



Q3 2011 Quarterly Investment Commentary

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The Basics: Getting Grounded in Turbulent Markets

For the quarter just ended, world equity markets experienced the steepest quarterly declines since the depths of the 2008-09 financial crisis. The US stock market, as represented by the S&P 500, fell 14%. Smaller companies and foreign markets fared significantly worse. This is the third major decline in just the last four years, including the 15%+ decline from late April to July last year.

Clients who participated in these three market upheavals, not to mention the early 2000s, are justified in asking themselves whether it makes sense to risk their financial future and emotional well-being on something seemingly as random and painful as the investment markets. In case some version of this question is nagging you during this market uncertainty, we wanted to share the following as a perspective that sometimes is lost during volatile times:

- 1. Markets Represent Growth Opportunities:** The financial markets do not exist to destroy growth and prosperity. Quite the opposite. Although it certainly doesn't feel that way now, it is true. Technology, science, air travel, etc. wouldn't be what they are today without the financial markets around to enable them. People around the world benefit personally from these innovations (think iPhones, cloud computing and cancer drugs). And those who risk their hard-earned money in these markets benefit as well. The US stock market, on average, has produced inflation-adjusted returns that are 9x times greater than cash.
- 2. Cash Returns:** Cash is comforting and feels very safe; unfortunately, its security is deceptive. In 1970, a dollar could buy you 16 first class postage stamps; today, it only buys you 2. After factoring inflation into the mix, cash returns are negative 35% of the time over the last 40 years. With current yields on cash at less than 1%, the effective return on it is decidedly negative today.
- 3. Use Planning to Stay on Track:** While markets generate positive returns over very long time frames, they operate in ways that are difficult to handle. Sentiment can change quickly and returns vary wildly from year to year. Stocks have delivered 9 – 10% returns on average over the last 85 years, but they rarely deliver returns around that level in any specific year. Individual year returns have almost always been quite a bit more, and sometimes considerably less, than that long term 9-10% average. It is difficult to have the emotional fortitude, especially in the lows, to stay on track, which is why ongoing planning and communication is so important.
- 4. Diversification Matters:** 2000–2010 was a “lost decade” for the US stock market, but not for world markets. Globally diversified portfolios made money, despite the two major downturns in the US markets.

5. **Markets Can Change Course Quickly:** The last time the market had quarterly performance as poor as this past one was the first quarter of 2009. Recall that the world — and financial markets, in particular — looked pretty grim and scary at that time. Unbeknownst to everyone, a recovery had already taken hold. The S&P 500 increased 20% from its March 9, 2009 low by March 31, 2009. And the second quarter of 2009 was profitable too; the index was up another 16% in those three months.

Third Quarter 2011 Market Performance

Asset Class	Index	Q3	YTD
Fixed Income - U.S.	BarCap Aggregate	3.8%	6.7%
Fixed Income - Foreign	BarCap Global Aggregate	1.0%	5.2%
Cash	30-Day Money Market Yield	0.0%	0.1%
Commodities (Dow Jones)	Dow Jones Commodity Index	-11.3%	-13.6%
Commodities (GSCI)	S&P GSCI Index	-12.0%	-9.6%
Large US Growth	Russell 1000 Growth	-13.1%	-7.2%
U.S. Stock Market	S & P 500	-14.0%	-8.8%
Real Estate	Wilshire REIT Index	-14.6%	-5.4%
Large U.S. Value	Russell 1000 Value	-16.2%	-11.3%
Mid Cap U.S.	Russell Midcap	-18.9%	-12.4%
Developed International	MSCI EAFE Equity Index	-19.0%	-14.6%
Small Cap U.S.	Russell 2000	-21.9%	-17.0%
Emerging Markets	MSCI Emerging Markets	-22.5%	-21.7%

Equity asset class diversification has hurt performance this year, the first extended period since the late 90's when that was the case. While large US stocks are down -8.8% for the first nine months of the year, mid cap US stocks are down -12.4%, small cap stocks are down -17.0% and emerging market stocks are down -21.7%.

Below are our detailed comments on portfolio returns, our thinking about the world's economies, and how they have been affecting markets. We have gotten technical, so for those interested, we invite you to read on.

Economic Commentary

We are in one of the most uncertain market periods since 2008. There are several major concerns troubling the markets: the sovereign debt crisis in Europe, US debt levels and our political acrimony, and fears of a global slowdown and possible recession. Our summary thoughts on each follows:

European Debt: Europe appears to be getting closer to confronting their difficult issues. Greece, while attempting to meet budget targets, will have a tough time doing so. The Euro area as a block, with the main contribution of Germany, has the financial capital to back the debt of most of the heavily indebted countries. European politicians are faced with two bad choices: reward the bad behavior of their Greek neighbors with a bail out or backstop their own banks with a lot of taxpayer funds. Not surprisingly, the policy makers are trying to avoid either of those unpopular choices. As demonstrated in the US with our subprime crisis, things have to get bad before those tough choices are decided upon.

At some point, solutions will be found, as the benefits of European integration have been strong for most Europeans.

