



What Is and What Should Never Be

Review

“You can avoid reality, but you cannot avoid the consequences of avoiding reality.” Ayn Rand

Quarterly performance for the indices we track is below:

	Benchmark Performance					
	Data as of June 30, 2011					
	<u>2Q11</u>	<u>YTD</u>	<u>1 Year</u>	<u>3 Years</u>	<u>5 Years</u>	<u>7 Years</u>
Bardays 5 Year Muni	2.73%	3.36%	4.31%	6.29%	5.68%	4.71%
Bardays Aggregate	2.29%	2.72%	3.90%	6.46%	6.52%	5.48%
S&P 500	0.10%	6.02%	30.69%	3.34%	2.94%	4.22%
Russell 1000	0.12%	6.37%	31.93%	3.68%	3.30%	4.76%
Russell 2000	-1.61%	6.21%	37.41%	7.77%	4.08%	6.28%
iShares MSCI EAFE	1.56%	4.98%	30.36%	-1.77%	1.48%	6.44%
iShares MSCI Emerging Markets	-1.15%	0.88%	27.80%	4.22%	11.42%	17.69%

Source: Morningstar Direct

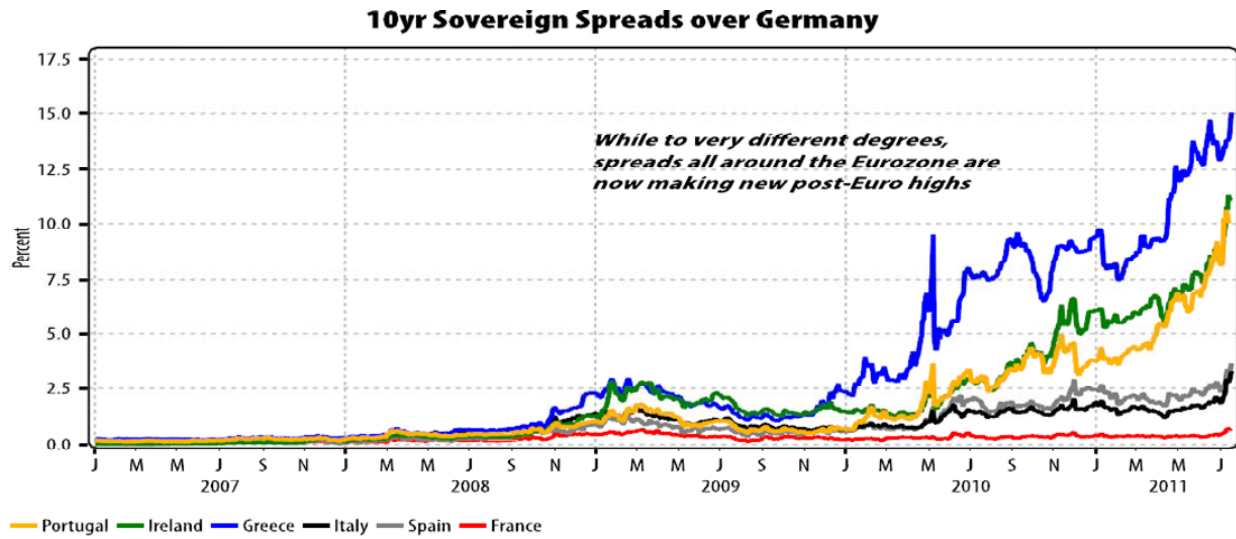
As usual, we post the graph of the S&P 500 for the past four quarters. The latest period was marked by the continuation of the uptrend in April, followed by a correction as the European debt crisis came back in the news in May. Notably, this is a similar pattern to what occurred last year when the Fed’s bond purchasing program (QE1) was winding down:



Source: Strategas which is not affiliated with Constellation Wealth Advisors LLC

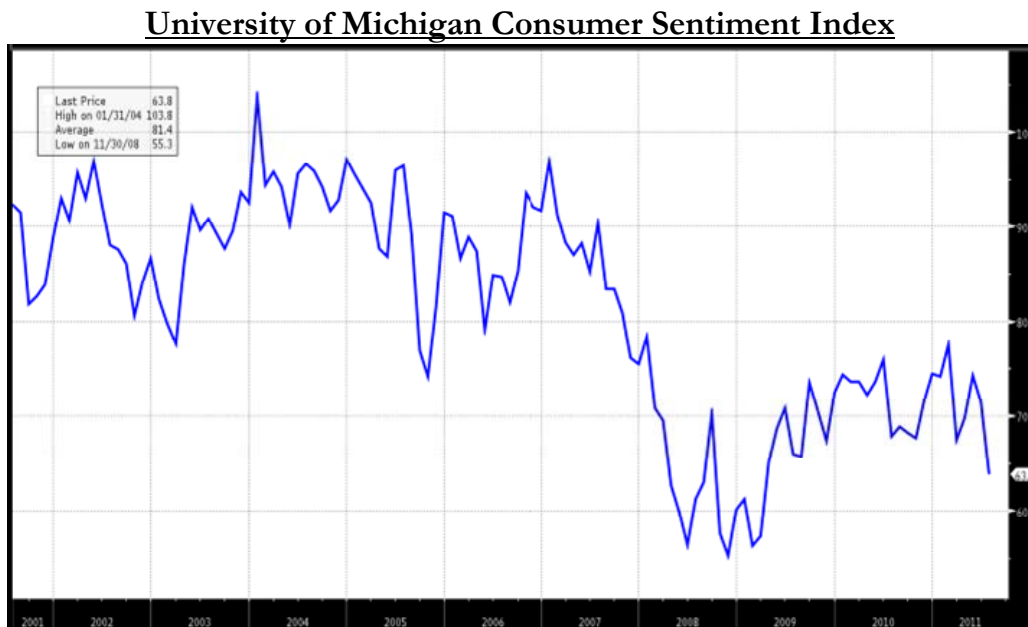
¹ Please review important disclosure language on the last page of this letter.

The markets demonstrated their displeasure with government’s inability to make difficult decisions both in Europe and in the US. In the EU, bond buyers began demanding higher yields to purchase the peripheral countries’ debt which added pressure to already strained budgets. With the German balance sheet the strongest of any major EU country, we show the spreads relative to the German 10 year below:



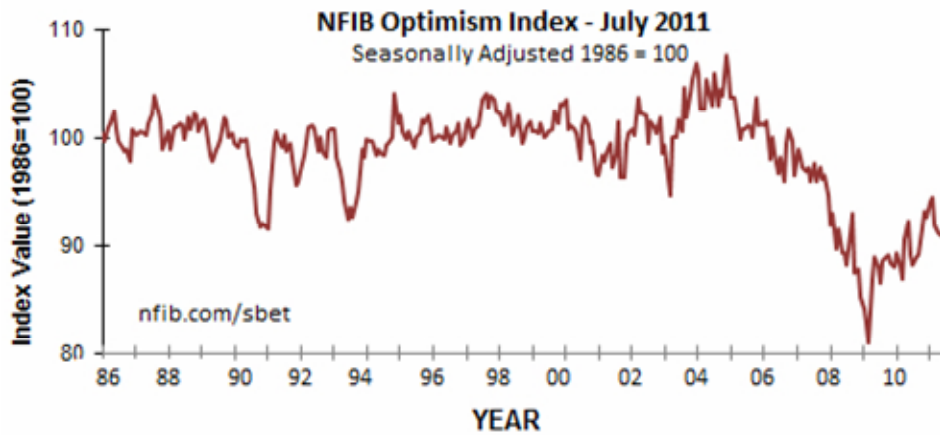
Source: GaveKal which is not affiliated with Constellation Wealth Advisors LLC

As expected, the economic data weakened during the quarter as the consequences of the Japanese disasters and subsequent disruption in various supply chains filtered their way through the system; automobile production was particularly affected. Nonetheless, most market participants were surprised by the magnitude of the slowdown (dubbed a “soft patch” by many economists) that developed. The spike in gasoline and continued difficulty in the economy’s ability to create jobs weighed on consumer sentiment during the quarter:



Source: Bloomberg which is not affiliated with Constellation Wealth Advisors LLC

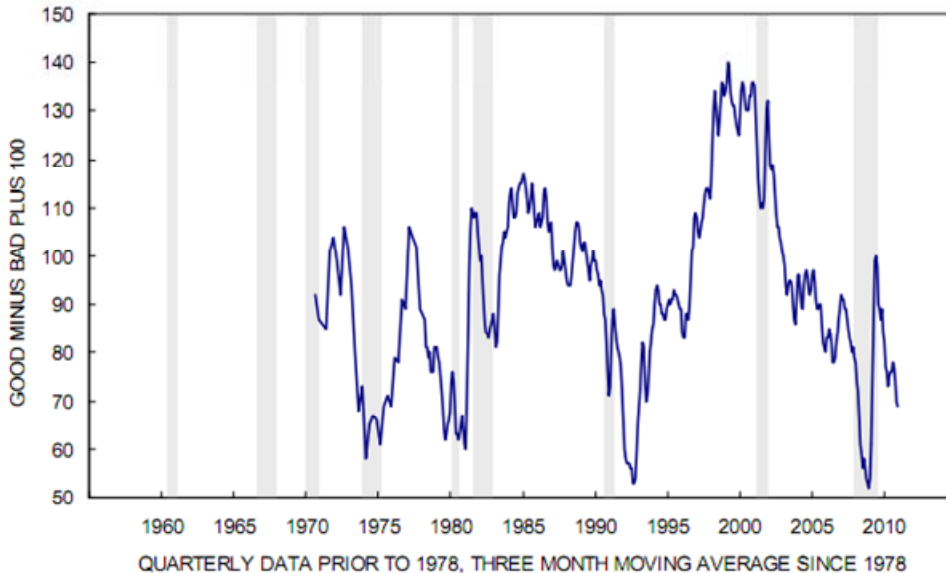
Business confidence also fell as seen in the recent downturn in the NFIB Small Business Confidence Index, although directionally, the index is still trending higher for now:



Source: NFIB which is not affiliated with Constellation Wealth Advisors LLC

All this was happening as the US's own debt issues were brought more keenly into focus. With the much-publicized debt ceiling needing to be raised, the political fighting reinforced the already diminished confidence in the dollar as well as the public's perception of Congress:

Opinions on the Government's Economic Policy – U of Michigan

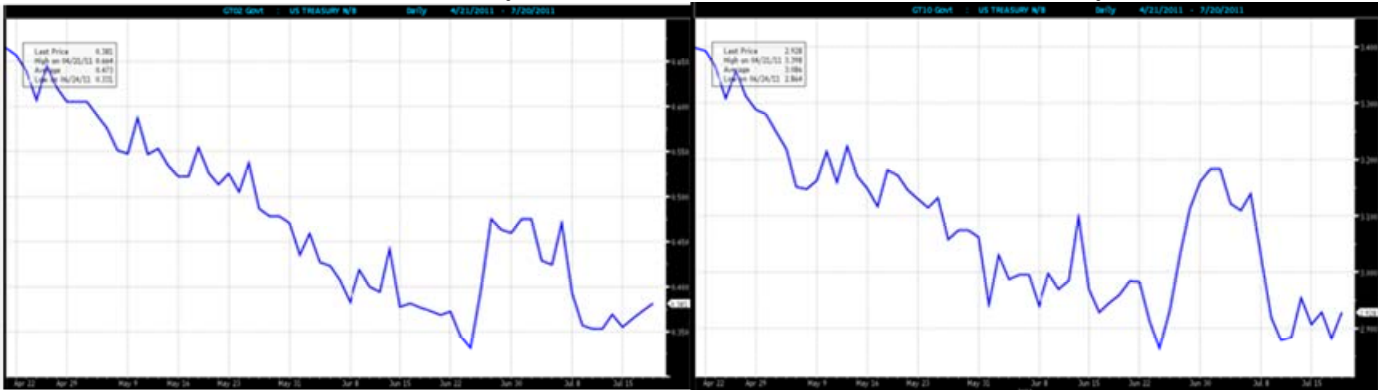


Source: www.sca.isr.umich.edu which is not affiliated with Constellation Wealth Advisors LLC

Interest rates had a fairly dramatic decline in response to the weak data and the flight-to-quality trade triggered by the renewed sovereign fears in Europe. Furthermore, the market began to discount a delay in tightening measures by the Federal Reserve:

