



Third Quarter 2009 Capital Markets Review

October 15, 2009

Performance for equities in the third quarter of 2009 was fairly remarkable considering what investors have been through in the past two years. The quarter started with mixed attitudes among investors regarding the state of the economy and ended with double digit performance returns in almost every equity index. While market appreciation has been considerable, particularly from the March lows, we believe economic conditions need to show additional improvement to validate investor enthusiasm.

Continuing the performance run from the end of the second quarter, equities added to their gains and are up healthy double-digits on a year to date basis. While equities across the board performed well, the financial sector within the S&P 500 turned in the best performance with returns of 25.1% for the quarter. Industrials and Materials sectors were also up over 20% for the quarter as commodity prices helped to propel share prices for companies within these sectors. Differences in market capitalization did not have particular impacts on performance during the quarter as small cap companies marginally outperformed large cap companies. However, growth companies significantly outperformed their value peers across the market cap spectrum.

As impressive as the returns in the U.S. have been for the third quarter, as well as the year to date period, international equity markets have performed even better. Investors continue to focus on the rapid economic growth being witnessed in international markets and have been voting with their investment capital that the growth expectations will not disappoint. China, as well as the countries surrounding what is now the second largest economy in the world, continues to estimate fairly rapid growth for the next couple of years. Parts of South America and Europe also appear to be ripe for continued economic growth and investors have been rallying behind those equity markets. At this stage, investors should keep a close eye on growth expectations as even a minor hiccup in countries meeting their projected economic growth rates may subject the markets to some level of correction. Even so, Emerging markets, as measured by the MSCI-EM Index, returned 21.0% during the third quarter and were up 64.9% year-to-date (in U.S. dollars). International developed markets, as measured by the MSCI-EAFE Index, were up 19.5% for the quarter and up 29.6% year-to-date (in U.S. dollars).

The U.S. Federal Government continued its quantitative easing efforts during the third quarter with the goal of keeping interest rates low by adding liquidity to the economic system. Additionally, the Federal Funds target rate continues to be in a range of 0.00% to 0.25%, again with a focus on having liquidity in the system. Improvements in the functioning of the credit markets seem to be continuing, though risk of defaults has not completely subsided. High yield bonds led the bond market returns for the third quarter,

turning in a return of 14.8%, and up 48.5% on a year to date basis, as measured by the Merrill Lynch US High Yield Master II Index. On the other end of the credit scale, U.S. Government Bonds were up 2.0% for the quarter and were down -1.2% for the year to date period. Fiscal problems in some states and localities made headlines during the summer months however, investors have been buying into higher quality positions throughout the year. The Barclays Municipal Bond Index returned 7.1% during the quarter and is up over 14.0% for the year to date period.

Recent market performance has added to optimism that the economic crisis of 2008 is behind us. The performance has also likely increased the risk appetite for some investors and we believe a wholesale move into “risky” assets should not be considered at this time. Potential issues remain within the economic environment including sustainability of the recent growth, quality of corporate profits, consumer spending, potential tax increases, and the health care debate. Each of these identifiable factors may have an adverse impact on the market environment as we move through the next few quarters. Additionally, there is increased debate regarding the manner and speed with which the U.S. Government plans to remove liquidity from the U.S. economic system, and will be scrutinized closely as the market may perceive some actions as a negative situation. It could be assumed however, that with mid-term elections occurring in late 2010, the central bank tendency would likely err on the side of excess liquidity to maintain confidence in the prospects for U.S. economic growth.

As we enter the corporate profits season, investors will likely focus on the quality of corporate earnings releases for the third quarter. Companies spent a considerable amount of time in the past year cutting expenses which should help to improve the profit margin picture. Therefore, it is important to see some companies meeting and/or exceeding growth estimates at the top line, and those companies that are experiencing revenue growth may offer insights into which sectors the economic growth is most pervasive. Interestingly, on a relative basis, third quarter earnings may be quickly overlooked as the fourth quarter year over year corporate profit growth is expected to be fairly impressive due to write-downs and charge-offs from the fourth quarter of 2008.

In consideration of the economic backdrop, we continue to believe having higher levels of yield on assets is an important part of the total return picture. The addition of preferred securities to client portfolios in early 2009 and the more recent incorporation of high income bonds as part of the bond allocation have exceeded our performance expectations. We believe both of these investments continue to be warranted within client portfolios. We may elect to take some of the performance gains off the table with the goal of locking in returns. In fact, we have already started the process of selectively taking some profits from the preferred securities investments within client portfolios.

We continue to maintain an allocation to Treasury Inflation Protected Securities (TIPS) as an inflation hedge within bond portfolios. While the current debate is that deflation is the issue at hand, inflationary pressures often come too quickly and unexpectedly for investors to predict. Also, with the unprecedented amount of liquidity present in the global economy, the deflation/inflation debate will likely begin to heat up as we move through the next few quarters. We believe having this inflationary hedge in place, as a part of the bond allocation, remains warranted in the event inflationary pressures occur more abruptly than currently anticipated.

We have also recently incorporated an investment in client portfolios which we believe offers an opportunity to participate in merger and acquisition activity around the world. Companies will be

searching for ways to improve their corporate profit growth and merger and acquisitions are a probable scenario for many companies to improve their growth profile. In an effort to achieve this exposure, without taking on a disproportionate level of risk, we elected to invest in an arbitrage investment which does not utilize leverage. This should help to provide some level of protection in the event of a sudden market downturn or correction.

As always, we look forward to discussing your specific investment results with you in the coming weeks.