

Summary

Investor Education (Page 3)

- In hopes of helping clients, prospects, and the general public with their long-term investment goals, we are introducing an investor education piece into our quarterly commentaries. This quarter, we discuss the importance of goals when planning investments.

World Economic Review and Outlook

US Economy (Page 5)

- Consumers are gradually recovering, but may continue to struggle as they are forced to deleverage their balance sheets and retrain for new work in an increasingly competitive market environment. The government has already overextended itself with various stimulus programs that are now creating fiscal irresponsibility headlines into the election season. Net exports will take some time to strengthen the economy as new investments are made within the country. In the near term, the US economy's main hope is business spending. Corporations have substantial amounts of cash on their balance sheets.
- During the quarter, in response to deflation hearsay, muted growth prospects, and persistently grim employment picture, the Federal Reserve signaled that they are likely to institute another round of quantitative easing aimed at reducing borrowing rates.
- Another very powerful event during the quarter was the passage of the Dodd-Frank Act. This piece of legislation took a strong step towards financial-reform and re-regulation.

Foreign Developed Economies (Page 7)

- Fears about the Eurozone sovereigns and the associated contagion effect have been alleviated. Assets in Europe, including the Euro, have recovered from their previous lows. Analysts have revised their forecast for a stronger than previously expected recovery in the region. However, we believe that deeper structural problems have yet to be solved.
- The Basel Committee on Banking Supervision, a unit that works under the Bank for International Settlements, passed Basel III. This new regulation requires banks to have substantially higher amounts of capital to protect them against future loan losses.
- The Ministry of Finance (MoF) and Bank of Japan (BoJ) announced plans to intervene in the FX market to combat the strong appreciation of the Japanese yen.

Emerging Economies (Page 8)

- The emerging market growth story continues on track. The output gap, the difference between actual GDP growth and potential long-run, full capacity GDP, has once again turned positive.

World Equity Market Review and Outlook

US Equities (page 9)

- We continue to believe that US large cap equities are one of the most attractive opportunities currently available anywhere in the world.

Foreign Developed Equities (page 10)

- European equities currently have some of the lowest valuations anywhere in the world¹⁴, especially as dividend yields soured past those in the US.¹ However, as discussed above and in the previous quarter, given the significant uncertainty about Europe's economic outlook, we are cautious investors in this space.

Emerging Market Equities (page 10)

- We have been tempted to increase the allocation to emerging markets given the fundamental attractiveness relative to developed world counterparts. However, we remain disciplined investors for our clients, who already have a substantial amount of emerging market exposure as part of their net worth and overall risk profiles.
- Another major cause for concern is the massive amounts of capital flowing into emerging markets.

World Fixed Income Review and OutlookUS Fixed Income (page 11)

- In our view, Treasury yields are just way too low. Short-term real yields are actually negative when you consider normalized annual inflation figures and taxes. High quality mortgage-backed securities and corporate credit are currently offering much greater relative valuations than Treasury yields.¹⁷

Foreign Developed Fixed Income (page 11)

- We once again reiterate that we have no exposure to bonds from Greece, Portugal, Ireland, Italy, or Spain (PIIGS) in our core strategies. This has been the case for quite some time as we do not believe that the risk/reward tradeoffs are beneficial over longer periods at this time.

Emerging Market Fixed Income (page 11)

- Both local and external emerging market bonds are likely to continue to benefit from investors seeking yield.⁵ However, there are many factors to consider when investing in emerging markets.

Commodities Review and Outlook (page 13)

- A heat wave struck Russia, which resulted in wildfires that destroyed large amount of crops. Given that Russia is one of the world's leading wheat exporters, wheat prices nearly doubled before retreating. We believe that the rise in wheat prices will normalize in the coming quarters as normalized supply returns to the market.²⁰

Currencies Review and Outlook (page 14)

- The US dollar dropped relative to most currencies as risk appetite increased and the Federal Reserve signaled further quantitative easing to help jumpstart the US economy.

Investor Education

In hopes of helping clients, prospects, and the general public with their long-term investment goals, we are introducing an investor education piece into our quarterly commentaries. This quarter, we discuss the importance of goals when planning investments.

There are several factors that make it more necessary than ever before for individuals to take control of their personal finances and plans for the future. Many families come to us for advice on their current portfolios not managed by GFG. More often than not, what we find is the portfolio risk level does not match the client's needs or lifestyle. Often, the lead family member, a financial advisor, or broker in charge of the accounts has concentrated holdings. These clients, financial advisors, or brokers are unnecessarily destroying hard earned wealth. For example, it would not be uncommon to see a 70-year individual with no dependents, ample liquidity to retire comfortably, and no major expenditures or donations needed, having 80% equity exposure. If this individual's lifestyle or circumstances would not change one bit if he had twice the wealth, why take on so much risk at such a phase in life?

We will go through ten points to consider about your existing or potential investment style that most overlook:

1. First, list out all the important factors that impact your total wealth. This will include your age, occupation related to major source of income, amount of income producing years remaining before retirement, other sources of income such as rental income, spouse's information, and dependents' information.
 - a. The more information you list, the more relevant you can make your portfolios. For instance, a doctor may have "bond-like" income and can afford to take more equity risk than an entrepreneur of a start-up consumer discretionary company. In another example, a person operating a business with significant emerging market exposure would have less emerging market financial assets than an individual running a business with significant developed market exposure.
2. When creating and evaluating an investment strategy, look at all the accounts per beneficiary in a consolidated view. Identify your family's total wealth, including ownership of businesses, land, homes, retirement accounts, savings accounts, and investment accounts.
 - a. Next, associate each asset and account with a beneficiary in the family. This will help create investment objectives for each beneficiary. You and your wife may have the same investment objective, risk profile, and time horizon. However, dependents may be able to take more risk given their longer time horizons.
 - b. Within this step, be sure to identify which accounts are tax-free or tax-deferred and the maximum amount of capital that can be contributed into those accounts every year. The compounding effect of deferring taxes in investment accounts is one of the simplest ways to build wealth that most people neglect.
 - c. Similarly, a slightly more complicated step that most individuals overlook is choosing certain types of assets for certain accounts. Assets that require substantial amount of taxes to be paid on a regular basis should be shifted to tax-shielded accounts, while assets that already defer taxes until sold should be placed in taxable accounts. The mix of between accounts will depend upon varying tax rates.
3. For each beneficiary, create a list of wealth goals separated by priorities, into "needs" and "wants" buckets. Listing these goals is likely to ensure planned investments meet absolute "needs" and that there is enough risk taken to reach "wants." Wealth goals may include the desire to retire by a certain age, pay for a dependent's college education, and buy a second home. This stage, along with the next, helps identify your short, medium, and long-term return requirements.
4. Associate a time horizon for each goal. For instance, a college education would need to be paid for within a certain timeframe, but the purchase of a boat may not be tied to one point in time. In addition, outline what type of contributions you intend to make into the portfolio on a monthly or yearly basis and the duration of those contributions. It will be difficult but effective if you try to stick to this schedule. This helps establish a sort of asset-liability investment model, similar to what is done by defined benefit program managers. Generally speaking, the longer you wish to make an outflow, the longer the portfolio has to compound returns or even recoup from any losses.
5. Next, identify the amount of risk you are willing to take. How would you react to a 5% loss in a month? How about a 10% loss? What if this translates into a \$100,000 loss in a month? Do you have previous experience with taking risks to build wealth? Market timing is very difficult to do and we have yet to see anyone successfully time market tops and bottoms over multiple cycles, there will be months of losses and you could realize a loss within your first month of investing. This stage will gauge whether or not you will have enough patience to overcome short-term volatility and give long-term asset allocation decisions enough time to pan out.