2 Year US Treasury Note

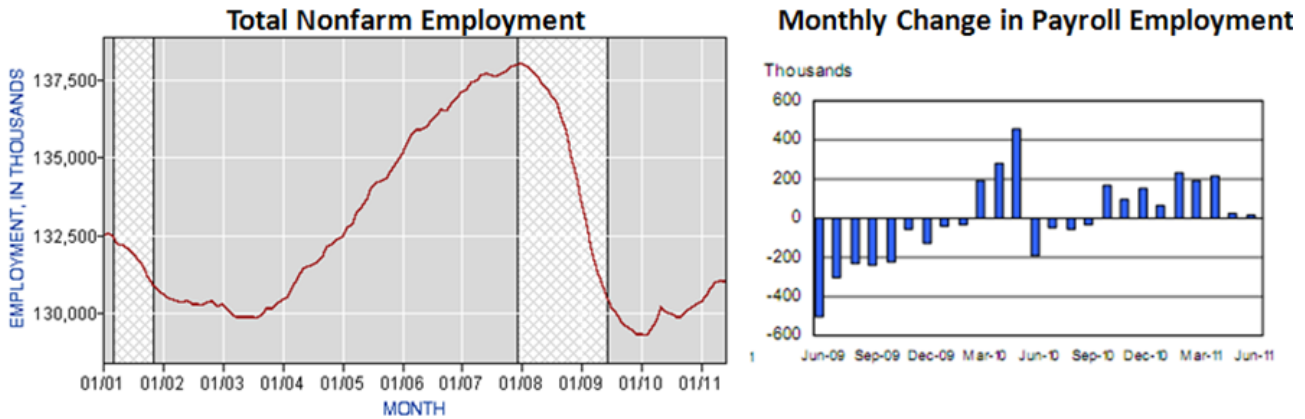
10 Year US Treasury Note



Source: Bloomberg

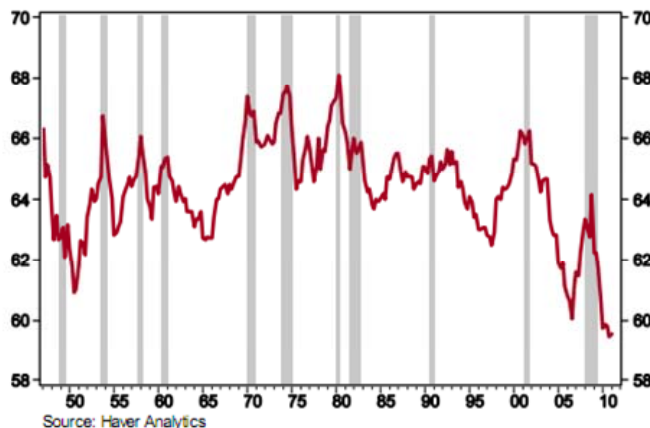
The two year note, most sensitive to Fed increases, declined from 83 basis points at March 31 to less than 36 basis points in mid-July while the ten year declined from 3.50 to 2.88 in the same time period. Both moves were fairly dramatic in such a compressed time frame.

Perhaps most disconcerting for the economy is the loss of momentum in employment growth. After several months of gains around the 200k level, the economy once again showed meager net job creation as shown on the chart at the right, and still employs seven million fewer people than at the peak three years ago (left chart):



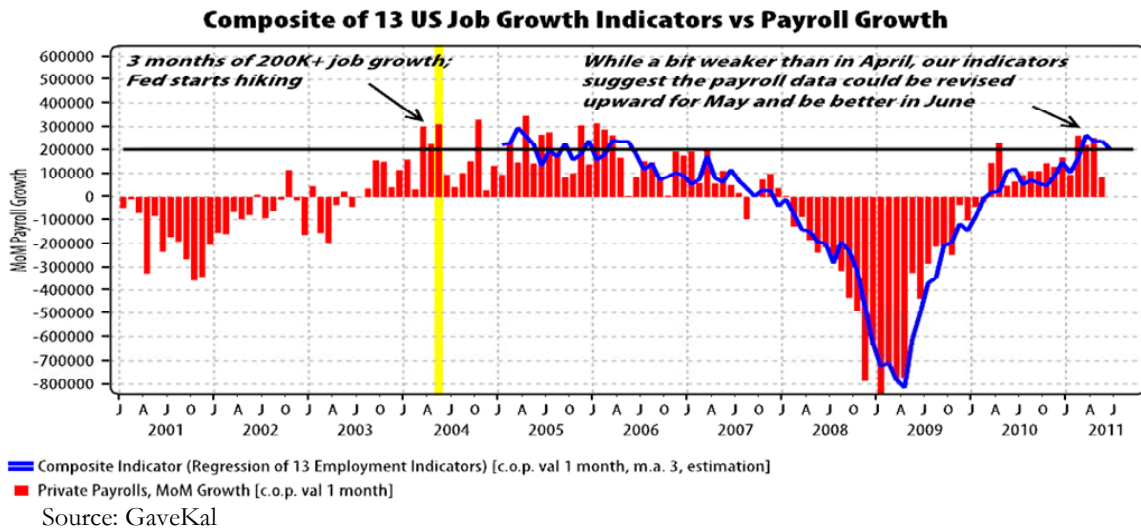
With confidence down and uncertainty high, companies have focused on raising productivity, choosing to invest in capital over labor. The result is that corporate compensation as a percentage of GDP is at 60 year lows:

Corporate Compensation as a Percentage of GDP



Source: Strategas

There is still hope that employment can resume its recovery. Budget constraints have caused state and federal governments to shed employees which has offset some of the net job creation picked up in the above data series. Further, GaveKal Limited, a well-respected economic consulting firm, assembles a composite jobs indicator for the US which appears to be pointing toward better numbers ahead:



Employment will be pivotal in finding a housing bottom, restoring much needed consumer and business confidence, and assisting the consumer balance sheet repair process.

Outlook

"To predict the behavior of ordinary people in advance, you only have to assume that they will always try to escape a disagreeable situation with the smallest possible expenditure of intelligence." Friedrich Nietzsche

The market continues to be driven by the overarching macroeconomic issues that are front and center in the media; predominately, the European sovereign crisis and the EU's attempt to contain it, and the debt ceiling debate in the U.S. Congress. These issues highlight the possibility of a major policy error as a risk to capital market stability. On both issues, politics have trumped pragmatism and common sense. As of this writing, the Europeans have released their second Greek bailout package in the hope of ring-fencing their sovereign issue. Their goal is to avoid a panic in other troubled markets, most prevalently Ireland, Portugal, Spain and Italy, the world's third largest debt market. The most recent package has been met, at least initially, with a positive response from the financial markets, but in our opinion, remains fatally flawed.

The thought process in developed economies in the post-Lehman era is that demanding some private sector haircuts from bondholders will prevent investors' willingness to purchase other troubled securities. An anonymous European Commission official was recently quoted as saying, "I would have preferred not to have this private sector involvement." This sentiment strikes us as emblematic of the problem. Decision makers prefer to throw taxpayer money at subsidizing bad investment decisions by both investors and governments, and in the process, eliminating the market's need to adequately price the true risk of underlying securities. Ironically, this is the very behavior that led to EU's current predicament to begin with (not to mention the US).

The goal of politicians in Europe for now is to defer the inevitable Greek debt restructuring until they can prepare the rest of the system for the more dramatic haircuts that must be taken on outstanding debt. This

includes allowing the banking system to continue to replenish its capital base and hoping that other peripheral countries can come close to balancing their budgets. The problem is that there is more debt in the system than the tax base can support. Below is a chart with numbers from Egan Jones that demonstrate the problem (all amounts are in Euros):

	Greece	Ireland	Italy	Portugal	Spain
Debt	330	200	1,843	160	639
Debt/GDP	153%	95%	125%	102%	60%
Interest Cost	50	30	129	24	45
Tax Revenue*	46	34	445	38	211
Government Deficit*	16	10	9.7	6	48

Source: Barrons which is not affiliated with Constellation Wealth Advisors LLC

In last quarter's letter (Darkness on the Edge of Town), we outlined the US' fiscal position in detail and used a debt to revenue metric as an indication of distress. As you recall, the US currently has roughly \$14.5 trillion in debt supported by revenues (albeit at depressed levels) of \$2.2 trillion, for a debt to revenue ratio of 6.5:1. That level is only palatable because interest rates are so low (keep in mind that the US debt number does not include the present value of the unfunded liabilities of Medicare and Social Security which is estimated to be between \$64 and \$99 trillion according to JP Morgan). By comparison, Ireland has a debt to revenue ratio of nearly 20:1 (including assumed bank debt of 400mm euro). And notably, Greece's interest expense exceeds its estimated revenue.

