

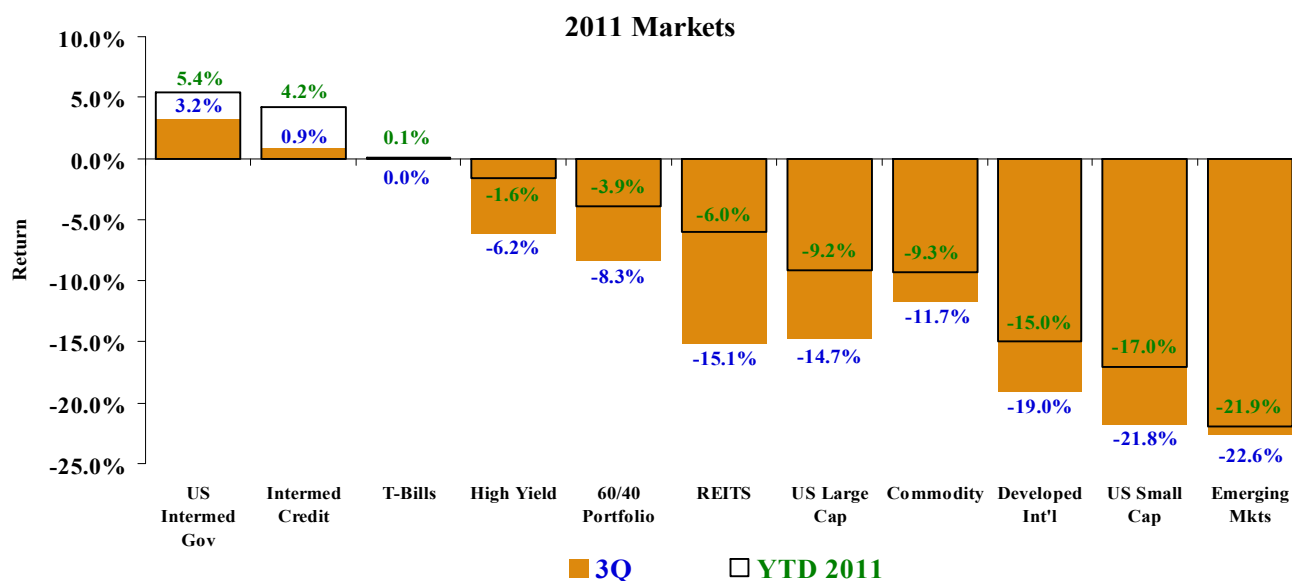
Third Quarter 2011
Investment Commentary



Investment Insight
Fiduciary Focus



Investors abandoned risk assets and fled into safe haven assets during the third quarter. They were fearful of a global recession and concerned that monetary and fiscal policy makers around the world had neither the tools nor the congruency of goals to fend off an economic downturn or something worse. US politicians brought the world to the brink of a US default and a historic downgrade of US debt. In Europe, rising fears of a Greek debt default were temporarily eased by a second rescue package. However, contagion fears spread as investors questioned the sufficiency of the European Financial Stability Fund (EFSF). Emerging markets growth, especially in China, also became suspect. Over the quarter, global stock prices lost -16.5% with the largest losses occurring in the middle of the quarter and in cyclically sensitive sectors and countries. As demand for traditional safe assets soared, yields on the most liquid and highly rated assets fell. Intermediate US Government bonds enjoyed a 3.2% return while long US Treasuries were up 24.7% for the quarter. The fundamentals for US pension plans deteriorated as the average 60% equity portfolio lost -8.3% during the quarter while reported liabilities for a typical plan rose by 15.8% according to the *BNY Mellon Pension Liability Index*.



Stocks Generate Worst Losses since 2008

Global equities sank by -16.5% for the quarter, leaving investors down -11.8% since January according to the *MSCI World Index*. US stocks lost -15.3% for the quarter followed by international developed markets and emerging markets with losses of -19% and -22.6%, respectively.

Despite strong corporate earnings reports in July, US equity markets softened as the politics of the US debt ceiling played out and investors contemplated a US default. The downward trajectory of US stock prices accelerated in August as US debt was downgraded from AAA to AA+ and US data confirmed slowing economic growth and loss of consumer confidence. 399 stocks in the S&P 500 fell an average of -9.21% with another 11 falling an average -28% for the month. By early September, additional signs of weakness in the US led to a \$447 billion fiscal stimulus proposal. Late in the quarter the Fed launched a plan, dubbed "Operation Twist" to reconfigure its \$2.65 trillion securities portfolio. These efforts had little impact on US risk markets which posted losses across virtually all asset type.