6. There are differences between willingness to take risk, ability to take risk, and the need to take risk, all of which can conflict. When creating an investment plan, you need to strike a balance between the three while taking into account your wealth goals. Will you be able to satisfy your “needs” with the level of risk taken? Are “wants” realistic with the level of risk taken? There is a possibility that one is nearing retirement age without enough assets to fully retire. In this case, the individual may not be willing to take additional risk in his portfolio and may not be able to either since the time horizon was so short. But, in order to generate a rate of return high enough to retire, the portfolio needed to take on more risk.
 - a. In another scenario, parents may position their children into ultra-conservative strategies. These children may not even be college age, yet their portfolios have six-figure values. In this case, the willingness to take risk and need to take risk was low, but the ability to take risk was very high. Should that portfolio have experienced losses, the investment horizon was still over 80 years, a timeframe long enough to recoup those losses. In addition, the children had over 40 years of working life remaining; they had their entire life ahead of them to rebuild themselves.
7. As briefly mentioned earlier, proper tax planning can have a substantial benefit for investors as assets compound. As an example, imagine that a portfolio grows 5% over two years and there is a 20% tax on realized earnings every year. If this 5% came from dividends or interest, you would only be getting 4% after-taxes in a regular account. This amounts to 8% at the end of the second year. If this was in a tax-shielded account, you would have 10%. If you took distributions at the end of the second year, you would still have more than the taxable account (8.2% vs. 8.16% - this differential can be significant over longer periods).
 - a. There are a number of other estate planning strategies that can help preserve wealth, such as utilizing Charitable Lead Annuity Trusts, Generation Skipping Trusts, Grantor Retained Annuity Trusts, and annual transfers below the gift tax to reduce death taxes. We recommend consulting an accountant or tax attorney with questions about various programs available.
8. The next key issue to identify is any special situations that may have an impact on the investment strategy best suited for you. For instance, do you have a substantial equity holding in a company that you are deemed as an insider? Do you have a strong bias not to invest in a certain country? With what investment tools are you comfortable utilizing to meet return requirements? Do you understand the strategy being implemented? In up markets, people tend to pay less attention to where they are invested, but when assets fall, quite often they will ask: well, why was I in that in the first place?
9. Taking into consideration all of the above, generate a diversified mix of asset classes that help you reach your return requirements within an acceptable risk budget. Choose investments that either track those asset classes closely or have the potential to outperform with low tracking error. Many people tend to bucket pools of assets in their minds as “safety money” and “play money.” In reality, it is still one consolidated picture and you will still have safety goals being reached. Within this stage, establish a suitable benchmark to evaluate your returns against. Create guidelines for rebalancing back to target weights for each asset class taking into consideration tax concerns and trading costs.
10. Monitor your investments relative to their benchmarks and the overall consolidated picture relative to your personalized benchmark. Give investments enough time to reach long-term expectations. Review your return objectives and risk tolerance periodically and adjust your exposures as circumstances change. As time progresses, so should your asset mix. Goals will be realized and time horizons will be shortened.

Simple right? The hardest part is staying disciplined and evaluating situations objectively. It is difficult to stick with your asset allocation or investment strategy when your neighbor is earning a higher rate of return with all equities. Similarly, it is difficult to maintain or even rebalance equity exposure after the spikes in volatility of 2008/2009.

World Economic Review and Outlook

World GDP	Actual						Forecast		
	2004	2005	2006	2007	2008	2009	2010	2011	2012
US	3.60	3.10	2.70	1.90	0.00	-2.60	2.70	2.50	3.10
Canada	3.12	3.02	2.83	2.20	0.53	-2.46	3.10	2.50	2.50
UK	3.00	2.20	2.80	2.70	-0.10	-5.00	1.60	1.90	2.40
France	2.50	1.90	2.20	2.40	0.20	-2.60	1.50	1.50	1.20
Germany	1.20	0.80	3.40	2.70	1.00	-4.70	3.20	2.00	1.65
Switzerland	2.53	2.65	3.63	3.65	1.88	-1.90	2.15	1.85	1.90
Australia	3.65	3.23	2.55	4.80	2.23	1.23	3.15	3.55	4.11
Japan	2.78	1.93	2.03	2.35	-1.18	-5.20	3.05	1.40	1.94
Brazil	5.71	3.16	3.97	6.08	5.17	-0.18	7.10	4.50	4.50
Russia	7.20	6.40	8.20	8.50	5.20	-7.90	4.00	4.50	4.50
India	7.25	9.23	9.83	9.50	7.48	6.73	N/A	N/A	N/A
China	10.10	11.30	12.70	14.20	9.60	9.10	10.00	8.90	N/A
South Korea	4.60	4.00	5.20	5.10	2.30	0.20	6.00	4.60	4.90
Mexico	4.00	3.20	4.90	3.30	1.50	-6.50	4.70	3.50	4.20

Current as of 10/9/10

Red = downward revision

Green = upward revision

Source: Bloomberg / Contributor Composite

US Economy

One of the most time consuming parts of wealth management is filtering through noise. This past quarter, it would not be uncommon to wake up to the news and being told that “the world is going to end.” Later in the same evening the news would have “experts” suggest that “the world is recovering faster than previously expected.” It seems like these swings were happening on a daily, if not weekly basis.

Can the world really change that fast? No. There are very few, if any, jobs numbers, inflation data, central bank commentaries, or political speeches given on a single date that changes everything in the world within 12 hours. When receiving headlines or snippets of information, it is important to first identify the incentive of that source to give you such news. The media is notorious for over dramatizing situations to sell an extra newspaper or advertisement.

