



## Quarterly Investment Commentary

Date: October 25, 2011

To: All Clients and Friends

From: Burt Associates, Incorporated

Re: Q3 Investment Commentary & Portfolio Positioning

### Eurozone Fears Continue to Grip Market

Concerns about Europe's debt woes and negative global economic news sparked recession fears and drove stock markets down steeply in the third quarter. In addition, we saw political tensions in the U.S. over raising the debt ceiling, coupled with falling interest rates, and the loss of the U.S. AAA credit rating. Indeed, a high level of uncertainty within the macroeconomic and political environments contributed to increased volatility within the global financial markets. On a positive note, earnings for corporate America continued to largely exceed consensus estimates.

### Market Performance

The large-cap S&P 500 Index fell 13.87% during the third quarter and has lost 8.68% year to date. This is a sharp reversal after ending the second quarter up over 6%. Small and mid-cap stocks also suffered significant losses in the quarter. The small cap Russell 2000 Index fell nearly 22%, while the Russell Mid Cap Index fell nearly 19%. Across the globe, international stocks were also hit hard. Developed-market foreign stocks, measured by the MSCI EAFE, were down 19.01% for the quarter and nearly 15% YTD. Emerging markets equities, measured by the MSCI Emerging Markets Index, were hit the hardest, down 22.56% for the quarter. While the third quarter was difficult for the global equity market, domestic equities in general have outperformed international equities year to date. From a style perspective, growth continues to have a slight performance advantage over value.

Total Returns for Select Indexes for the third quarter 2011 and YTD

U.S. Stock Indexes	3Q	YTD	Non-U.S. Stock Indexes	3Q	YTD
S&P 500	-13.87	-8.68	MSCI EAFE	-19.01	-14.98
S&P MidCap 400	-19.88	-13.02	MSCI Europe	-22.61	-15.61
S&P SmallCap 600	-19.83	-13.79	MSCI Japan	-6.44	-10.89
Russell 3000	-15.28	-9.90	MSCI EM	-22.56	-21.88
Russell 3000 Growth	-13.90	-7.90			
Russell 3000 Value	-16.63	-11.85			
Russell 2000	-21.87	-17.02			
Russell 2000 Growth	-22.25	-15.57			
Russell 2000 Value	-21.47	-18.51			
Russell 1000	-14.68	-9.25			
Russell 1000 Growth	-13.14	-7.20			
Russell 1000 Value	-16.20	-11.24			
Russell Mid Cap	-18.90	-12.34			
Russell Mid Cap Growth	-19.33	-11.59			
Russell Mid Cap Value	-18.46	-13.01			
			U.S. Bond Indexes	3Q	YTD
			Barclays Capital US Agg Bond	3.82	6.65
			Barclays Capital GNMA	2.94	6.57
			Barclays Capital US Govt 1-3 Yr	0.47	1.35
			Barclays Capital US Treasury Long	24.66	27.55
			Barclays Capital US Treas. Bill 1-3 Mo	0.01	0.07
			Other Indexes	3Q	YTD
			DJ UBS Commodity	-11.36	-13.62
			DJ US Select REIT	-14.54	-5.20

Source: Morningstar (total return in US \$)

Domestic high-quality, intermediate-term bonds, measured by the Barclays Capital U.S. Aggregate Bond Index, gained 3.82% in the third quarter and are up 6.65% year to date. The index benefited from fears of a Eurozone sovereign default and was driven by investors' flight to the relative safety of Treasuries. Long term rates

continued to fall, as the Fed implemented further monetary policy initiatives to bolster a sluggish economic recovery. As such, long term issues significantly outperformed shorter maturities.

## Investment Outlook

In the first part of our commentary, we run through some of the big-picture issues we think are most significant. Our list of concerns has not changed and as we write an update this quarter we are struck by how similar things are to previous quarters. As we have written at length on these concerns in past commentaries—and they are all the subject of extensive and ongoing coverage by both the popular and financial press—we will keep our comments fairly brief.

## Politics and Policy

One of the challenges for investors today is that government policy is likely to determine the path taken by the global economy. This creates tremendous uncertainty because not only is it impossible to predict what will be decided by legislative bodies, it is also difficult to have confidence in what the ultimate effects of those decisions will be. Policymakers seem especially divided on how to approach the fiscal challenges in this particularly vulnerable global economy.

Along these lines, the past three months saw much debate and little progress on the U.S. fiscal deficit, as topics like tax policy continue to be very polarizing. The debt ceiling showdown earlier in the summer was the quarter's most dramatic example of politics contributing to general uncertainty. Many of the portfolio managers and strategists we follow watched the debt ceiling debate in disbelief that politicians seemed to flirt openly with a U.S. default—an occurrence that could be extremely serious if it happened. Despite an 11th hour agreement, the contentious process and lack of meaningful action seemed to drive down consumer confidence and were specifically cited as part of the reason for Standard & Poor's subsequent decision to downgrade the U.S. sovereign debt rating from AAA to AA. The downgrade did not reflect any new information about the debt challenges we face as a country and so we do not view the actual decision as a highly material development. Nevertheless, the downgrade coincided with a sharp downturn in stocks immediately after the news.



