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Market Letter – Third Quarter Review and Outlook

Review

Investors hoping for a sleepy summer were deeply disappointed in the third quarter. Sovereign debt woes and concerns about the strength of the economy sent the market on a wild ride that at times resembled the volatility of the financial crisis in 2008. The broad-based Morningstar U.S. Index[1] stumbled 8.54% during the last 13 weeks ended September 27. The index is now down 5.6% year to date but still up 5.4% during the last 12 months.

Sovereign debt and deficits dominated the headlines through much of the quarter. In the United States, a heated battle over raising the debt ceiling led the nation to the brink of default. A last-minute deal averted the immediate crisis as both sides agreed to create a bipartisan congressional committee to consider ways to balance the budget and bring down the deficit. Despite the deal, Standard & Poor's downgraded the United States' sovereign debt rating to AA+ from AAA.

But in many ways the real action was in Europe. Successive plans to stem the sovereign debt crisis and contain it to peripheral eurozone economies failed to soothe investors. Worries that the problems could lead to bank failures, or to the end of the euro altogether, sent shares of French and other European banks plummeting and credit spreads on sovereign debt soaring. Coordinated central bank intervention, continued promises from leaders that they are willing to act, and another round of Greek austerity measures calmed markets somewhat toward the end of the quarter. But there remain many outstanding questions about whether the eurozone is taking the right steps to solve the crisis and get Europe back on the path to growth.

Corporations continued to report decent earnings in the quarter. Belt-tightening during the peak of the recession and exposure to emerging markets left firms with lean cost structures and kept profitability high, even in the face of relatively weak U.S. demand.

Index Levels	9/30/11	12/31/10	YTD %	9/30/10	1 year %
Dow Jones 30	10,913	11,578	-5.74	10,788	1.16
Russell 2000	644	784	-17.86	676	-8.5
S&P 500	1,131	1,258	-10.09	1,141	-0.88
MSCI World	1,373	1,658	-17.19	1,561	-12.04

Source: JP Morgan[2]

For the quarter, stocks lost ground across the board with Small-cap core stocks performing the worst shedding 20.47%, and small-cap value, mid-cap value, and large-cap value categories following close behind losing 17.07%, 16.13%, and 12.83%, respectively. Large-cap growth companies constituted the best performing style, only down 8.08% on the year.[3]

Returns across stock sectors were fairly widespread. Communications services led the pack, rising 3.89% in the quarter. The second-biggest gain came from the technology sector (up 0.15%) while the consumer defensive sector (down 0.12%) was third. The biggest losses were in financial-services stocks, which dropped 13.00%. The industrials sector was the second-worst with an 8.70% loss, while energy was third with a 6.81% decline.[4]

Outlook

At the end of last quarter, we noted we would be watching to see if the troubling news that had emerged during the second quarter was a blip or the beginning of a long-term trend. The events of the last three months seem to support the idea that these issues will not be fleeting. As we turn to the fourth quarter, the pressure points that emerged in the third quarter will still be in focus. We expect the next three months will be filled with plenty of drama surrounding the eurozone and how to fix the finances of the United States. However, we remain firmly in the camp that opportunity abounds in equity investing, and we continue to be on watch for undervalued stocks and bonds.

Investment Manager Turnover

As we field questions during our meetings with individual and institutional investors, we often discuss the changes at investment funds or separately managed account companies. These changes can be with and among the investments, but often the conversation turns to the people running the portfolio.

In the past month, several well-known investment houses have experienced manager turnover among some of their most popular portfolios.[5] This occurrence is not new, however. It is becoming more of a question today as investing has become increasingly difficult. Because of our role as Portfolio Manager in some instances and Consultant in others, we dedicate a great amount of resources to measuring the stylistic changes that come about when one manager or group leaves their post, and a new one is assigned.

But have we found that these changes result in positive or negative returns? The data does not strongly support either outcome, thus the conclusion is inconclusive which means investors must be even more vigilant when evaluating managers and filling out their asset allocation model. Many investors are demanding investment alternatives that provide greater transparency with their portfolios.

Past performance is no guarantee of future results. Indexes are unmanaged, do not incur fees or expenses and cannot be invested in directly. Investing in sectors may involve a greater degree of risk than investments with broader diversification. International investments are subject to additional risks such as currency fluctuations, political instability and the potential for illiquid markets. Investing in emerging markets can accentuate these risks.
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[1] The Morningstar U.S. Index is a broad based market index representing 97% of the U.S. equity market capitalization. The Russell 2000 Growth Index is an unmanaged index comprised of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 2000 Value Index measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values. The MSCI World Index is a market capitalization weighted index composed of companies representative of the market structure of 22 developed market countries in North America, Europe and the Asia/Pacific Region.
[2] JP Morgan Asset Management, 9-30-2011
[3] Morningstar, Jeremy Glaser, *Our take in the Third Quarter,* 9-30-2011.
The Morningstar Style Index family consists of 16 indexes that track the U.S. market by capitalization and investment style using a comprehensive, rules-based, 10-factor methodology. Based on the same methodology as the well-known Morningstar Style Box, Morningstar has developed a comprehensive family of 16 indexes that target 97% coverage of the U.S. equity market. The recently enhanced style methodology, which uses ten factors to identify distinct growth and value attributes, creates an integrated framework for stock research, portfolio assembly, and market monitoring.
[4] Morningstar, Jeremy Glaser, *Our take on the Third Quarter,* 9-30-2011.
[5] Vanguard - press release 9-30-2011; Fidelity – press release 9-13-2011.