Similarly, equity managers have an incentive to tell you that the world is growing and that you should invest in equities, while investment grade managers will tell you that the world is coming to an end and that you should convert your entire portfolio to fixed income securities. Meanwhile, high yield managers will tell you something in between citing a deteriorating economic environment but surprisingly low default rates.

Last quarter, we discussed the components of US GDP figures. We pointed out that consumers and government spending are likely to weigh on figures. Consumers are gradually recovering, but may to continue to struggle as they are forced to deleverage their balance sheets and retrain for new work in an increasingly competitive market environment. Unemployment is likely to remain above 8% for years to come, that needs to be accepted as the new norm. (By the way, over the twelve months ending September 2010, 344,000 jobs were created – not ideal, but definitely not a doomsday scenario). The government has already overextended itself with various stimulus programs that are now creating fiscal irresponsibility headlines into the election season.

However, we did discuss some glimmer of hope with net exports and gross private investments. Net exports will take some time to strengthen the economy as new investments are made within the country. A falling dollar is likely to make US goods are more competitive in the global market place. In addition, emerging markets are likely to increase their imports from developed markets gradually.

In the near term, the US economy’s main hope is business spending. Corporations have substantial amounts of cash on their balance sheets. To put things into perspective, at the end of the second quarter, S&P 500 companies had enough cash on their balance sheets to buy 12% of the S&P 500 equity. Ten years ago, they only had enough to buy 3%.¹ This is not a US phenomena, but a global one. At some point, companies will have to shift cash into more productive areas whether it is rehiring much needed personnel, investing in infrastructure, buying up other productive assets and/or companies to grow, or distributing cash to shareholders via dividends or share buybacks. All of these points will help jumpstart the rest of the economy. It has begun to occur already with increased mergers and acquisition activity, as well as increases in dividends and share buybacks. However, we believe it is likely to happen at a faster pace once there is clarity from Washington with regards to long-term taxes and a new round of legislation increasing regulations and possibly impacting foreign trade relations.

Although the truth is that the US is heavily dependent on businesses to act, the government and Federal Reserve continue to push through programs aimed at helping consumers. In 2008/2009, the Fed surprised the market by announcing “quantitative easing,” a program aimed at purchasing mortgage related assets and other very high quality securities in the open market to provide liquidity, ease credit conditions for private borrowers, and lower mortgage rates to slow the decline in the housing market.² This program essentially added a structural buyer in the market with \$1.25 trillion to spend. Given the size of the package and confidence it gave the market about Federal support, this program was very effective as mortgages are very liquid securities, high quality borrowers can again find lenders, and mortgage rates are near record lows.

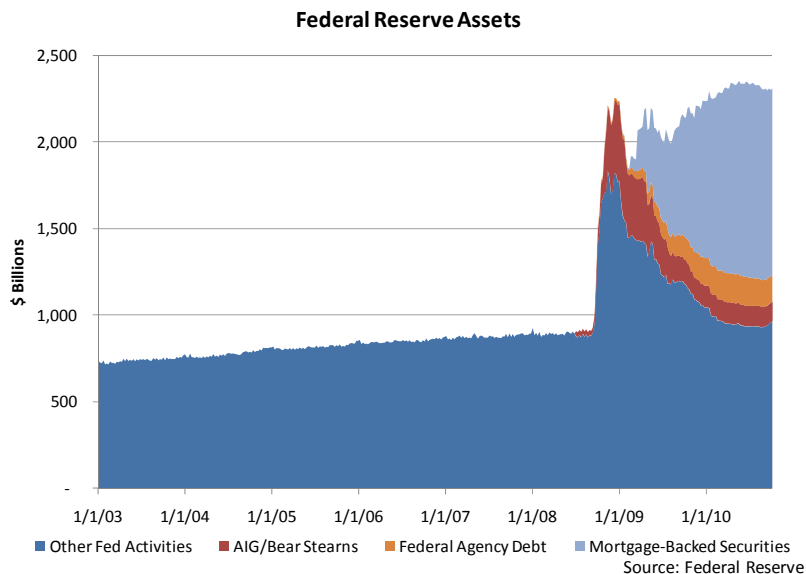
The previous quantitative easing and miscellaneous programs instituted by the Federal Reserve swelled their balance sheet assets from below \$800 billion to over \$2.2 trillion. This prompted many to be concerned about the inflationary pressure on the economy when the Fed decides to reduce their assets to pre-crisis levels. However, why does the Fed need to reduce their assets at all? What is the upward limit on how much assets they can hold? Can they increase it to \$4 trillion, what stops them from raising it to \$10 trillion? The truth is that they do not need to reduce the size of their balance sheet ever and that there is no upper limit on how much quantitative easing they can provide the market. The Fed continues to reiterate that they are “prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time.”

During the quarter, in response to deflation hearsay, muted growth prospects, and persistently grim employment picture, the Federal Reserve signaled that they are likely to institute another round of quantitative easing aimed at reducing borrowing rates. We expect to get more clarity with regards to amount and timing in November. The ultimate goal of the program is to lower the costs for private borrowers beyond mortgages, which would have a positive impact on all asset prices, including equities.² Acknowledging that this may have an inflationary consequence in the economy, they even discussed raising the board’s medium-term inflation target.³ As a result, inflationary expectations by the general public spiked, while yields remained the same or lowered – the exact impact that the Fed was hoping to achieve.

We do not believe that a new round of quantitative easing would reduce Treasury yields much further. It has yet to be seen how much the Fed intends to raise their balance sheet assets. However, we believe that the impact in the financial markets has already been felt. In addition, it does not come as a surprise as it did in 2008/2009. To have a much greater impact on borrowing rates, the Fed would need to announce an amount substantially greater than \$1 trillion and they would have to widen the types of securities they intend to purchase beyond their previous commitments, which would introduce more credit risk in their portfolios. There may be mass disappointment if the Fed fails to meet expectations or even only meets expectations. In any case, all else equal, there would be substantial amount of downward pressure on the US dollar, which would further increase inflationary pressures in the economy. As a result, this would reduce 1) the relative attractiveness in sovereign debt on a risk-adjusted basis, 2) real returns net of inflation, and 3) real returns net of taxes. Therefore, we once again look to businesses to start pumping real cash into the hands of real people for a real recovery.