In the US stock market, losses varied in rough proportion to market capitalization, indicative of a broad based flight from risk. Larger capitalization companies are thought to have more attractive valuations, better diversification and resiliency in tough times. According to the Russell indices; large caps lost

-14.7%, mid-caps fell -18.9%, small caps were lower by -21.8%, while micro caps were down -22.7% for the quarter. The shift in equity market leadership from early stage cyclical companies to late stage defensive & dividend payers continued through the quarter. Growth outperformed value in large caps by 3.1% while it underperformed value in small caps by -.8%. The large cap banks, heavily represented in the value sector, were among the worst hit during the quarter with many falling 25% or more. Technology, normally a cyclical sector, and consumer staples are well represented in the growth index. Many large technology stocks attracted investors. Their strong balance sheets and low historic price earnings ratios offset some of their usual cyclical risk. Tech stocks such as Apple and IBM, and higher yielding consumer growth stocks like McDonalds and Coke, actually generated positive returns for the quarter.

Active Funds Underperform

It continued to be a difficult environment for active stock managers as macro market trading themes and coincident higher correlations dominated. Asset prices generally responded to a top down view of global issues rather than a fundamental bottom up view. With the dispersion of sector returns so high, a manager's sector calls, valuation discipline and macroeconomic overlay seemed to have more impact than stock selection on relative results. Large capitalization US equity managers generally under performed their market benchmarks as smaller cap and international holdings hurt comparative results. The *S&P 500 Index* ranked in the top 18% (19% YTD, 17% 1 year) of mutual funds in the Morningstar Large Blend Fund Universe for the quarter.

S&P 500 Sector Returns	3Q 2011
Utilities	0.4%
Consumer Staples	-4.9%
Information Technology	-8.0%
Telecomm	-9.2%
Health Care	-10.5%
Consumer Discretionary	-13.3%
S&P 500 Index	-13.9%
Energy	-20.9%
Industrials	-21.5%
Financials	-23.1%
Materials	-25.0%

International equity managers were equally flummoxed by this investment environment. Both the developed markets *MSCI EAFE Index* and the broader *MSCI World Ex Us Index* ranked in the top 17% (EAFE 15% YTD, 19% 1 year) of the Morningstar Foreign Large Blend mutual fund universe for the quarter. Composite hedge fund results, often viewed as a proxy for the performance potential of active investment management, were mostly negative for the quarter. For example, the *Hennessee Hedge Fund Index* lost -7.2% for the third quarter.

A European debt deal, designed to provide financial relief to Greece, provided some support for international stock markets early in the quarter. However, slowing economic momentum in France and Germany elevated concerns about the sufficiency of the Greek bailout fund. Fears of contagion to Spain and Italy as well as to the Euro banks, drove overseas stock markets down further than the US, some to bear market lows. International equity fell -19.0% over the quarter, -per the *MSCI World ex US Index*. The economic prospects for even the strongest European economies were tainted by peripheral Europe's debt problems and looming austerity measures. The German market fell by -30.9% followed by a -30% loss for France for the quarter. These quarterly losses exceeded those of the PIIGS members, Portugal (-25.2%), Italy (-31.2%), Ireland (-21.2%) and Spain (-23.7%). Only Greece fell further, losing -45.3% for the quarter. Euro banks did worse than US banks. Even the strongest northern European banks, with no exposure to Greece, fell by almost 50% from their highs. Japan was only down by -5.9% for the quarter despite the aftermath of first quarter's natural and nuclear disasters and a surging yen which threatens its export industry. Non-euro countries like the UK (-16.7%) and Switzerland (-18%) also suffered quarterly losses, but more in line with the US.

While Euro-zone issues captured the headlines for the quarter, the economic status of emerging markets

surfaced as a central issue for investors. Emerging markets sold off during the quarter, losing -22.6% per the *MSCI Emerging Market Index*. Emerging economies, particularly China, lead the global recovery after 2008. But its government driven growth initiatives coupled with US monetary reflation efforts which were effectively adopted by China as it pegged the yuan to the dollar, created inflationary pressure. Investor's fears of government anti-inflation policies and falling economic activity culminated in a rapid sell off of emerging markets shares over the quarter. China lost -25.2% while India lost -19.9% for the quarter. Commodity dependent economies like Brazil (-26.9%) and Russia (-30.9%) also lost ground late in the quarter based on faltering Chinese growth.