US Debt and Politics: The US political battles over our growing debt continue. Neither party has chosen to propose the combination of long-range solutions that are needed to actually deal with our problems, despite the recommendations of several bi-partisan commissions over the years. Government at the federal level is just beginning to shrink, while a retrenchment is already apparent at the state and local levels throughout the US. Part of the reason our overall job growth has been so anemic (and unemployment remained high) is due to private sector job growth getting offset by government job reductions. Our current Federal deficit needs to come down, particularly in the intermediate and long term. Whether we will see anything constructive during the coming 12 months is dubious.

Global Growth Slowdown: The final worry for markets is the fear of slowing growth worldwide with a near-term developed markets recession. We think these fears come from a few different concerns:

- Leadership, or the perceived lack of it. The US Congress and the President have shown a remarkable lack of concern with the actual problems of the day as they wage a political war. Compromise seems impossible to generate and we seem to get closer to the brink of whatever problems we face each time.
- A lack of short-term solutions to our slow growth and unemployment. After years of overspending by both individuals and governments, there is no easy solution. In their recent announcement, the Federal Reserve actually increased the concern and worry, and acknowledged the difficulties, settling on a move to lower long-term rates that were already near all time lows.
- Investors fear that China's growth may be coming to an end as they try to finesse moderating the inflation in their economy.
- The baby boomers are facing the end of their working years and beginning to see the need for income generation from their portfolios, along with a myriad of other problems with the likes of Social Security and Medicare. As a result, consumer spending is moderating.

Looking Forward: We understand these fears, and at the same time are responsible for the long-term investment of our client's wealth. This means we constantly assess probable and potential outcomes and the options for managing portfolios diversified across multiple asset classes.

- Europe will manage to handle the sovereign debt crisis and austerity measures will continue for the peripheral countries. Sovereign debt woes notwithstanding, the economic and social benefits of European integration have been strong for most Europeans. Portugal, Spain, Italy and Greece will experience negative growth as their economies adjust, but Europe will muddle through.
- In the short term, the data do not suggest a deep recession is imminent. In the long-term, the US will make some tough decisions resulting in important cuts of \$2T to \$4T from our fiscal spending over the next ten years (\$200B to \$400B per year). These cuts will tend to slow the growth of the US economy. At the same time, offsetting some of these growth challenges are

the effects of historically low interest rates. Even with unemployment high, many people will do fine and a new refi boom will help those with mortgages. US housing issues will be resolved over the next 3 – 5 years (the rate of housing price declines has slowed considerably). Pockets of innovation will continue to drive growth, especially in the tech sector.

- Emerging market economies generally will continue to grow, providing the developed countries with opportunities for export growth. Over the balance of this year and into 2012 we expect slowing global growth, with developed countries overall just barely growing while emerging economies slow down as they dampen inflation.

What is Risk? The Fixed Income Conundrum

Risk is defined as “a situation involving exposure to danger” and in investment terms “the chance that an investment will lose value.” Historically a very low risk asset class, fixed income has had periods of time when fixed it was very volatile. For example, between November 4, 2010 and Feb 8, 2011 the Barclays Aggregate Bond Index declined by almost 5%. Losses like this come at times when rates are low and economic growth improves, causing holders of fixed income to want higher interest payments in anticipation of rising inflation. Where are we now? Currently fixed income in the form of treasuries looks very risky to us. Just as internet stocks rose for years, before their “crash,” treasuries have been expensive and continue to become even more so during this period of “flight to safety.” Several weeks ago, 10-year treasuries hit a yield low of 1.74%, a yield not seen since the 1940’s. Any rise now in yields will cause losses in fixed income portfolios. This is why a historically “low risk” investment is now quite the opposite. Our portfolios contain fixed income managers that track bonds and currencies outside the US. It is very possible that rates could fall even further, causing additional periods of bond underperformance to our index, but with the risk of loss so high, we plan to stick with our strategy and will see the portfolios benefit from it. Rates will eventually rise again, at which time may better support investing into treasuries at higher yields.

Emerging Markets – Key Thesis for Growth

Emerging markets are expected to be the fastest growing economies for the rest of the decade. It’s estimated that by 2030, the BRIC countries alone (Brazil, Russia, China, India) will account for more than 25% of the world’s GDP. While GDP in advanced economies grew on average 3% in 2010, emerging and developing economies grew 7.2%, and the IMF forecasts that the two-speed trend will continue this year. In absolute terms, emerging and developing economies will consume \$1.7 trillion more in goods and services this year than last year. While emerging economies represent 12% of the world’s global stock valuation, those same economies represent almost 50% of the world’s GDP. Opes’ portfolios contain significant allocations of emerging markets, with the Conservative Growth allocation currently at 17%. Growth in emerging market countries will not be linear and there will be setbacks as steep growth has the potential to generate inflation. Emerging economies also are usually suppliers to developed countries and not immune to the business cycles of their customers. On balance, we anticipate emerging market stocks will provide excess returns, and our diversified use of three managers helps mitigate some of the valuation swings.



Portfolios Looking Forward and Conclusion

For our portfolios' fixed income components, an extended period of slow growth probably means rates rising a bit from the current fear-based lows, but stabilizing at historically low rates. We will position fixed income to generate income where possible, but in this low-yield world we do not expect this part of the portfolios to generate much return. It does, however, provide stability to the portfolios. In equities, we are balancing some conservative positioning with exposure to emerging economies where the best opportunity for growth in the coming years resides. We are expanding our holdings in alternative investments to both control overall volatility while looking to gain better return possibilities than those available in current low interest rates.

Best regards,

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