Another very powerful event during the quarter was the passage of the Dodd-Frank Act. This piece of legislation took a strong step towards financial-reform and re-regulation. There were three major takeaways from this enactment: 1) it established a systemic regulator, 2) it strengthened the oversight of the “shadow banking system,” and 3) it created for how to handle a potential non-bank failure. Large banks have already started to divest some business units and assets in order to conform to this new piece of legislation.

Even though this was a strong step forward to strengthen the financial system as a whole, legislators lost an opportunity to streamline US supervisory agencies so that the left hand knows what the right hand is doing. In addition, although financial stability has returned and bank capital has been boosted, many small and mid-sized banks are still unprepared to compete against larger firms that have sufficient access to the capital markets and huge amounts of Federal Reserve support to weaken the impact of toxic assets.⁴ As a result, we are likely to continue to see bank failures for some time, which increases the importance of the FDIC.



Foreign Developed Economies

Since we wrote last, fears about the Eurozone sovereigns and the associated contagion effect have been alleviated. The immense amount of liquidity provided to the banks via the European Central Bank, sovereigns via the European Stabilization Mechanism and European Financial Stability Facility, and quantitative easing by the ECB has effectively given troubled peripheral countries more time to adjust their fiscal balances.⁵ Officials have justified fiscal consolidation in a slow growth macroeconomic environment by preaching that government soundness is likely to restore confidence in the private-sector, which is likely to restore household and business spending. They expect that the decline in government spending would be more than offset by the private-sector. This is a dangerous game and officials need to be very cautious about consolidating too quickly as it may trigger another recession in the region, as per the OECD's warning.⁶ Unfortunately, the fiscal adjustment required over the coming years may need to be more aggressive than assumed at the time these previously mentioned bailout programs were announced. With regards to Greece, the credit environment is likely to continue deteriorating. Funding stress is likely to increase recourse to the central bank, leading to tighter lending standards, which in turn is likely to result in bank making shorter term loans.⁵

Assets in Europe, including the Euro, have recovered from their previous lows. Analysts have revised their forecast for a stronger than previously expected recovery in the region. However, we believe that deeper structural problems have yet to be solved. Last quarter, we discussed how these deeply rooted problems have not appeared overnight. The last minute liquidity facilities put in place are merely temporary fixes, as we noted. There was a secret committee set up in 2008 in charge of creating a plan to avoid a default by any member in the Eurozone. This task force intentionally kept the public and even most governments shielded from the gravity of these problems. However, due to political reasons, the task force never came up with a strategy. Instead, member nations delayed coming to a solution until the entire Eurozone was on the verge of collapse.⁷ As a result, our view has not changed. We still believe that the Eurozone needs to restructure certain obligations in a realistic manner so that the entire region can build a healthier future. At this pace, a painful subdued economic growth environment far longer than what the US is likely to experience seems inevitable.

During the quarter, the Basel Committee on Banking Supervision, a unit that works under the Bank for International Settlements, passed Basel III. This new regulation requires banks to have substantially higher amounts of capital to protect them against future loan losses. The solvency ratio would need to be increased from an average of 4% to 7%.⁸ Markets embraced this reform as most major international banks already had sufficient capital. In addition, Basel III provides more time than expected for troubled banks to raise sufficient capital. As in the US, smaller banks may continue to face difficulty given the level of access they have to capital markets and the limited amount of support they receive from central banks relative to larger counterparts. Although this was a major step in protecting the financial system against future disasters, it was mostly focused on capital adequacy. Future regulation may include distinctions between risks of different types of assets, such as derivative transactions, and provide levels of acceptable leverage based on varying risk parameters.⁹

With respect to Asia, Japan continues to make an excellent case study whenever new quantitative easing measures are proposed in other developed countries. Robert Shiller could not have said it better, but "they used to refer to Japan's 'lost decade.' Now it is more appropriate to describe that experience as the 'lost decades.'"¹⁰ Japan's economy has struggled to generate sufficient inflation and maintain a steady pace of economic growth for years. Monetary and fiscal policies have been overextended for a while, yet officials continue to add more stimulus.

Most recently, the Ministry of Finance (MoF) and Bank of Japan (BoJ) announced plans to intervene in the FX market to combat the strong appreciation of the Japanese yen. The appreciation of the yen has been attributed to 1) the flight to safety, 2) interest rates in Japan that are more attractive now that benchmark rates in the US, Europe, and UK have dropped so much, and 3) Asian demand for high quality Japanese goods.⁵ The rise in the yen continues to add deflationary pressure in the economy. Even though Japanese companies have altered their cost structures, improved reaction speed to falling prices, and enhanced capital ratios, pressures have increased substantially to remain competitive given the pace of the appreciation.¹¹

Historically, Japanese intervention in the FX market has not been successful. Unlike most central banks, the MoF determines the timing and scale of interventions, not the BoJ. However, there are some legislative actions that may occur in the near future that may improve the efficiency of the country's monetary policy by coordinating with other departments. However, this may threaten the central bank's independence, which would have dire long-term consequences.⁵

	Central Bank Rate		
	Jun-07	Oct-10	Δ
USD	5.25%	0.25%	-5.00%
EUR	4.00%	1.00%	-3.00%
JPY	0.50%	0.10%	-0.40%
GBP	5.50%	0.50%	-5.00%
CHF	2.50%	0.25%	-2.25%
CAD	4.25%	1.00%	-3.25%
AUD	6.25%	4.50%	-1.75%
NZD	8.00%	3.00%	-5.00%
MXN	7.25%	4.50%	-2.75%

Source: Bloomberg

Emerging Economies

Generally speaking, the emerging market growth story continues on track. The output gap, the difference between actual GDP growth and potential long-run, full capacity GDP, has once again turned positive. Unless EM economies are able to effectively reinvest in domestic development, a slowdown is inevitable and investors are likely to overpay for assets. As expected with a positive output gap, core inflation has followed pace with growth. At the heart of EM inflation is food prices, which account for roughly 25% of consumer prices. Inflation numbers have accelerated recently due to a jump in agricultural commodities, led by wheat thanks to the heat wave and wildfires that resulted in crop damage in Russia. Despite a positive output gap and increased inflationary pressure, EM economies have been slow to raise interest rates, preferring to keep their currencies weak to maintain exports. In fact, many EM countries have been intervening in the FX market. With the exception of India, every central bank in Asia has in some way artificially slowed the rise in their currencies. In Latin America, most central banks have been buying US dollars, including Brazil, Mexico, Peru, and Colombia. If EM countries allowed free markets to determine rates, their economies would return to more normalized GDP growth rates. As their purchasing power increases, they would provide support to economic recovery in developed economies.⁵

