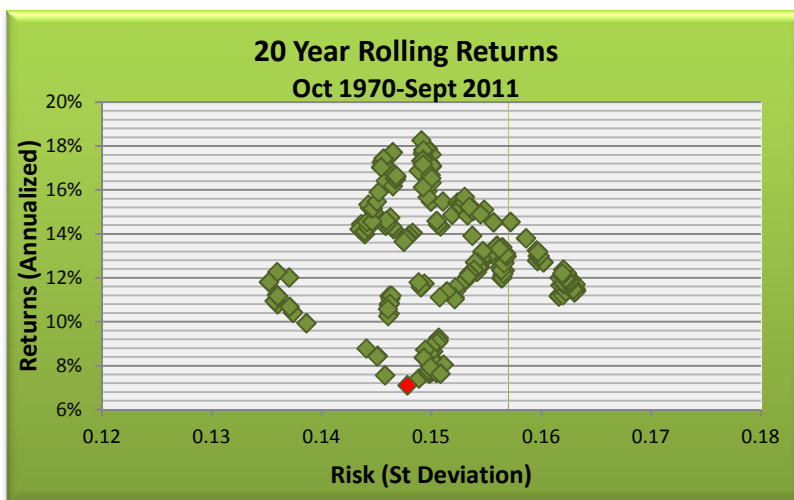


Risk and Uncertainty

One of the biggest challenges to the long-term investor is dealing with uncertainty. If, like the commercial suggests, we could boil our financial goals to a specific number that magically floats over our head, and we could count on a fixed rate of return, it would be an easy matter to determine how much we need to save to achieve our goals. Unfortunately it is not that simple. Especially when dealing with a goal like funding retirement, it is far more complex. How long are you going to live, what will future inflation be, how secure are your other forms of income, what will your health be like are all questions that will impact how much you will need going into retirement. If that was not challenging enough, you then have to consider what kind of return on your investments you might earn both leading up to and in retirement, which is impacted by a variety of other factors such as interest rates for fixed income, and earnings growth for stocks. All of this uncertainty is very unsettling. This is why the financial industry is rife with 'Rules of Thumb' for how much you should save, how much you can spend from a portfolio, or how you should be invested based on your age, to try and bring some degree of certainty to an unsettlingly uncertain endeavor.

Given all these uncertainties, and our natural aversion to it, it only makes sense that as the investment markets becomes more and more volatile, our anxiety increases. Our natural reaction to this is to want to remove the source of our anxiety, often executed by moving to cash. This, however, is a false security. Although it may lessen our current anxiety, it does not actually do anything to reduce the overall uncertainty of our situation. In fact, it may increase that uncertainty even more, as there is now a new variable in the scenario, market timing. We have some understanding of the range of outcomes that a well diversified portfolio can produce, but there is no way to estimate the range of outcomes of moving in and out of the market based on emotional factors. Since we generally want to 'shore up' against loss after markets decline, we may reduce some of the risk of additional short-term loss, but we also risk significantly underperforming over time.

Most of us have seen the studies quantifying the risk of market timing, and how missing the best 20 days out of a 20 year period cuts returns by two-thirds, and missing the 40 best days turns a respectably positive return of 9.1% to a minus 1%. Since many of the best market days follow closely some of the worst, it is not inconceivable that a timing strategy based on anxiety could produce this result. But this represents only one 20 year period. What is more important is that this risk increases the uncertainty of your potential outcome long-term. Looking at *every* 20 year period (measured from month end) between October 1970 and September 2011, the *worst* outcome is 7.1% per year. Our example above is almost 8% below that, meaning that the range of outcomes, i.e. the uncertainty, is now greater. So by trying to avoid the anxiety caused by market volatility, we have increased the risk of failing to meet our goals. This is what a disciplined investment strategy is designed to avoid.



Market Review

US Equities

The selloff in US equities intensified over the quarter with each month of the quarter showing a loss greater than the one previous. Overall the US Equity Market lost 15.3% for the quarter as reflected in the performance of the **Russell 3000 Index**. This pulled the year-to-date return down to -9.9% and the 12 month return to almost even. The broad market now stands more than 19.5% below the November 2007 peak, but more than 64.8% above the March 2009 bottom.

