



MARKET UPDATE

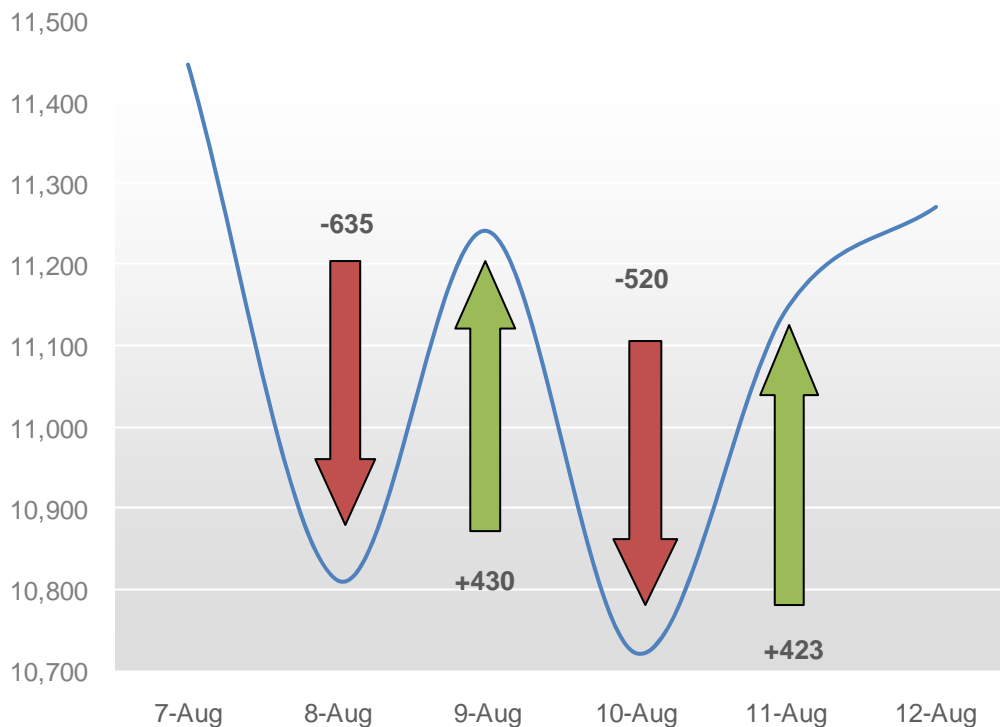
How to Invest in a Bipolar Market

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With the Dow Jones Industrial Average posting 500 point swings on a regular basis lately, it's no surprise investors are uneasy. The markets have been extremely volatile in August due to uncertainty surrounding the ability to contain Europe's debt crisis, a slowdown in U.S. and global economic growth, stubbornly high inflation in emerging economies and the threat of additional downgrades in several developed economies. Investors have responded by reversing the risk trade, sending equities into correction territory, Treasury yields to record lows and gold prices to all-time nominal highs. Although some would argue that much of the information disseminated in the last two weeks was already known, the markets are now trading on fear and emotion, exacerbated by shaky confidence among corporations, consumers and investors.

Dow Jones Industrial Average



Source: Factset, August 15, 2011

Are there any silver linings?

Although most of the headlines have been negative, there are some positive signs that we've seen lately:

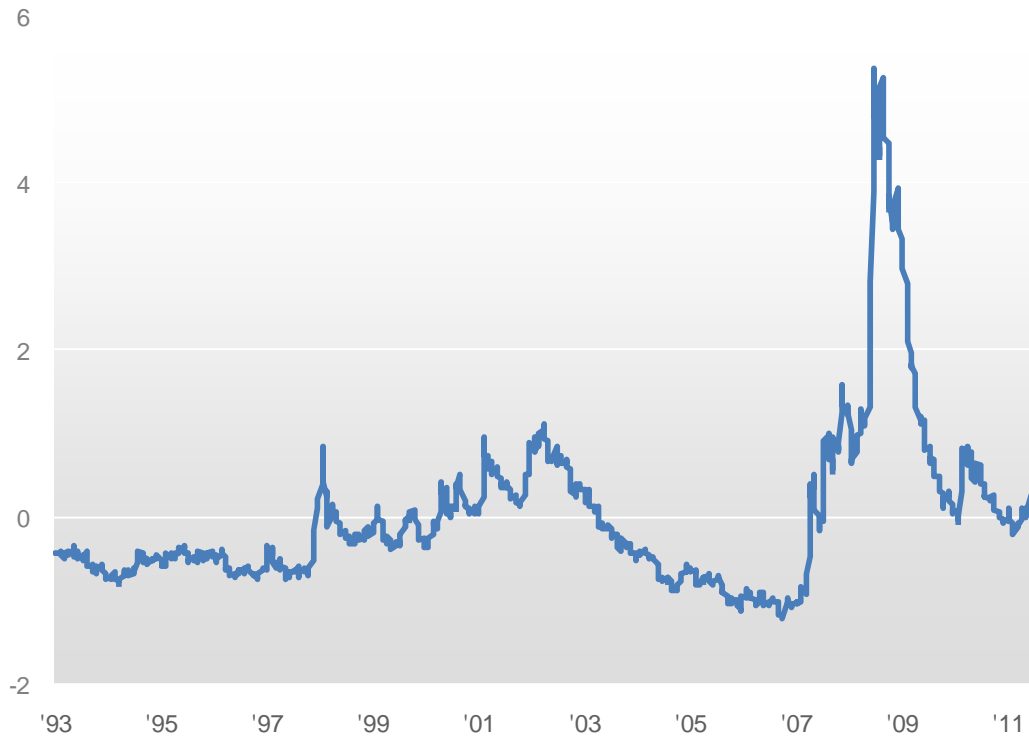
- Recent economic reports on employment, manufacturing, industrial production and consumer spending show a sluggish economy, but do not point to a recession. Specifically, weekly jobless claims are now under the key 400,000 level, payrolls are still growing, manufacturing activity continues to expand and July retail sales were relatively strong.
- Although fiscal policy will most likely be a drag on economic growth over the next two years, monetary policy will not, with the Fed stating exceptionally low rates likely will be in place through mid-2013.
- Inflation is likely peaking around the world with aggressive tightening measures in emerging economies and slower growth pushing commodity prices lower. This should be a positive for consumer confidence and spending.
- Corporate profits are at record highs and reached those levels with anemic economic growth in the first half of the year. Soaring growth rates may be curtailed, but overall earnings should remain fairly strong, while balance sheets are in pristine condition.
- Equity market valuations are extremely attractive even if earnings do contract modestly (which is not our expectation). The 10-year U.S. Treasury yield is now at 2.25 percent compared to a dividend yield of 2.35 percent on the S&P 500 and 2.92 percent on the Dow Jones Industrial Average.

Is this 2008 all over again?

The short answer is no. In our view, the 2008 financial crisis was a combination of irrational exuberance in the housing market, too much leverage at the consumer and corporate level and a liquidity crisis that culminated in the elimination or absorption of multiple high profile financial institutions. Today, consumer and corporate balance sheets are in much better shape; however, sovereign debt is now at the heart of crisis.

Governments, corporations and consumers all rely on the free flow of credit to make investments. When credit becomes scarce, such as during the 2008 financial crisis, confidence sinks and the economy grinds to a halt. With this in mind, there are certain "indicators" that tell us whether or not financial markets are stressed and if banks are increasingly unwilling to lend to one another. Some examples include LIBOR (London Interbank Offering Rate), the TED (Treasury-Eurodollar) spread and corporate bond spreads. The Fed has also created its own Financial Stress Index, which incorporates a total of 18 variables into its analysis. What these and other credit metrics are telling us today is financial conditions have weakened modestly, but are nowhere near levels reached during the 2008 financial crisis or even the initial European debt crisis in 2010.

