



Quarterly Investment Update

October 12, 2010

Brief Market Recap

The stock market continued its roller coaster ride in the third quarter, with strong September gains bringing returns solidly into the black for the full quarter. The S&P 500 Index (a proxy for large cap domestic stocks) rose 11.3% for the third quarter, yet has gained just 3.9% for the year. Foreign stocks had an even stronger quarter aided by a weakening dollar; the MSCI EAFE Index gained 16.5% for the quarter and only 1.1% for the year, and the MSCI Emerging Market Stock Index rose 18.2% for the quarter and 11% year to date.

On the bond side, Barclays Capital U.S. Aggregate returned 2.5% for the quarter and a healthy 7.9% year to date, while Barclays Municipal Bonds Index gained 3.5% for the quarter and just under 7% for the first three quarters. Foreign bonds also benefitted from a weaker dollar, rising over 10% over the quarter and 8.3% for the year.

Market Environment

At the close of the second quarter of 2010, the then 14-month old equity recovery had been noticeably bruised in a sharp decline during May and June. Equities regained their footing after the Fourth of July holiday and rallied through the rest of the month. August was met with a fair amount of consolidation and retrenchment as economic news soured to some extent. However, when September arrived, investors flooded back into risky assets and sent stocks sharply higher through the close of the quarter. In fact, the nearly 9% upward move in the S&P 500 was the Index's best September showing since 1939.

Despite the strong equity results, the economic landscape in the U.S. and abroad remains uncertain and the recovery fragile. While corporations appear fairly healthy and earnings expectations have returned close to 2007 highs, companies remain reluctant to begin hiring at a meaningful rate. Joblessness remains at multi-year highs and new jobs are being created at a rate that is struggling to just keep up with labor force growth, let alone begin chipping away at the nearly 10% unemployment rate.

Conditions also remain fragile in Europe, as the heavily indebted economies of Southern Europe and Ireland struggle under the weight of their debt load and the cost of their social programs. Asia entered the crisis with a much better debt position, yet weakness in demand and declining purchasing power from Western countries make those Asian export-based economies more challenging. This reality was illustrated in September when the Bank of Japan intervened in the currency markets to stem the consistent rise in the value of the yen. The Japanese currency reached a 15-year high in mid-September prior to the Bank of Japan selling something on the

order of one trillion yen in an attempt to halt the currency's rise and protect the interests of Japanese exporters.

Stock market valuations appear to remain at reasonable levels with the possible exception of emerging markets. The price-to-earnings ratio on the S&P 500 sits at 12.3 times forward earnings estimates and 3Q10 aggregate earnings on the S&P are expected to come in at about \$92 - just a few dollars below the peak reached in 2007. However, despite the significant recovery in earnings and market rebound, the S&P would need to rally further over 35% to regain its closing high of 1,565 on 10/09/2007. Developed foreign markets enjoy a similar discount to long term average valuations; however, emerging markets are currently valued a bit richly in comparison to long term averages.

Fixed income investments continued to post gains in the quarter despite historically low yields. Yields on 2-year and 10-year U.S. Treasuries drifted down to 0.42% and 2.53%, respectively. In the opening days of October, yields continued to drop as traders' conviction escalated following the September FOMC meeting about the likelihood of the Federal Reserve embarking on additional quantitative easing. These anemic Treasury yields confound market observers who cannot believe the continued demand for the low-yielding paper. Asset flows into fixed income mutual funds have topped \$200 billion thus far in 2010 on the heels of \$375 billion in inflows for 2009. As a result, news headlines alluding to a coming "bond bubble" have increased markedly.

In the eyes of many pundits, the current monetary and fiscal policy environment is generating a significant risk of inflation in the coming years. While both headline and core (excluding food and energy) CPI are quite low in the aggregate, the picture changes somewhat once one parses the components of CPI. For example, housing broadly makes up 42% of headline CPI and more than half of core CPI. The current housing malaise has pushed its contribution to a slightly deflationary impact. Apparel and recreation also are experiencing deflationary situations. Other areas of the consumption basket, such as transportation, education, and medical care, are experiencing significant price increases. If housing and retail consumption begin to experience price increases, inflation may trend noticeably higher.

Investment Outlook

The National Bureau of Economic Research recently announced that the Great Recession officially ended in June 2009, marking the country's longest and deepest recession since the 1930s. While this is positive news, our big-picture view of the economic environment in the United States remains cautiously optimistic and is largely unchanged from what we have been describing over the past year. We continue to believe we are in for a sustained (multiyear) period of subpar economic growth as a consequence of the financial crisis of 2008 and its aftermath. Ongoing "structural" headwinds such as consumer deleveraging, high levels of unemployment and underemployment, weak wage and income growth, tight credit availability to households and small businesses, weak housing markets, higher taxes, and cuts in local, state, and federal government spending in response to their financial difficulties all imply that aggregate demand, and ultimately corporate revenues and earnings growth, are likely to be under pressure for a while. In short, this is not your typical post-WWII business cycle as shown below.