The market is losing patience with can-kicking solutions because it can see that the debt loads are too big for the respective underlying economies. As a result, investors have begun to discount the alternative, which is that the debt is nationalized (assumed by the pan-European community in one form or another). While this is a difficult sale politically, it comes down to a dilemma of either bailing out the troubled governments or recapitalizing the banks which have too much exposure to this debt relative to their already slim capital levels. To that end, investors have begun to discount the former choice as shown by the spike in German CDS (in orange) above that of the US (in blue) despite its better debt ratios and the US' potential technical default:



Source: Bloomberg

Meanwhile, US politicians continue negotiating terms for raising the debt ceiling ahead of the early August deadline. Ironically, it is the rating agencies, perhaps the entities most responsible for the financial crisis, that are pressuring lawmakers for substantive cuts. Standard & Poors has declared that it would like to see

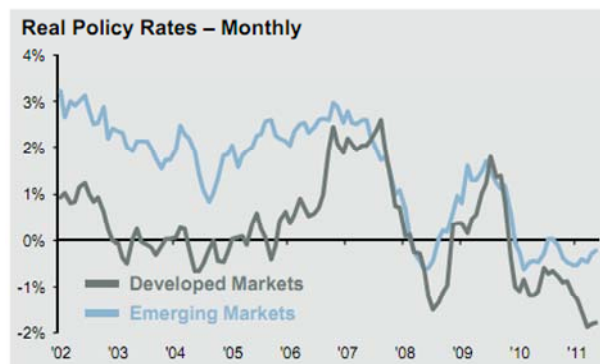
a package that cuts \$4 trillion from the deficit over the next ten years in order to avoid a downgrade from the coveted AAA level. We have little hope for an agreement that contains substantive spending restraint, especially given the limited time that the two sides will have given themselves to actually hammer out the details of any agreement. Furthermore, unless the entitlement programs are addressed in a meaningful fashion, which it appears they will not, this issue will linger with us for years.

The media has speculated about the various scenarios that may or may not transpire should an agreement not be reached. It is important to remember that this is a discussion focused on when, rather than if, investors will be paid. The US government cannot fully default on debt issued in its own currency. The crux of the issue is the ultimate worth of the dollar should the debt be monetized. We can't help but conclude that when a deal is finally reached, which it will be, the damage will have already been done as the faith in our system and our currency will have taken another confidence hit.

All of the political focus as well as the Japanese disruptions have clouded the true economic run rate of GDP in the US. There is obviously little room for fiscal stimulus, and the Fed is also much less likely to become more accommodative given that unlike when QE1 ended, inflation is now nearly back in the Fed's own target zone. In recent testimony, when questioned about the potential for QE3, Chairman Bernanke said:

"I think the important point to make is that the situation today is somewhat different than it was in August of 2010, when we began to initiate discussion of further purchases of securities. At that time, inflation was dropping, inflation expectations were dropping. It looked like deflation was becoming a potential risk to the economy and a serious risk."

The Fed already possesses an extremely large balance sheet and, along with its developed market brethren, is keeping interest rates below the rate of inflation (negative real rates) as shown below:

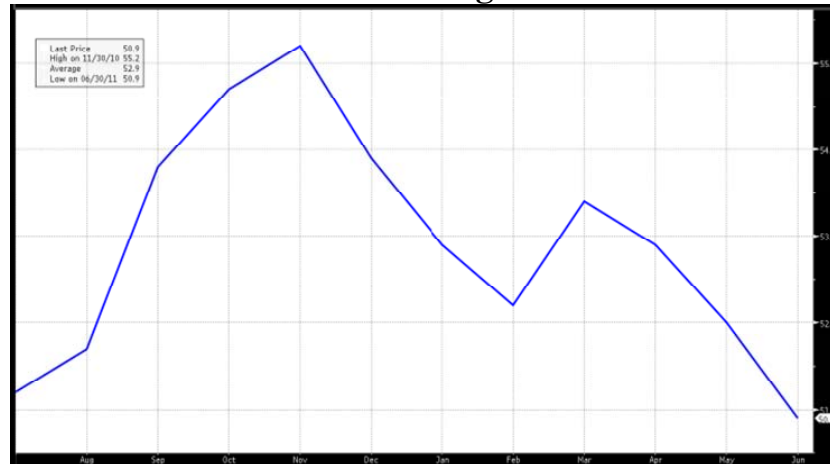


Source: JP Morgan which is not affiliated with Constellation Wealth Advisors LLC

Despite the above, not all of the economic data is weak, and there remain signs that the economy can continue to grow (although below trend) once the major uncertainties are removed. Positive factors include some household debt metrics showing progress in the consumers' deleveraging process, an expected pick-up in auto production that should meaningfully improve Q3 GDP numbers, and some improving employment metrics (initial jobless claims ticking down, average workweek and aggregate hours worked moving up).