Sharp drops in the M2 money multiplier (equal to the M2 money supply divided by the monetary base) show that even though the Fed has pumped up the monetary base with its quantitative easing, very little of this potential liquidity has made it into the actual money supply because banks are not lending out the reserves.

Overall, we continue to view policy mistakes, or simply inaction, as a major unknown and a potential risk factor. Too much austerity too soon could prove counterproductive and reduce tax receipts by a greater amount than spending cuts, thereby worsening the deficit problem. Failure to address the deficit and debt in a meaningful way runs the risk of markets forcing the issue: investors demanding higher returns for taking on the risk of owning U.S. debt, forcing interest rates higher and further choking off growth, not to mention raising the cost of servicing our debt.

Meanwhile, with fiscal policy stalled by politics, monetary policy has been more aggressive with the Federal Reserve deploying a range of tactics for boosting the economy. The quarter began with the end of QE2, the Fed's second bond-buying campaign, and it ended with Operation Twist, by which the Fed will in effect exchange short-term debt on its balance sheet for long-term debt in an effort to reduce long-term interest

rates and encourage lending and investing. The Fed has also made an unusually explicit commitment to keeping rates low until at least 2013. All of these efforts represent extraordinary measures intended to further the Fed's dual mandate of ensuring price stability, and fostering full employment.

Our view of the potential for monetary policy to help has not changed, and we do not believe it will have a significant impact on the economy in the long run. We continue to believe the problem is not that we have overly tight monetary conditions, but that we have stalled liquidity as banks, corporations, and consumers hang onto their dollars rather than spending or lending them into the economy.

### **Debt Reduction Update**

Despite the increasingly heated rhetoric of recent months, little progress has been made toward bringing down the government deficit and debt. The compromise agreement that enabled Congress to raise the debt ceiling promised some deficit reduction, mostly coming after the 2012 election. Nearer term, the budget reduction it effected is minimal and the plan puts off the inevitable decision to raise taxes, cut entitlements, or some combination of both, without which the deficit will reach unsustainable levels.

As we have discussed before, the need for further deleveraging at the consumer level is a major factor in our view that economic growth is likely to be subpar because as consumers pay down debt and increase their savings they have less available to spend. There has been some progress in bringing down the level of consumer debt relative to income, which is necessary for the economy to again grow at a healthy rate.

### **Debt and the Eurozone**

European government debt problems are one of the other issues with potentially huge ramifications for the economy and financial markets. Investors grew increasingly concerned about Greece and the larger economies of Italy, Spain, and even France, as well as European banks due to their exposure to European government debt. We share the view of most experts that Greece cannot repay its debt without some kind of restructuring and is thus a technical default. The question comes down to whether it is an orderly default, which can be managed in a way that avoids a damaging contagion effect that brings down other governments and/or banks, or a disorderly one, in which all bets are off.

As has been the case all along, we worry that markets may essentially force a resolution to Europe's debt issues by driving up bond yields and funding costs thereby pushing the weaker Eurozone nations such as Greece, Portugal, and Ireland towards default. Additionally, this could also force Spain and Italy into a liquidity crisis and potential insolvency. We expect central banks to step in to provide liquidity but this scenario would be a harsh economic shock at a time we can ill afford it.

### **China**

Last quarter we highlighted the potential for a hard landing in China. Since that point, questions about the quality and pace of China's growth have been more prominent. China, like emerging markets overall, is not immune to the slowdowns in the United States and Europe as these markets are key sources of demand for goods produced there. However, our long-term positive view of emerging markets remains intact even as the nearer-term period may see higher volatility and slower growth. Recently, investors have seemed to recognize the potential for an economic slowdown and emerging-markets equities have taken a beating. In fact, toward quarter end, a sell-off in emerging-markets equities has made the asset class attractive from a relative value perspective.

### **Portfolio Positioning - A Rough Three Months for Risk Assets**

This quarter's developments—in which we saw heightened concerns about a global economic slowdown, political gridlock, and serious concerns about shorter-term European and longer-term U.S. debt problems—are consistent with the higher risk levels being seen in the global financial markets. We have continued to have a cautious outlook, believing that the market may not be adequately discounting the significant risks to the global economy and future earnings growth. It is possible that market expectations and prices will come down to better align with the current economic conditions. In the meantime, we will continue to invest and research opportunities within the fixed income and alternative markets that may provide attractive return potential and the ability to mitigate downside risk.