Within Mexico, the economy has enjoyed a modest recovery due to manufacturing exports. As mentioned last quarter, capital inflows and China's gradual appreciation of the yuan are likely to support a stronger currency. The Mexican peso strengthened to 12.59/USD at the end of the quarter from 12.94 in the previous quarter and 13.09 at the beginning of the year. However, weakening demand from the US and heavy dependence on oil revenues continue to threaten the economy. An increase in private consumption and investments is needed to offset a slowdown in exports to the US. This remains a challenge as slow job creation has left consumer confidence very low and foreign direct investment (FDI) growth has slowed over the past three years. Moreover, nearly 40% of public finances are funded by oil revenues. Lower prices and lower output levels are widening the country's fiscal gap. Tax revenues are only 10% of GDP given the widespread tax evasion, loopholes in place, and limited progress in tax reform. In addition, monopolies and oligopolies are widespread as there is weak enforcement of anti-trust legislation. As a result, Mexico's economy and potential growth may be limited from the potential it could reach in a more domestically competitive environment. President Felipe Calderon has taken steps to promote job growth, reduce poverty, and reform the labor market, but his attention has been divided by heightened drug-related violence.¹²

In other Emerging Market news, China surpassed Japan as the world's second-largest economy and could overtake the US economy by 2030 if current growth trends continue. South Korea implemented a number of measures to boost demand in its weak property sector, including extending tax breaks and easing lending standards, contrary to the moves taken in other EM nations, in particular China. Brazil continues to strengthen with domestic demand on the rise due to higher disposable income and strong loan growth. Finally, Russia's much publicized heat wave and wildfires, which heavily impacted its agriculture sector, are not expected to have much of an impact on annual GDP growth rates.¹³

World Equity Market Review and Outlook

Equities	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
S&P 500	11.3%	3.9%	10.2%	-20.0%	3.2%
MSCI EAFE	16.6%	1.6%	3.9%	-24.6%	13.4%
MSCI EM	18.1%	10.9%	20.4%	-3.7%	83.3%

USD Total Return Source: Bloomberg

US Equities

During the quarter, the S&P 500 TR gained 11.3%, bringing year-to-date numbers up 3.9% and 1-year returns to 10.2%.

We continue to believe that US large cap equities are one of the most attractive opportunities currently available anywhere in the world. Last quarter, we discussed how high quality companies have easy access to cheap capital, have substantial amounts of cash already on their balance sheets, and are likely to use resources to grow organically and through acquisitions. Examples of this include Microsoft issuing debt with coupon payments below the dividend rate on their equity, Cisco announcing that they are evaluating the possibility of instituting a dividend policy for the first time ever, and Dell competing with HP over 3Par's takeover. Stories similar to this will continue to develop once there is clarity from Washington on long-term tax policies.

We believe that US large cap equities remain attractive for several reasons. First, most investor portfolios are underweight equities.⁵ Earlier we discussed long-term return requirements to reach goals. Most investors need to increase their equity holdings to achieve those returns, especially since fixed income yields are so low. This includes pension funds that are underfunded, endowments that subsidize the costs of their institutions, and individuals that cannot rely on any defined benefit program.

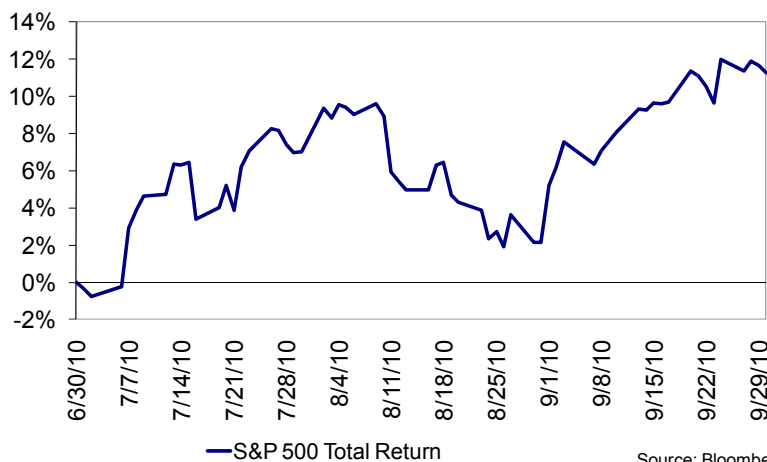
Second, US large cap equities are currently paying dividends close to the yield on 10 year Treasuries. These dividends are expected to grow in 2011, especially as financials begin to pay normalized dividends, which they were restricted from doing over the past two years. Moreover, as of August 2010, the earnings yield (the earnings a company generates as a percentage of its share price) of the S&P 500 was 7.0%, one of the highest yields in decades. Treasuries are yielding roughly 2.5%, a spread of 450 basis points. In addition, as mentioned earlier, S&P 500 companies have enough cash on their balance sheet to buy up 12% of their market cap versus just 3% ten years ago. Over the same period, they are earning \$1.6 trillion versus \$815 billion.¹ All of this comes at a time where valuations are depressed relative to historic norms.

Third, a weakening dollar may also support relative valuations of US companies versus non-US companies, especially since US goods become more attractively priced.

Fourth, large US companies have taken aggressive steps toward expanding globally, including buying up assets in emerging markets. If you conduct a sum-of-parts valuation on these businesses, the valuations on emerging markets are much lower than direct emerging market publicly traded.

Lastly, mergers and acquisitions is accelerating, supporting aggregate asset valuations.

S&P 500 Total Return Three Months Ending 9/30/10



S&P 500 Sectors	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
Consumer Discretionary	15.2%	13.4%	23.7%	-4.1%	11.0%
Consumer Staples	10.6%	7.5%	12.9%	8.5%	37.5%
Energy	12.9%	-0.8%	4.7%	-23.2%	13.8%
Financials	4.3%	0.5%	-2.8%	-54.8%	-44.6%
Healthcare	8.9%	-0.7%	8.3%	-8.3%	7.4%
Industrials	14.3%	13.3%	19.4%	-21.5%	9.7%
Info. Technology	11.8%	0.0%	10.7%	-8.0%	17.1%
Materials	17.8%	2.7%	10.2%	-17.1%	34.6%
Telecom. Services	21.0%	10.8%	19.1%	-20.3%	28.6%
Utilities	12.3%	4.3%	11.9%	-10.8%	13.2%

USD Total Return Source: Bloomberg

US Equities	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
Russell 1000	11.6%	4.4%	10.8%	-19.0%	4.5%
Russell 2000	11.3%	9.1%	13.4%	-12.3%	8.4%
Russell 1000 Value	10.1%	4.5%	8.9%	-25.6%	-2.3%
Russell 1000 Growth	13.0%	4.4%	12.7%	-12.5%	10.8%
Russell 2000 Value	9.7%	7.9%	11.8%	-14.2%	3.9%
Russell 2000 Growth	12.8%	10.2%	14.8%	-10.8%	12.4%

USD Total Return Source: Bloomberg

Foreign Developed Equities

During the quarter, the MSCI EAFE (Europe, Australasia, and Far East) index gained 16.6%, bringing year-to-date gains to 1.6%. About half this return was attributable to a falling US dollar. Aside from the UK, the S&P 500 outperformed each major foreign developed equity index in local terms. Germany, Europe's powerhouse to recovery, only gained 4.4% in the quarter.