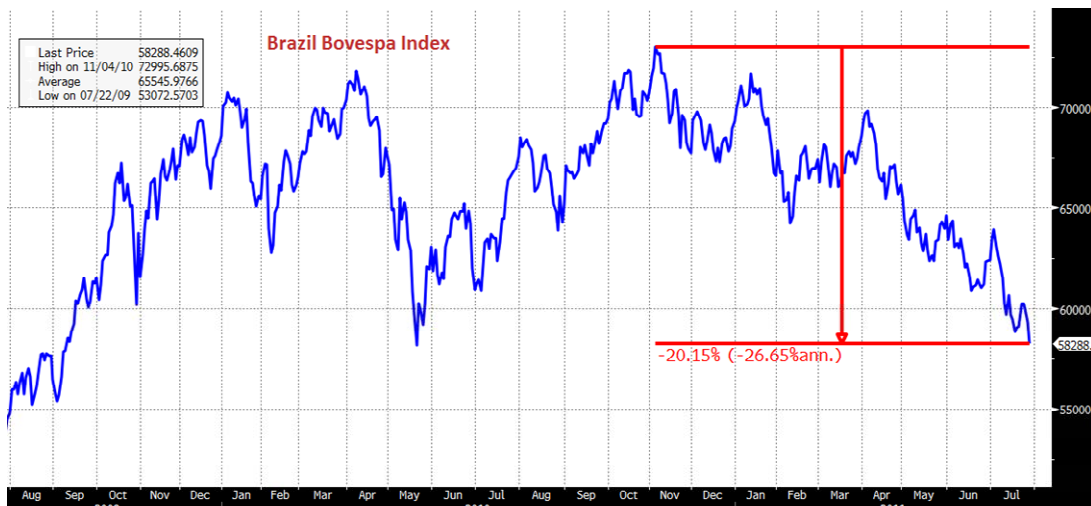
Meanwhile, the emerging market economies, the main growth drivers for world GDP, have been raising rates to fight inflation which has caused a headwind for their economies and equity markets. This is especially true for China where significant monetary tightening has transpired and many investors are concerned about a hard landing. Below is a chart of China's PMI Index over the past year with the latest reading approaching 50% (below which would be demonstrative of contraction):

China Manufacturing PMI Index



Source: Bloomberg

Another emerging standout, Brazil, has seen its stock market enter bear market territory having corrected 20% from its recent high:

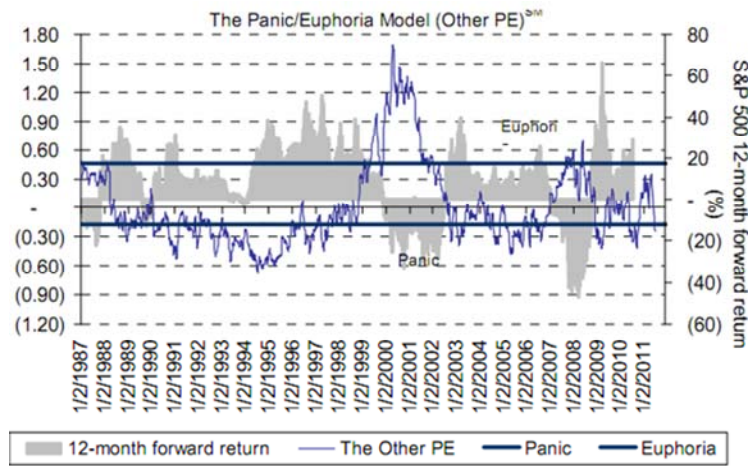


Source: Bloomberg

However, the recent softness in the economic data has exerted disinflationary pressures which should give central banks some leeway. This is generally a positive for equity and bond markets as interest rates approach their cyclical peaks.