Large company stocks significantly outperformed small company stocks, as investors sought to divest themselves of riskier assets and sought the refuge of large, staid companies. The **Russell 1000 Index** dropped 14.7% for the quarter versus the **Russell 2000 Index's** 21.9% decline. Large company stocks were driven by the largest stocks in the Index as the Russell Top 200, which tracks the largest 200 stocks traded on US exchanges, outperformed both the Russell 1000 and 2000, losing 12.8%. Large company stocks have now pulled well ahead of small company stocks for the last 3 years, but longer term the Russell 2000 is outperforming the Russell 1000 in the 5 and 10 year periods.

Growth Stocks edged out Value stocks for the second consecutive quarter. The **Russell 3000 Growth Index** is now outperforming the **Russell 3000 Value Index** on average for the 1, 3, and 5 year periods. Only at 10 years do Value stocks edge out Growth, by 0.4% per annum.

The continuation of the second quarter's flight to quality again benefitted dividend paying stocks. The **DJ US Select Dividend Index** posted the best quarterly returns among broad US equities for the second consecutive quarter, losing less than 8%, remaining close to even for the year. Year-to-date dividend paying stocks are outperforming the broad market by more than 9.6%.

Every sector declined in the Third Quarter with Basic Materials and Financials faring the worst, dropping 28.6% and 21.7% respectively. Historically defensive Utilities stocks were the best performer by a large margin, losing only 1.2%, while the second best performer, a tie between Consumer Goods and Technology, lost more than 9%. Year-to-Date only Healthcare and Utilities stayed out of the red, and Healthcare only did so by ending the Third Quarter where it began the year.

International Equities

Returns from International Stocks continued to suffer from concerns about the continuing debt issues in Europe and a flight to quality. The **MSCI All-Country World Index (ACWI) ex US** declined **20.4%** for the quarter and is now down almost 19% for the year. Currency had a major impact, exacerbating the losses by as much as 4.5 percentage points, as money sought the relative safety of US dollars in the form of US Treasuries.

Developed Market stocks generally outperformed Emerging, almost solely as a result of currency. In local terms the **MSCI World ex US Index** lost 16% for the quarter to the **MSCI Emerging Markets Index's** -15.7%. But when converted into dollars, the picture flips, with the MSCI World ex US dropping 19.6% to the MSCI EM's losing more than 23%.

Regionally, Europe was the major detractor both in the developed and emerging markets. In the developed markets, the **MSCI Europe Index** lost 23% for the quarter with losses concentrated in the EURO countries which collectively lost more than 28% as measured by the **MSCI EURO Index**. Asian countries fared much better, with the **MSCI Pacific Index** losing 12.7%. Japan was a major contributor, with the **MSCI Japan Index** losing just 7.3%, one of the few places where currency added to return. In fact Yen appreciation boosted local returns by more than 50% for the quarter. Even without Japan, however, the **MSCI Pacific ex Japan Index** outperformed European stocks, ending the quarter down just above 20%. The final region, Canada, fared better than both European stocks and Asian stocks outside of Japan. The **MSCI Canada Index** closed the quarter down 19.4%.

In the emerging markets, it was again European stocks that were the biggest detractor, Eastern European stocks excluding Russia in particular. The **MSCI EM Europe Index** declined almost 30% for the quarter while the **MSCI EM Eastern Europe ex Russia Index** declined more than 34.6%. Asian and Latin American countries fared better, declining 21.9% and 25% respectively. The closely watched BRIC countries of Brazil, Russia, India and China, collectively lost 26.3% for the quarter, with the **MSCI India Index** performing the best, down 20.3% and the **MSCI Russia Index** finishing the worst, down just over 31%.

Currency played a major role, detracting from the returns of most foreign investments in the 3rd Quarter. The one notable exception was the Yen, which added more than 50% to Japanese stock's returns. Latin American investment saw the most significant negative impact, losing more than 50% of their return to currency movement.

Real Estate

After a solid start to the year, Global REIT Investments succumbed to the general aversion for risky assets in the 3rd Quarter. The **Dow Jones Global Select REIT Index** dropped 14.5% in the 3rd Quarter, pulling the year-to-date return in negative territory, down 6.3%. REITs had been staging an impressive comeback in the low-yield environment, rising more than 23.8% in 2010. As of the end of the quarter, however, Global REITs are just hanging on to a positive return for the trailing 12 months, and are still showing a negative return over 3 and 5 years.