European equities currently have some of the lowest valuations anywhere in the world¹⁴, especially as dividend yields soured past those in the US.¹ Our managers continue to find strong, stable businesses with broadly diversified global revenue streams. However, as discussed above and in the previous quarter, given the significant uncertainty about Europe's economic outlook, we are cautious investors in this space. We intend to tactically keep exposure below targets until we feel that Eurozone officials have made sufficient progress towards building a healthier European environment. We will continue to monitor sustainable risk appetite and reallocate back to target allocations opportunistically.

Emerging Market Equities

During the quarter, the MSCI Emerging Market index gained 18.1% during the quarter, bringing year-to-date gains to 10.9%. Currency fluctuations only had a marginal impact on returns and nearly all major indices outperformed the S&P 500 index in local terms. Notably, consumer sectors were among the top performing.

We have been tempted to increase the allocation to emerging markets given the fundamental attractiveness relative to developed world counterparts. Emerging markets have a healthier banking system, healthier reserves, healthier growth prospects, healthy growth in their consumer sector, healthy secular and demographic trends as a whole, healthy levels of capacity utilization and inflation pass-through levels in place. However, we remain disciplined investors for our clients, who already have a substantial amount of emerging market exposure as part of their net worth and overall risk profiles.

As discussed before, we try to complement our clients' various different exposures. In addition, we need to consider how much equity market exposure they already have through the developed market companies that have expanded globally. As discussed in the US equity segment, many large firms, the ones we have been encouraging our clients to invest in for some time have expanded into emerging markets already and are continuing to do so. As a result, their portfolios already have emerging market exposure that is not clearly labeled as "EM." Some of these developed market equities are assigning cheaper valuations to those EM exposures than direct EM exposure through EM equities.

Another major cause for concern is the massive amounts of capital flowing into emerging markets. As an example, the iShares MSCI Emerging Market Index and Vanguard Emerging Markets ETF are among the 5 largest ETFs by assets. John Gabriel from Morningstar Inc. estimates that over the past three years, 61% of all flows into international stock ETFs have been to emerging markets. The two ETFs received inflows of over 10% of their NAV in just August.¹⁵

Foreign Devlpd. Eq.	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
S&P/TSE (Canada)	13.8%	10.3%	15.9%	-7.1%	45.4%
FTSE 100 (UK)	19.7%	2.9%	10.2%	-24.6%	10.8%
CAC-40 (France)	20.3%	-7.4%	-5.4%	-30.0%	8.9%
DAX (Germany)	16.0%	-0.7%	2.1%	-24.2%	39.8%
SMI (Switzerland)	12.9%	4.5%	8.2%	-8.9%	36.0%
S&P/ASX 200 (Australia)	23.8%	5.8%	11.4%	-8.9%	66.0%
Nikkei 225 (Japan)	6.7%	-0.3%	0.9%	-19.4%	0.5%

USD Total Return

Source: Bloomberg

MSCI EAFE	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
Consumer Discretionary	18.6%	9.9%	13.1%	-20.0%	15.0%
Consumer Staples	14.7%	8.9%	17.7%	5.0%	65.0%
Energy	22.5%	-7.9%	-1.4%	-19.8%	3.7%
Financials	17.9%	-2.5%	-6.8%	-41.9%	-15.5%
Healthcare	11.2%	-0.6%	4.8%	-6.5%	17.9%
Industrials	15.9%	9.2%	10.8%	-22.9%	28.2%
Info. Technology	8.3%	3.5%	0.8%	-35.8%	-7.4%
Materials	19.5%	0.2%	13.5%	-22.5%	50.7%
Telecom. Services	20.4%	4.7%	6.4%	-11.2%	29.4%
Utilities	11.3%	-6.4%	-6.7%	-22.9%	34.9%

USD Total Return

Source: Bloomberg

Emerging Market Eq.	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
Bovespa (Brazil)	20.8%	4.1%	17.7%	24.2%	187.5%
MICEX (Russia)	12.3%	4.4%	19.4%	-31.4%	55.1%
BSE SENSEX 30 (India)	17.5%	20.3%	27.2%	6.7%	142.8%
Shanghai SE (China)	12.9%	-15.9%	-0.8%	-43.8%	199.8%
KOSPI (South Korea)	18.6%	14.5%	17.6%	-18.6%	53.9%
TAIEX (Taiwan)	19.6%	6.7%	16.9%	2.1%	73.2%
FTSE/JSE (South Africa)	24.2%	15.0%	30.2%	5.7%	83.3%
IPC (Mexico)	9.5%	8.8%	24.1%	1.1%	93.6%

USD Total Return

Source: Bloomberg

MSCI EM	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
Consumer Discretionary	25.4%	23.5%	39.2%	26.1%	92.8%
Consumer Staples	20.6%	24.3%	43.8%	43.6%	154.3%
Energy	13.0%	-0.6%	7.5%	-13.2%	55.7%
Financials	19.3%	12.6%	20.0%	-3.5%	93.4%
Healthcare	17.8%	21.1%	37.5%	49.5%	100.0%
Industrials	25.6%	20.0%	26.5%	-26.4%	85.7%
Info. Technology	13.8%	2.7%	12.2%	-0.5%	39.5%
Materials	21.8%	10.4%	25.6%	-8.3%	126.6%
Telecom. Services	13.5%	12.1%	13.9%	-11.0%	83.0%
Utilities	9.7%	8.4%	15.2%	2.0%	100.6%

USD Total Return

Source: Bloomberg

World Fixed Income Review and Outlook

US Fixed Income

During the quarter, US Treasury yields once again fell across maturities. This time, yields were supported by the Federal Reserve signaling a second round of quantitative easing, central banks around the world buying up US dollars and reinvesting them into Treasuries in an effort to weaken their own currencies, and persistent recessionary fears in the market.⁵

Currently, fixed income markets are already pricing in massive amounts of quantitative easing. We believe that the Fed is very likely to deliver on those expectations, but there is still the risk that they do not deliver or that they do not deliver as much as the market expects. There is a possibility that investors sell off "on the news" forcing yields up sharply.⁵ Once again we take the contrarian view,

believing that 10-year Treasury yields are unlikely to fall much further. As discussed before, we believe that yields are likely to realize upward pressure due to 1) the relative attractiveness in sovereign debt on a risk-adjusted basis, 2) real returns net of inflation, and 3) real returns net of taxes. If yields to fall much further, investors may end up extending duration further and taking on more interest rate in their portfolios, and/or taking on more credit risk than suitable.¹⁶ The part that concerns us the most is that investors looking to retire in the near future, who have appropriately positioned their portfolios to be ultra conservative, may need to work longer or take on more risk in order to have sufficient funds to retire comfortable.