Financial Stress Index



Source: Federal Reserve Bank of St. Louis, 8/11

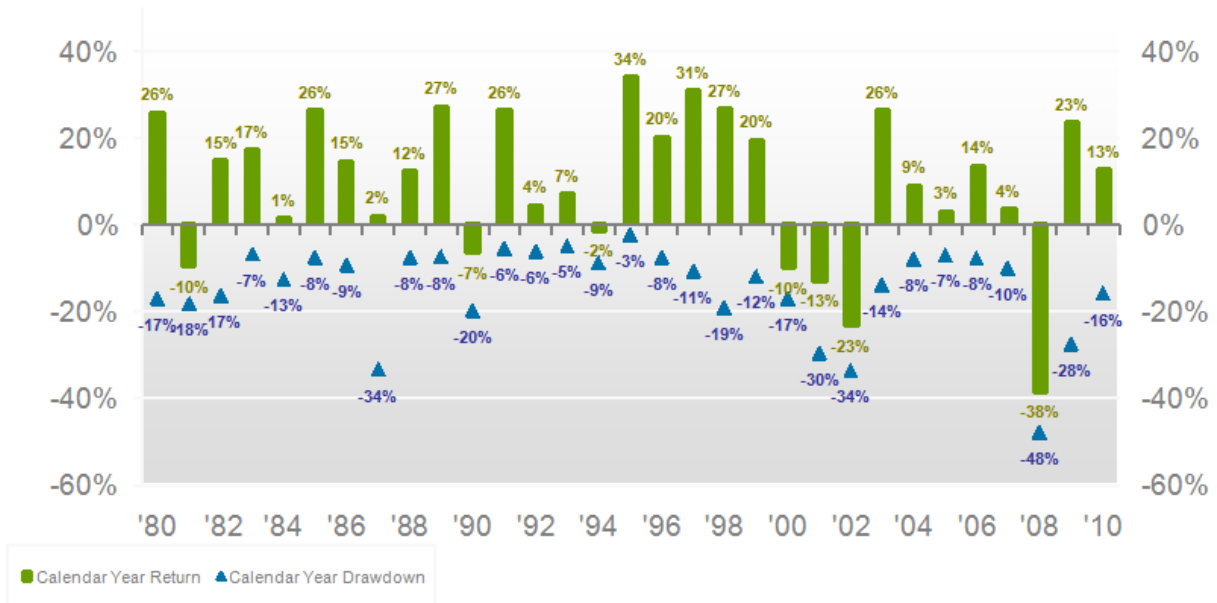
Is this volatility unprecedented?

Although recent market gyrations sting, especially with 2008 still fresh in our memories, the current correction is not out of the ordinary and was somewhat expected. We know from history that ten percent equity market corrections have occurred at least on an annual basis and in some cases more frequently. It had been well over a year since our last correction and we were calling for market consolidation for much of the year. Nonetheless, the recent downdraft was swift and understandably caused angst among investors.

In 2010, the stock market dropped 17 percent between late April and early July. At that time, investors were worried about the European debt crisis and a double-dip recession in the U.S. Thanks in part to QE2 and improvement in the U.S. economy; markets rallied and ended the year higher by 13 percent. Similar headwinds exist today and have caused an 18 percent correction more recently; however, history shows it may not be a lost year.

Below is a chart that illustrates historical calendar year returns and intra-year market declines. We have averaged a 14 percent correction each calendar year over the last 30 years, while markets have finished the year higher 77 percent of the time.

Market Corrections and Annual Returns



* Returns are price only

Source: WMG Research, Factset, Returns are price only

What should investors do?

We suggest that investors should employ a globally diversified portfolio with exposure to fixed income, equities, and real assets, in accordance with their risk tolerance levels and investment objectives. With equity prices on a roller coaster ride lately, it reminds investors how critical it is to have a balanced approach to investing. Although stock prices have fallen in August, high quality bond prices have risen and commodities have only posted modest losses.

Tactically, we believe our portfolios are well-positioned to take advantage of the current market environment. For investors with a long-term time horizon, we see a significant buying opportunity in large-cap equities. Corporate earnings remain strong and the recent sell-off has driven valuations down to levels not seen since the market bottom in early 2009. Likewise, we see tremendous opportunity in emerging market equities with cheap valuations and expectations for solid economic and earnings growth. With developed sovereign rates at or near record lows, we continue to underweight U.S. Treasuries and developed international bonds in favor of spread products such as corporate bonds and emerging markets debt.

Now is not the time for investors to be overly aggressive in their portfolios. Volatility could linger for a while as the European debt crisis and global economic slowdown unfold. This is a good time, however, to rebalance allocations back to strategic weights, to buy underperforming assets at a discount and sell outperforming assets at a premium. Investors who are overexposed to cash may want to consider averaging back into the markets to take advantage of equity prices that just went on sale.

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