**U.S. Equities:** During the quarter, we made several changes to our U.S. equity allocation. The rationale behind these decisions were driven by multiple factors, including performance, sector allocations, portfolio construction, and management changes. We have added a unique passive investment in the Schwab Fundamental Large Company Index. This investment differs from traditional index investments in that it does not determine stock allocations based on market capitalization, but rather underlying stock fundamentals. In recent years, new index strategies have been introduced detailing the benefits of alternative index construction (i.e. non-market cap weighted). We view this allocation as a complement to our other passive investments, with the opportunity to provide unique risk/reward characteristics in different market environments. Additionally, we added the FMI Large Cap Fund to our model allocations. The managers of this fund have run a relatively concentrated portfolio focusing on companies with strong franchises, solid balance sheets, and attractive valuations. We like the fact that the managers of this fund have an excellent track record of above average risk adjusted performance, and have historically been good stewards of capital in down markets. We continue to maintain a significant allocation to large cap equities, and in general, our funds performed in line with their respective benchmarks for the quarter.

**International Equities:** The ongoing sovereign debt crisis in Europe proved detrimental again for developed market international equities. On top of this, inflation expectations and slowing economic growth punished emerging markets equities in the third quarter. Our international managers believe fundamentals and valuations appear attractive, but macroeconomic concerns, technicals, sentiment and risk aversion are controlling the market. Emerging markets equities suffered significantly in the quarter, but now offer valuations not seen since early 2009. While emerging economies face a different set of challenges relative to the developed markets, they maintain some of the strongest and most fiscally sound economies in the world, coupled with a growing middle class, increasing consumption and improving corporate governance. We continue to believe this is an attractive proposition, especially given the recent pullback and current valuation levels.

**Fixed Income:** Our largest core bond holding, the PIMCO Total Return Fund, struggled a bit in the third quarter. This came as a result of a tactical underweight to U.S. Treasuries, which benefitted once again from the “flight to quality” trade and the decrease in long term interest rates during the quarter. We see this as a short term tactical error, not a long term trend, as the fund boasts one of the most well respected investment managers in the industry and an exceptional long term track record. We provide portfolio managers the discretion to make tactical decisions, understanding that they will not always be 100% correct. Moreover, it is the ability of the management team to identify and own their mistakes, such that they will not be repeated in the future. Our Investment Committee has previously discussed trimming our allocation to PIMCO Total Return to mitigate the risk of underperformance from tactical allocations, and will continue to evaluate additional managers that we believe will provide superior risk adjusted long term performance. Our allocations to inflation protected bonds and GNMA securities performed well during the quarter, while our short term corporate allocations were adversely affected by a shift to higher credit quality sectors. We continue to research and review additional opportunities within the fixed income markets.

**Alternative Investments:** Our allocation to alternative investments provided some support for the quarter. Our long/short allocations significantly outperformed the equity markets, with the Hussman Strategic Growth Fund up 7.25% in the third quarter. Our allocation to the Gateway Fund also proved beneficial as the hedged strategy also significantly outperformed U.S. and foreign stocks. However, the performance of our global macro fund, the Ivy Asset Strategy Fund, suffered. The managers have continued to invest along several themes. They have allocated significant assets to gold as a global currency hedge. While this has benefitted the fund in previous quarters, gold saw a significant sell-off in the third quarter. Additionally, they continue to invest globally in companies they believe will benefit from the rising middle class within the emerging markets and increased consumption. The manager’s commented that the third quarter saw equity correlations rise significantly, meaning good companies with solid fundamentals sold off as the markets fell and negatively impacted performance. They continue to have a high level of conviction in their positioning, and believe that as correlations fall, companies with strong global growth rates and solid fundamentals will be rewarded. Given the current volatility in the global financial markets and dismal third quarter, we continue to evaluate additional

alternative investments within our portfolio, including managed futures, REITs, and/or commodity related investments.

### **Investing is a Marathon Not a Sprint**

We are not short-term investors. We have little confidence in forecasting what will happen to interest rates or the stock market over the next few days, weeks, or months. Furthermore, we would certainly never base investment decisions on such short term views. We do have confidence in our ability to analyze trends in the capital markets, evaluate investment opportunities, and tactically shift asset allocations over the long term. Over a long term horizon, we believe economic fundamentals and valuations will drive investment returns. Additionally, we continue to focus on the downside-risk analysis in our tactical asset allocation decisions. Our hope is that you, our clients, have a similar long term perspective on investing. Investors should never judge their decisions based on a moment in time. The point we want to emphasize is that when looking at the short-term performance of a fund, manager, or asset class, remember that it is just short-term performance. It is important to understand what is driving the performance and whether or not that is consistent with your investment rationale and expectations moving forward. Do not overreact to the short term. When markets are volatile, as they certainly have been the past few months and years, the long-term cost of overreacting to short-term performance-swings is potentially even higher. Fortunately, market volatility, while unnerving, can also create buying opportunities for disciplined investment managers. We believe we will continue to see significant volatility within the global equity markets over the short term, and that uncertainty regarding not only the macroeconomic environment, but also the political sphere, remains unusually high. Of course, the future is always uncertain. But, in the aftermath of this debt-driven global financial crisis, we believe the range of possible outcomes is wider than most investors would normally consider, especially if expectations are based on historical standards. Matching a client's risk tolerance with the proper portfolio objective and managing expectations is always important, but, in this highly uncertain and volatile environment, it is particularly so; as is maintaining an appropriate long-term time horizon.