Regionally, the **DJ US Select REIT Index**, down 14.5%, outperformed the **DJ Global ex US REIT**, which declined 16.3%. European REITs, the best performer in Q2 were the biggest detractor, down 24.7%. In another reversal of last quarter, Asian/Pacific REITs were the best regional performer, down 11.2%, with Japanese REITs, aided by a strong Yen, losing only 2.7%.

Looking at REIT types, Self-Storage and Healthcare REITs led the field by a pretty good margin, down 4.3% and 6.4% respectively. Every other type experienced double-digit losses with Hotel REITs bringing up the rear for the second consecutive quarter, losing more than 31%.

Commodities

Similar to the 2nd Quarter, Commodities began the quarter strong as the **DJ-UBS Commodity Index** rose close to 3% in July and added another 1% in August. However, the mounting anxiety finally reached commodities in September, which resulted in a 14.7% drop for the month, which set the loss at 11.3% for the quarter. Maybe most troubling is that losses were concentrated in Energy and Industrial Metals, two important commodities for economic expansion. The only two subsectors to avoid losses for the quarter and for the

year were Livestock and Precious Metals, up 5.9% and 2.3% for the quarter and 1.6% and 9.3% for the year respectively.

Copper led the decline for the quarter, dropping more than 26% on news of a global economic slowdown. Gold was the best performer, gaining almost 8%, as some investors continue to use it as a safe haven, however, it was not immune the market volatility as the price per ounce reached just over \$1900 per ounce, just to fall back to \$1620 per ounce by the end of the quarter.

Energy products, including Unleaded Gas and Heating Oil dropped for the quarter, good news for those filling their tanks for winter, and Agriculture has cooled down considerably, losing 9% for the quarter and down 15.6% for the year.

US Taxable Fixed Income

Interest rates declined yet again, in the face of a flight to quality in the 3rd Quarter. Yields on US Treasuries declined across the board, to all-time lows for many maturities, with the largest declines at the longest end of the curve, prompting the **Barclay's Capital (BarCap) Long-Term Treasury Index** to surge more than 24% for the quarter. This helped lift the **BarCap US Aggregate Bond Index** 3.8% for the quarter, and 6.7% for the year. High Grade Corporate Bonds also fared well, as shown in the 3% return on the **BarCap US Credit Index**. Mortgage-Backed Securities, the third major component of the broad market was the laggard, managing a 2.4% return, which is understandable given its much shorter duration which benefits less from falling interest rates.

Lower grade bonds also got swept up in the general sell-off of risky assets. High Yield bonds, which were still outperforming higher grade bonds at the end of the second quarter, gave up more than 6.3% as measured by the **Merrill Lynch/Bank of America (ML/BOA) US High Yield Master II Index**, and are now in negative territory for the year. This caused the spread, the amount they yield over a comparable US Treasury Bond, to widen out almost 300 basis points (3%), the highest level we have seen in over 2 years. Floating Rate Bonds, which help protect against a rise in interest rates, were out of favor in a falling rate environment, and fell more than 3.7%, and now are just slightly below even for the year.

Municipal Bonds

Falling rates helped the municipal market shrug off several negative credit events and continue the year-long rally into the 3rd Quarter with the **S&P National AMT-Free Municipal Bond Index** rising 3.95% for the quarter and 8.94% for the year. Tight supply continues to be a major driver as well, with new issuance well below that of previous years. Yields on Municipal Bonds ended the quarter in excess of 100% of Treasury yields, boosting the tax equivalent yield of the Index, the amount you would need to receive from a taxable investment to have the same after-tax income, to over 5.3%. Just for comparison sake, the Index had an Average Weighted Maturity of just over 14 years and a Yield to Maturity of 3.47%. As of the end of the quarter a 20 year Treasury was yielding 2.66%.

International Bonds

A rally sparked by the hopes of a bailout for Greece helped push the **ML/BOA Global Broad Market ex US Index** up almost 4.8% through mid-quarter, but renewed concerns over Greece and European Banks sent it

plunging back down to where it started, ending the quarter mostly even, down 0.55%. For the year, however, the Global International Bond Market is still holding onto a 4.9% return. Yields fell over the quarter, pushing prices up just over 2%, but the strengthening dollar worked against US investors, causing the decline. Emerging Market Debt severely underperformed developed markets, as the **ML/BOA USD Emerging Sovereign & Credit Index** declined 4.4% for the quarter. As noted above, emerging market currencies were hit especially hard during the quarter which explains some of the underperformance. A general flight to quality explains the rest. Emerging Market debt is now just holding on to a slight 0.33% return for the year.