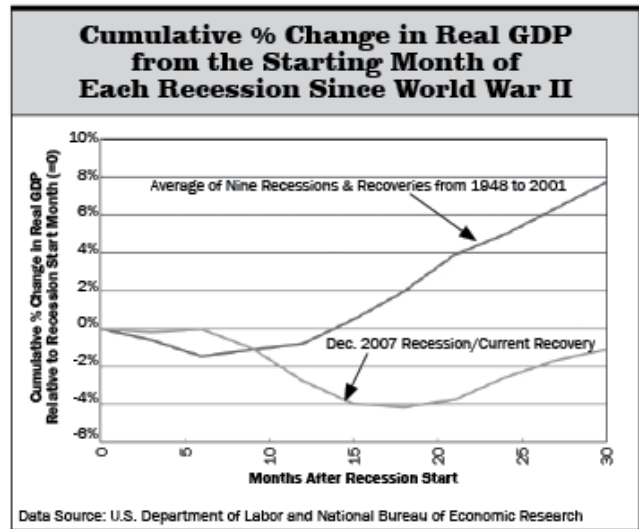
Exacerbating the economic uncertainty is the significant political uncertainty and risk of policy errors. Most pronounced is the tension between those who argue for fiscal austerity now in order to start addressing our deficit and debt problem, and those who maintain that more government stimulus is needed to get the economy out of its current rut. On the one hand, if the creditors who are lending to the U.S. government at the current very low interest rates (2.5% for a 10-year Treasury note) start to lose faith in the credibility and credit-worthiness of the United States and/or the dollar, that could lead to a sharp rise in interest rates, which would not be good for the economy.

However, the news is not all negative, as there are some positive economic signs. Industrial production and earnings have rebounded strongly (more strongly than we expected). Profitability is high (due to aggressive cost cutting during the recession) and companies also have very high levels of cash on their balance sheets.

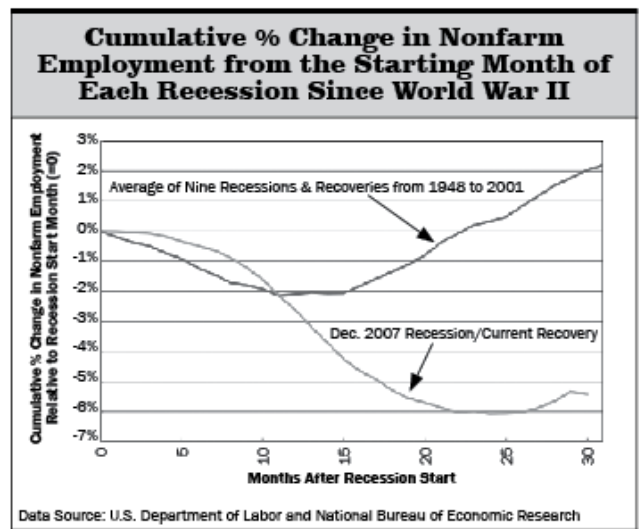
The personal savings rate rose to 6.1% in the second quarter, which, while not helpful for near-term economic growth, is necessary for the longer-term healing of the economy. While interest rates remain low and relatively stable, the exceptionally low rates also reflect the risk of deflation. Developing economies continue their high rate of growth (the IMF forecasts they will grow 6.5% next year versus 2.5% for the developed world) and have relatively strong fiscal/debt balances, which should drive growth in emerging-market demand for U.S. exports.

Concluding Thoughts

As we have worked through the credit crisis and its aftermath, it has become clear to us that we are entering an era that is far different than any other in the post-WWII period. Therefore, in our opinion investors should not rely on the cycles of the past few decades as a road map for what the next five years are likely to entail.



GDP data through June 2010.



Employment data through June 2010.

In our view, we are in the early stages of an environment that requires an intensive and disciplined analytical approach that is also flexible and open-minded in assessing the risks and investment opportunities. The range of potential economic outcomes is unusually wide, with some severe bad outcomes probably more likely than historical experience would suggest. The multi-decade tailwind of declining interest rates for bonds is likely over, so returns from traditional bond indexes will be low. Equity index prospective returns also look subpar relative to their long-term historical averages.

With lower returns likely, it is a good time for investors to revisit their financial independence or retirement plan and make adjustments accordingly. Lower returns compounded over the next five to 10 years might push back retirement dates or require adjustments to spending levels. Investors should also reevaluate and be honest about their true risk tolerance and make sure their overall portfolio allocation is consistent with it. The experience of 2008 through 2009 provided everyone a real-world test of their ability to handle extreme risk and volatility.

In light of the above, we believe this is an environment that favors CapGroup's **Adaptive Risk Management** approach which combines the active management of traditional stock and bond investments with non-traditional/opportunistic investments in asset classes and strategies outside of the standard stock and bond indexes. Our role will be to continue focusing our research efforts on assessing risks across a variety of scenarios, identifying compelling asset class opportunities when they occur, and owning active managers/strategies that we are confident can outperform.

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