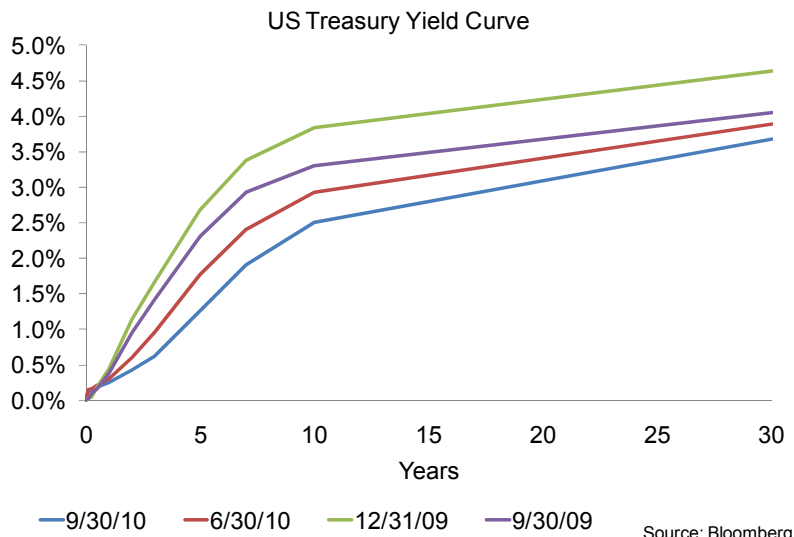
In our view, Treasury yields are just way too low. Short-term real yields are actually negative when you consider normalized annual inflation figures and taxes. High quality mortgage-backed securities and corporate credit are currently offering much greater relative valuations than Treasury yields.¹⁷ As a result, during the quarter, we realigned our fixed income exposure to take advantage of this dynamic, especially since the Fed has announced that they will no longer be reinvesting their mortgage exposure back into mortgages related securities. High yield has had a great year as investors chased yield and default rates decline to record lows on improving fundamentals.⁵ However, we are concerned about the increases in covenant-lite loans as investors seeking yield neglect the nuances distinguishing the detailed risks that are highlighted within prospectuses.¹⁸ There is simply much more to fixed income investing than yield, duration, rating, and the company issuing the debt. Our managers do spend the extra energy going through the various details related to fixed income investing that most investors overlook.

Foreign Developed Fixed Income

We once again reiterate that we have no exposure to bonds from Greece, Portugal, Ireland, Italy, or Spain (PIIGS) in our core strategies. This has been the case for quite some time as we do not believe that the risk/reward tradeoffs are beneficial over longer periods at this time. However, because of our long term, prudent view, this allocation may underperform its index given the short-term sentiment change towards Italy and Spain, the larger troubled peripheral countries within the index. During the quarter, we complemented our core conservative foreign developed fixed income manager with a higher risk appetite allocation that should benefit the entire portfolio should sentiment change in favor of higher risk exposures. As an example, although we do not have exposure to PIIGS, our complementary manager has significant exposure to non-core currencies (USD, EUR, JPY, and GBP) which benefit from the return of risk appetites. In addition, a substantial amount of that manager's exposure is in sovereigns with very sound monetary and fiscal policies. As a result, our overall foreign developed fixed income exposure should protect quite well on the downside and outperform overall on the upside.

Emerging Market Fixed Income

Both local and external emerging market bonds are likely to continue to benefit from investors seeking yield.⁵ However, there are many factors to consider when investing in emerging markets. This quarter we will highlight some of the intricacies of investing in Brazil, one of the more popular destinations for yield chasing investors.



First of all, unlike the Federal Reserve, Banco Central do Brasil is not independent, and as a result one needs to pay closer attention to the amount of political influence driving monetary policy. Next, the Brazilian Real is not fully convertible and all trades still require registration. This may become a challenge as 90% of Brazil's debt is denominated in local currency. In order to be able to trade in local markets, foreign investors need to open a special investment account commonly referred to as the 2689 account. Furthermore, foreign investors typically target longer-dated securities given their long-term investment views on the country, their asset allocation models, and relative yield advantages. However, most local investors focus on shorter maturities and the central bank typically issues fixed-rate bonds on the shorter end of the yield curve to boost near-term liquidity. As a result, the spreads on the back-end of the curve may be wide enough to eat away large amounts of returns when buying and selling securities. And, similar to equities, we remain concerned about the fund flows into emerging market debt. In Brazil, foreign holdings of local fixed income as a percentage of total debt outstanding has increased from less than 1% in January 2005 to over 8% by April 2010.¹⁶

Commodities Review and Outlook

Commodities	Cumulative				
	QTD	YTD	1 Year	3 Year	5 Year
*Energy	3.0%	-8.7%	-2.0%	-43.1%	-58.0%
**NYMEX Crude Oil	5.7%	0.8%	13.3%	-2.1%	20.7%
**NYMEX Natural Gas	-16.1%	-30.5%	-20.0%	-43.6%	-72.2%
*Precious Metals	6.0%	19.8%	28.9%	67.5%	164.9%
**COMEX Gold	5.0%	19.3%	29.7%	76.1%	178.8%
**Silver Composite	16.9%	28.9%	30.7%	58.0%	191.8%
*Industrial Metals	21.0%	3.7%	20.7%	-17.2%	79.1%
*Agriculture	31.3%	7.4%	19.6%	-17.4%	19.7%
*Livestock	3.5%	7.7%	10.9%	-39.2%	-41.2%

* S&P GSCI Official Close Indices TR

Source: Bloomberg

** Price Change

Frequent questions we receive from clients are “why aren’t you holding more gold” and “should I buy some bullion?” It is not easy convincing clients that we recommend keeping only modest exposure to a certain asset class when that asset class is being pumped up in nearly every piece of media out there and every week that asset continues to rise. We mentioned twice in this quarter’s commentary how important it is to remain disciplined to long-term asset allocation decisions that fit your return requirements and risk profile. This may be painful when your neighbor is making money hand over fist chasing the next hot thing to own. However, it does pay off. There is no question about that.

