

MANAGERS' SPECIAL REPORT

February 3, 2010

DAL Investment Company has been actively managing mutual fund portfolios for high net worth individuals and businesses since 1969 and currently manages well over \$1 billion. DAL has published its proprietary mutual fund rankings in the popular and highly rated investment newsletter, NoLoad FundX, since 1976 and served as investment manager of a series of mutual funds since inception in 2001. DAL bases buy and sell decisions on proprietary rankings that measure current mutual fund and ETF performance, capitalizing on the observation that market leadership changes over time. More details of this process, called Upgrading, can be found on any of our websites. We also welcome calls at our San Francisco office, 800-323-1510, or emails to DAL@dalinvestment.com.

The comments below are designed to share some of our current observations based on our rankings and models. None of these comments relate to any specific portfolio managed by DAL. Specific newsletter portfolios are published in NoLoad FundX and available by subscription only, mutual fund portfolios are updated monthly at www.upgraderfunds.com (generally 7 days after each month-end), and private client portfolios are not publically disclosed. Our goal is to show you how we apply some of our current observations to meet a variety of popular investment objectives. None of the comments are recommendations. Any actions described are meant to help interested investors better understand how we select among highly ranked funds and ETFs to buy, which lower ranking candidates to sell, how we determine appropriate position sizes and, where appropriate, what actions we are taking to add or reduce exposure to stock and/or commodity funds, bond funds and cash – and why. We hope that by sharing real-time examples, updated monthly, readers will better understand how we are managing portfolios they may be holding – or at least glean insights that help them better navigate the markets in their own portfolios.

General Guidelines for allocating among core and speculative equity funds**Growth Objective**

A typical growth portfolio (designed to beat broad market indexes like the S&P 500 over time through our Upgrading strategy, but with similar risk) is composed primarily of core mutual funds and ETFs. We generally hold between seven and twenty core funds in a growth portfolio, but individual investors can get away with as few as five and be reasonably diversified. We model our core holdings as equally weighted, but tend to take larger positions in larger funds that are less restrictive or ETFs that we believe trade with sufficient liquidity. We sometimes take small positions in highly ranked funds that are harder to trade (either due to size or restrictions) or we skip these funds in favor of other highly ranked candidates. We take smaller positions in more speculative funds and restrict total exposure to speculative funds to less than 1/3 of a growth portfolio. In total, our typical growth portfolio will hold at least 30 mutual funds or ETFs, providing broad diversification.

Summary: A growth portfolio holds larger positions in diversified core mutual funds and ETFs and limits exposure to speculative funds.

General Guidelines, Continued

Aggressive Growth Objective

A typical aggressive growth portfolio (for clients willing to take more risk in hope of greater potential return) holds the same mutual funds and ETFs as our growth portfolio, but with twice the weighting to speculative funds. Also, each holding is equally weighted (except if liquidity is a consideration), implying that each core fund will typically be a smaller holding relative to a growth portfolio, and each speculative fund will have a greater weight in the aggressive portfolio. We maintain a meaningful allocation to core funds in aggressive portfolios, except in our ETF-only aggressive portfolios where we are willing to invest 100% in speculative ETFs because there is no minimum holding time per position.

Summary: Aggressive portfolios hold the same funds and ETFs as a growth portfolio, but take larger positions in speculative funds, and total exposure to speculative funds is twice that of a growth portfolio.

Conservative Growth Objective

A typical conservative growth portfolio is designed to participate in market gains using our Upgrading strategy and buffered by an allocation to our Flexible Income strategy. A conservative portfolio holds the same core mutual funds and ETFs as our growth portfolios, but avoids speculative funds altogether, and generally holds about 40% in fixed income funds, cash, or low volatility alternative funds based on our flexible income strategy.

Summary: Conservative growth portfolios hold the same core mutual funds and ETFs as growth portfolios, but avoid speculative funds altogether and hold significant exposure to our Flexible Income strategy to buffer volatility.

Tactical Portfolios Overview

Most of our portfolios are fully invested at all times, and we manage risk through the total number of holdings, limiting the allocation to more speculative funds, and by allocating part of most client portfolios to multiple strategies including our Flexible Income strategy.

We also manage Tactical portfolios designed to increase and decrease equity exposure based on objective measures of current market risk. We use our Upgrading strategy for buy and sell decisions in all portfolios including our Tactical portfolios, but Tactical portfolios may also hold considerable cash, and their equity holdings may be hedged in a variety of ways based on our current observations of market risk vs. reward potential.

Our primary tactical model is a composite of risk measures (signals) based on valuations, investor sentiment, the strength of a market trend, market breadth, monetary conditions and the relative attractiveness of stocks versus bonds and cash. We weight our allocation decision based first on a composite score across the model's signals, but we also may respond to divergences between the individual signals that shape the tactical model.