Recommendations

The economic backdrop remains consistent with our view for the past several years; one that consists of uneven economic growth below historic recoveries and expansions. As such, our recommendations have not changed dramatically but we continue to look for new areas where income can be generated with some inflation protection and where equity money offers the most attractive risk/reward proposition. The negative news backdrop has created a renewed level of investor pessimism which can be positive for future stock returns. The sentiment gauge in Citi's Panic/Euphoria model has swung back into panic territory; this has foreshadowed positive stock returns in the ensuing 12 months over 90% of the time:



Source: Citigroup Research which is not affiliated with Constellation Wealth Advisors LLC

Equities: With sentiment low and growth hard to come by, companies that have true secular growth stories should be afforded higher PE multiples as investors become willing to pay up for reliable earnings momentum. We favor large capitalization growth stocks as their valuations remain most compelling (per JP Morgan, their PE ratios are roughly 69% of their 20 year average). We continue to like both domestic and international dividend-oriented stocks since yields can be obtained that are higher than bonds, have some inflation protection, and that grow over time as dividends are increased. Additionally, as mentioned above, the time may be approaching for a turning point in emerging markets which we continue to favor averaging into.

Bonds: Yields remain uninspiring and despite all the talk about a technical default, the treasury market continues to attract healthy demand. Municipal bond yields have returned to levels that are within normal ranges but still offer the high bracket taxpayer better tax equivalent yields than can be found in quality corporate issues. With respect to portfolio construction, we continue to recommend either a barbell weighted to the short end of the curve or a ladder of no more than intermediate duration. We maintain our belief that while inflation is a risk (especially with the dollar under pressure), rates may stay low longer than many market participants expect.

Alternatives: Our alternative asset recommendations have not changed. We favor long/short equity and credit hedge funds that can avail themselves of market volatility to make money. Yield oriented real estate remains one of our favorite themes and the data continue to reinforce its potential.

As always, we welcome any questions or comments and thank you for your trust and confidence.

Additionally, Constellation Wealth Advisors LLC is a SEC registered investment advisory firm, and in accordance with Rule 204-3 of the Investment Advisers Act of 1940, we are obliged to deliver our clients a copy of our Form ADV Part 2B “Brochure Supplement” for those individuals you rely upon for investment advice. The Form ADV Part 2B is a new requirement taking effect this year.

The Part 2B supplements information included in our Part 2A Firm Brochure which has previously been sent to you. The Part 2A is available by contacting us directly or at www.adviserinfo.sec.gov.

If you would like any additional information about our firm, please contact me directly at (212) 697-0500 or by electronic mail at MylesE@cwllc.com. Thank you.

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INDICES

Barclays 5 Year Municipal Bond Index is composed of 35% state general obligation bonds, 50% revenue debt and 15% pre-funded bonds.

Barclays (“Capital”) Aggregate Bond Index, is a broad base index, maintained by Barclays Capital and is often used to represent investment grade bonds being traded in United States.

S&P 500® index has over US\$ 4.83 trillion benchmarked, with index assets comprising approximately US\$ 1.1 trillion of this total. The index includes 500 leading companies in leading industries of the U.S. economy, capturing 75% coverage of U.S. equities.

Russell 1000 measures the performance of the large-cap segment of the U.S. equity universe and is constructed to provide a comprehensive and unbiased barometer for the large-cap segment and is completely reconstituted annually to ensure new and growing equities are reflected.

Russell 2000 measures the performance of the small-cap segment of the U.S. equity universe and is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

iShares MSCI EAFE measures the performance of publicly traded securities in the European, Australasian and Far Eastern markets.

iShares MSCI Emerging Markets Index is designed to measure the equity market performance in the global emerging markets. The index consists of 21 emerging markets with the three largest sectors by component weighting were financials, energy and materials.

National Federation of Independent Business (“NFIB”) Small Business Optimism Index measures whether business owners expected sales to improve and is calculated by subtracting the percent of company leader giving a negative answer from those with a positive response and adjusting the results for seasonal variations.

China Manufacturing PMI Index is published by the China Federation of Logistics & purchasing and the National Bureau of Statistics and is derived from Bloomberg.

(Brazil) Ibovespa-Bovespa Index is an index of about 50 stocks that are traded on the São Paulo Stock, Mercantile & Futures Exchange and is derived from Bloomberg.

Citigroup Panic/Euphoria Model is an aggregate measure of sentiment.