With regards to why we are not exposing our clients to more gold: we discussed this in our last quarterly review. We are nervous about a potential bubble building given the flood of investors choosing to allocate increasing amounts of their portfolio into this asset class. At the end of the day, commodities need actual demand to make sense owning. With gold, you can either make a lot of money or lose a lot of money. We are not willing to take that gamble on pure speculation about increased investor demand.

Next, with regards to buying actual bullion, the answer is no. Our response is supported by the increase in gold ATMs, where you can actually put liquid currencies into a machine that shoots out illiquid pieces of gold. First of all, there is an administrative burden with holding physical commodities. Here are some questions to have answered before you decide to build your own Fort Knox: Who are you going to sell your gold bricks to and are you going to get a fair rate? What is the bid/ask spread that your trader is charging? Where are you going to store your commodities and how are you going to keep them safe? What is the cost associated with that safety? What is the opportunity cost of the money you are spending on the physical commodity today?

We prefer to get our commodity exposure through futures. The bid/ask spreads are tight, the exchange prices are at fair market values, the administrative costs are built into prices, and opportunity cost is accounted for. With futures, returns are more than just the quoted “spot” prices you hear about in the news. There is an extra “roll yield” gained or lost when rolling a contract from one month to another. If the market is in “backwardation,” prices are declining as maturities are extended. Backwardation occurs when there are short-term supply disruptions where the benefit of holding a commodity outweighs the administrative costs of holding it for tomorrow. In this market, there is a positive roll yield gained. If the market is in “contango,” prices are increasing as maturities are extended. Contango is the natural reflection of financing, storage and other costs charged by the market for guaranteeing those commodities to you tomorrow. In this market, there is a negative roll yield. Our managers engage in a dynamic rolling process to address the unstable nature of commodity forward prices. They evaluate the supply and demand flows, annualize the cost of each contract, and determine the cheapest to hold on an apples to apples basis. In addition, they will evaluate the changes in commodity index rebalancing, which drive substantial amount of capitals toward and away certain commodities, look at short term relative price averages versus long term relative prices averages, and invest the collateral in more productive assets than cash given the low amounts of capital required to actually invest in futures.

With regards to major events during the quarter, a heat wave struck Russia, which resulted in wildfires that destroyed large amount of crops. In response, local authorities implemented a grain export ban that led to a spike in global wheat prices as fears of a food crisis spread. Given that Russia is one of the world’s leading wheat exporters, wheat prices nearly doubled before retreating. In our view, the spike was unwarranted as other key producers are able to meet increased demand, including Australia and Argentina. The US is also a major producer, but there are some short term hurdles currently being addressed. Another major reason why the spike in food prices was unwarranted is that wheat from Russia is typically used as animal feed rather than for human consumption. Animal feed is much easier to substitute. We believe that the rise in wheat prices will normalize in the coming quarters as normalized supply returns to the market.²⁰

Currencies Review and Outlook

During the quarter, the US dollar dropped relative to most currencies as risk appetite increased and the Federal Reserve signaled further quantitative easing to help jumpstart the US economy. In addition, confidence is gradually returning to the Eurozone as the bailout facilities put in place in May restored much needed liquidity to banks and sovereigns, easing contagion fears. Moreover, troubled member nations continued to announce plans to tighten their fiscal spending further.

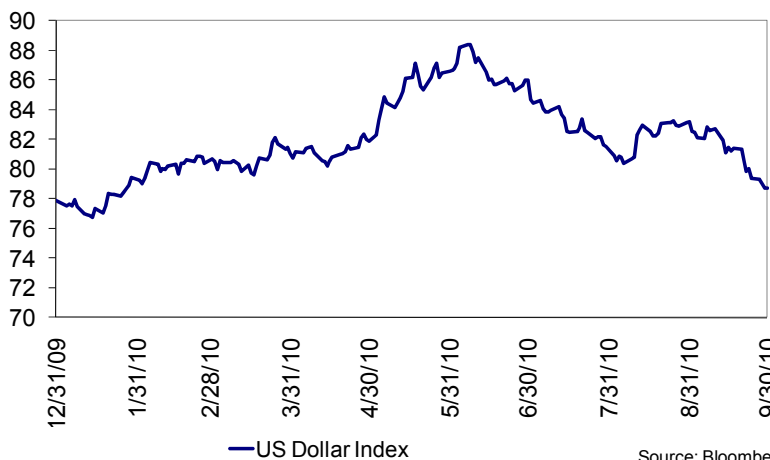
In our view, dollar weakness is beneficial for the entire world. The US is still heavily tied to every major economy in the world, and their growth is dependent on a revival in the US. A weakening dollar would make US goods, services, and assets more attractive on a global basis, reduce the level of imports into the country, and the appreciation of non-US currencies would help develop domestic demand in emerging markets, which would help accelerate the world's growing middle class.²¹

As previously discussed, the major events during the quarter included the Federal Reserve signaling that they may reinstitute quantitative easing and the Japanese announcing they will take steps to intervene in the currency markets to weaken the yen. With regards to the Fed, we believe that their announcement has weakened the dollar at an accelerated rate and that the impact of their actions may already be priced into markets. The Fed would need to announce a program more aggressive than expected in order to avoid a “sell on the news reaction,” which would further put pressure on the US dollar. With regards to the BoJ and MoF, when looking at historic interventions, the Japanese have never been able to sustain a weak yen, and as a result we expect their efforts to be futile once again. Without the massive amounts of artificial currency weakening initiatives undertaken by countries around the world, we would expect the yen to naturally weaken overtime as discussed in the previous quarter.

FX Rates	9/30/10	6/30/10	12/31/09	9/30/09	6/30/09	3/31/09
EURUSD	1.36	1.22	1.43	1.46	1.40	1.33
USDJPY	83.53	88.43	93.02	89.70	96.36	98.96
GBPUSD	1.57	1.49	1.62	1.60	1.65	1.43
USDCAD	1.03	1.06	1.05	1.07	1.16	1.26
AUDUSD	0.97	0.84	0.90	0.88	0.81	0.69
USDCHF	0.98	1.08	1.04	1.04	1.09	1.14
USDMXN	12.59	12.94	13.09	13.51	13.19	14.17

Source: Bloomberg

US Dollar Index
YTD Through 9/30/10



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