Commodities Reverse Course

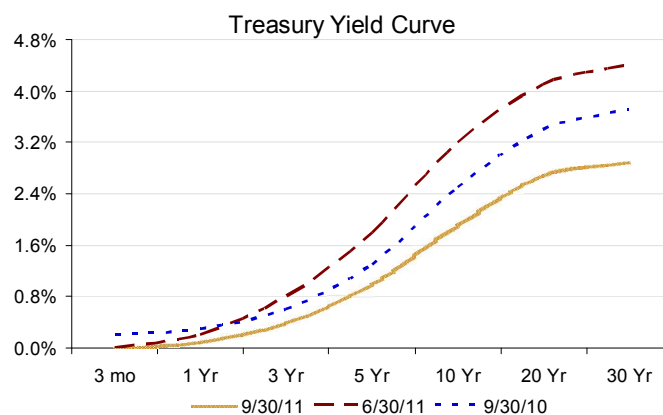
Commodities reversed positive year-to-date returns in September, ravaged by fears of recession, slowing growth in China and a strengthening dollar. The *S&P GSCI Index* was down -11.7% in the quarter leaving a -9.3% loss YTD. All sectors generated losses during the quarter except for precious metals and livestock. Industrial metals fell the most, losing -22.5% due to the uncertain direction of the Chinese economy. Gold rose to a new all time high of \$1921 in September then fell dramatically, fueled by forced redemptions and shocked investors who invested in the belief that it was a safe harbor store of value from the global fiscal crisis. Despite the volatility, gold ended the quarter up 7.8%.

US Treasuries Dominate in Flight to Safety

Recessionary fears across the globe, falling equity prices and the stress in the euro sovereign bond market unleashed a torrent of money into safe haven bonds. The *Barclays Aggregate Bond Index* was up 3.8% for the quarter. Ironically, despite the debt ceiling fiasco and S&P downgrade, US Treasuries were the standout performers for the quarter as their yields fell to generational lows. In the third quarter the 10 yr Treasury yield fell 1.26 basis points from 3.18% to 1.92%. The *Barclays Intermediate Government Index* was up 3.2% for the quarter. 30 year

Treasury rates fell 148 basis points to 2.9% at quarter end, boosting the *Barclays US Long Treasury Index* by an incredible 24.7%. Falling rates benefited other spread sectors as high quality corporate bonds were up .94% for the quarter. Treasury Inflation Protected Securities had a good quarter as well returning 4.5% according to the *Barclays TIPS Index*.

But not all bond sectors rallied. Recessionary fears trumped falling yields in riskier credits. The *Merrill Lynch High Yield Index* lost -6.2% for the quarter as high yield credit spreads widened from about 1.5% in the first quarter to around 8%, still well below the credit crisis peak of about 16%. International bonds, a recent favorite of investors, were eventually hurt by the euro issues and a strengthening dollar. The *Merrill Lynch Global Broad Market ex US Bond Index* lost -.55% for the quarter. Emerging-markets bonds also tumbled, losing an average of -4.4% in the quarter. US money market funds were scrutinized for euro bank exposures and substantially reduced their European bank holdings during the quarter, successfully avoiding investor panic. Most active bond managers were left behind their benchmarks as well this quarter. The *Barclays Capital Bond Index* ranked in the top 7% (7% - YTD, 11% - 1 year) of Morningstar's Intermediate Term Bond mutual fund universe for third quarter.



The Case for Stocks

The primary reason retirement plans and retirement oriented investors allocate savings to stocks is to generate higher expected long term returns than bonds or cash. The price investors pay for the additional return is short term volatility. The value proposition for stocks is called into question in periods like this where investors must not only stomach unexpectedly high volatility but receive negative returns as their payback. Heavy cash-flows out of stocks confirm that many investors have been refiguring their stock holding calculus based on the short term. We think this is a mistake. For long term investors who value incremental returns, stocks remain a preferred asset class, especially relative to bonds or cash over a multi year horizon. Nominal cash yields are close to zero, now and for the foreseeable future. In fact, cash yields are negative on an inflation adjusted basis. Bond yields are at historic lows and are likely to rise as the economy stabilizes and growth is eventually restored. This will put downward pressure on bond prices.

Even if future economic growth falls short of past growth due to de-leveraging, it seems prudent to continue having a sizeable proportion of a portfolio's long term return seeking assets allocated to stocks. While some argue that the future equity return premium could be smaller, none suggest it will be negative.

Sincerely,

Timothy C. Burns, CFA
Hunter Capital Advisors, Inc

