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www.tamgmt.com

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or write or call:

TITLEIST ASSET MANAGEMENT, LTD.
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609 Castle Ridge Road, Suite 315
Austin, Texas 78746
512.494.1003

7373 Broadway, Suite 108
San Antonio, Texas 78209
210.826.2424

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2011

Second Quarter Report

The S&P 500 returned 5.6% in the first half of 2011 while the Barclays Aggregate Bond Index returned 2.81%. The healthcare sector was the strongest performer over the first two quarters while energy and consumer discretionary stocks came in a distant second and third place. After significantly underperforming the overall market for the past two years, it was only a matter of time for the healthcare sector to catch up. Our portfolios continue to have the biggest concentration in the energy and technology sectors.

Weak economic data and further deterioration in EU sovereign debt sparked concerns of a slowdown and resulted in a big reallocation into defensive sectors such as healthcare and consumer staples. We think the recent flow of weak data is a continuance of the uneven recovery rather than the start of a cyclical slowdown. This temporary slowdown is a result of sovereign debt concerns in Europe, concerns about the debt ceiling, disappointing employment data, a severe spike in gasoline prices, and further weakness in residential real estate.

With regard to the sovereign debt issues within the EU, we do not expect any meaningful resolution anytime soon. Even though an eventual default seems inevitable, it appears EU member countries have chosen to continue buying time over the next few years so the banks holding all this debt can earn enough to buffer against the eventual losses they will take on sovereign credits. Our best guess is that they will continue offering bailout programs as long as austerity measures are taken for the next year or two. The politics surrounding this issue are very complicated and could change very quickly.

Housing has surpassed energy costs as the biggest threat to our economic outlook in the near term. With almost 20% of all existing mortgages underwater both the consumer and banking systems are severely constrained. As we have mentioned in the past, credit is the lifeblood of any economy. Until the banking system can work through the mortgage write-downs we do not anticipate much improvement in lending.

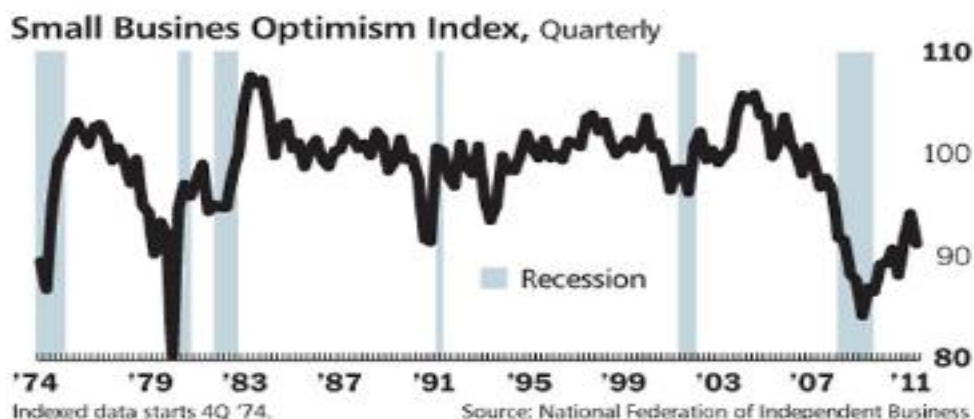
Home prices declined 3.1% in the first quarter this year, the worst decline since the financial crisis erupted in the fourth quarter of 2008. After another downtick in April, it was encouraging to see a modest uptick in the May Case-Schiller Home Price Index. This was the first uptick in housing prices since the first-time home buyer tax credit expired 13 months ago.

After a disappointing first half, consensus forecasts for GDP in the second half of the year have been revised down from 3.0% to 2.6%. The downward revisions are almost entirely attributed to lowered expectations for consumer spending. These growth rates are subpar by any standard, especially considering the unprecedented amount of monetary and fiscal stimulus applied over the past two years. However, this should be enough growth to put a little downward pressure on the unemployment rate from its current 9.2%.

Another key reason for the mediocre expansion is that small business remains in recession. Until there is more certainty regarding future tax policy, changes to Obamacare, and credit availability loosens we do not anticipate any meaningful changes in the near term. Notice how much higher confidence was following all prior recessions dating back to the early 70's.

Still in Recession

The Small Business Optimism Index has fallen back from its first-quarter 2011 high of 94.1 and remains in recession territory.



Despite all of the headwinds mentioned above, corporate earnings and guidance continue to remain incredibly strong. Emerging market growth around the world has provided a strong tailwind to multinational companies and we expect this trend to remain intact for decades to come. Demand for commodities, goods, and services will continue to increase as people inevitably improve upon their quality of life around the world.

In the aftermath of the stock market crash and Great Recession, fear remains at extreme levels. As a result, most areas within fixed income are extremely over owned and overpriced. Jim Grant, of the widely followed Grant's Interest Rate Observer, put it best when describing the current fixed income environment as "return free risk". While treasuries used to be considered the "risk free return", now one must go out almost 10 years to get an interest rate that exceeds today's rate of inflation.

In our view, investors are not being adequately compensated for the risks of future inflation or credit quality of the US Government. Those sitting paralyzed on the sideline watching their wealth erode in money markets and other short-term debt earning negative real returns - the yield after accounting for inflation - will eventually realize there are also risks involved in being permanently ultra-conservative.

In closing, it is important to keep in mind that everything in today's media - whether it's positive or negative - is exaggerated and overplayed. We expect the financial markets both here and abroad to remain volatile in the second half but continue to remain positive on equities while keeping durations on fixed income at extremely low levels. Our accounts remain positioned for trend like economic growth going into the second half of this year.