Our Tactical portfolios hold mutual funds and ETFs based on Upgrading, very similar to those held in a growth portfolio. We emphasize ETFs so we can more actively add or reduce equity exposure, and we can raise cash and buy or sell options to help manage risk exposure. We may also hold "inverse ETFs" that gain when a market index declines and decline when the index rises. Our Tactical Total Return strategy includes an allocation to our Flexible Income strategy.

Current Buys and Sells

Based on data through February 1, 2010

Core equity funds (Class 3 for newsletter subscribers)

Last month we reduced exposure to diversified developed market foreign funds (mainly European) in favor of domestic mid- to large-cap funds. Our rankings now favor domestic mid-caps, especially mid-cap value, and the current core “buys” are now only 13% foreign. Including “holds”, our core holdings are now less than 30% foreign. ETF-only portfolios have only 10% in foreign core ETFs.

Summary: We continue holding or reducing foreign developed market fund exposure in favor of domestic mid-cap funds. ETF-only portfolios replaced domestic large-cap growth with mid-cap value.

Speculative equity funds (Classes 1 and 2 for newsletter subscribers)

Despite a volatile start to 2010, emerging markets remain highly ranked and speculative holdings are roughly two thirds emerging markets. We favor diversified emerging market funds and BRIC [Brazil, Russia, India, China] funds over individual country funds. Technology fell in our rankings, while banks and small cap value funds rose. We still have modest exposure to retail, materials and semi-conductors.

Summary: We continue to hold mainly diversified emerging market funds and ETFs. We also have modest holdings in leading domestic speculative funds, including small cap value, banks, retail, materials and semi-conductors.

Flexible Income

Bond yields retreated in January as stocks pulled back leading to gains in fixed income and our flexible income strategy. We continue to hold high yield bond funds and selected alternative funds. Our greatest weighting is short-term bond funds.

We are starting to see a tug-of-war between massive US treasury issuance and fresh credit concerns (especially from Europe) versus a flight to safety as stocks have pulled back and the US dollar has strengthened. Our decision to sell foreign bonds proved timely, while reducing duration has been premature. For the month, we enjoyed modest gains and take comfort that we also faced relatively modest volatility. We are slightly increasing exposure to intermediate-term bonds and selling one of our more speculative alternative holdings. Our portfolios remain “barbelled” with a substantial allocation to very short-term, high quality bond funds on one side, and a combination of high-yield and alternative funds on the other. We have only modest exposure to high-quality intermediate term bond funds.

Summary: Last month’s decision to sell foreign bonds proved timely, while reducing duration has been premature. For the month, we enjoyed modest gains and little volatility. Our holdings are “barbelled” between low risk short-term bond funds and higher risk high-yield and alternative funds with only modest exposure to intermediate term bond funds.

Current Buys and Sells

Based on data through February 1, 2010

Current Tactical Model perspectives

Composite: Neutral (from Bullish)
Trend: Neutral
Valuation: Bearish (but improving)
Sentiment: Neutral to Bullish (from Bearish)

January 2010 started strong but finished poorly, with all stock indexes posting losses. Leading sectors like technology were punished and emerging markets fell sharply. Our tactical portfolios held up nicely as we were prepared for a correction.

Last month, we perceived excessive optimism (or investor complacency) and high valuations as potential headwinds, and observed bullish but weakening trend momentum. The recent pullback has dramatically corrected the sentiment picture and our sentiment models are now either neutral or bullish. Valuations remain stretched, but a combination of lower prices and improved earnings has moved us closer to a neutral reading.

We continue to view this move as a correction in an ongoing bull market, but our composite model is now neutral and our attention is squarely on trend momentum.

As always, the core of our portfolios is based on Upgrading. We therefore emphasize domestic mid-cap funds and ETFs, especially mid-cap Value. We have modest exposure to core foreign funds and some speculative exposure to diversified emerging markets ETFs.

Last month we talked about using put options and covered calls to hedge our long positions so we could “take advantage of a possible correction.” In addition to hedging with options, we also hold some cash. We remain cautious. If we turn bearish, we would raise more cash by selling ETFs and possibly replace some of our put options with inverse ETFs.

At this time, we are looking for a trigger to increase long exposure and/or reduce our defenses. That trigger could be a thrust higher, but odds favor a continued correction first.

Summary: We remain cautiously optimistic. Our Tactical portfolios held up well in January’s pullback due to considerable defensive posturing. We are not bearish – but we remain cautious. Our attention has shifted away from sentiment and valuation and we are now focused squarely on trend momentum.