over five years in our balanced models
- add value by being opportunistic and investing more aggressively at lower prices if more negative scenarios play out, and
- protecting against our 12-month downside thresholds even in a severe market sell-off. Of course, it is possible that we could violate our 12-month loss thresholds slightly if our worst case assumptions turn out not to be severe enough. Nonetheless, we are comfortable taking on this risk in our portfolios because we believe there is a range of other less severe scenarios that are more likely to play out. And, the opportunity cost of being heavily positioned for one extreme scenario can be very high if that scenario doesn’t occur.

We’ll close with a reminder that we are in an environment with significant macro risks that are difficult to predict, and the range of possible outcomes is very wide. This makes it especially important that investors consider carefully how they might react in various outcomes and choose a strategy accordingly. Risk-averse investors should stay patient and resist the temptation to ratchet their risk level higher because markets “feel good” after a strong run.

On the other hand, investors with long time-horizons and the fortitude to ride out sharp shorter-term downturns can accept more risk. As always, across all the strategies we manage we’ll be adding to risk only when our research convinces us it is prudent to do so. Conversely, we’ll reduce risk (as we have currently) when we believe returns won’t be high enough to reward us sufficiently.

We appreciate your continued trust and confidence. If you have any questions, please don't hesitate to contact us. We're here to help.

Best regards,

Align Wealth Management