



Year-to-Date Performance

Dow Jones Industrials	-3.19%	S&P 500 Index	-8.68%	NASDAQ	-8.95%
Bonds ¹	6.58%	International ²	-16.31%	Gold ³	23.57%

October 4, 2011

Dear Valued Client,

A characteristic of good leadership is the ability to pursue **decisive** action in the midst of elevated public anxiety surrounding complex challenges. Looking back 3 years after the financial crisis in the United States, the decisive nature of how our leadership responded is noteworthy. From the troubled asset relief program (TARP), to the various funding facilities and asset purchase programs, both the Federal Reserve and the Treasury worked cooperatively in unprecedented ways to prevent our financial system from spiraling out of control. Although our economy is still struggling from elevated unemployment, tight credit, and depressed housing, each metric would have been much worse had those decisive actions not been made. Looking back is relevant to today's environment because we can see stark differences between the decisiveness of the United States and the more deliberative 17-member European Union (EU). Given the multiple finance ministers and parliaments involved in setting policy, it's understandable why negotiations can be more difficult and prolonged. Unfortunately, market participants do not like uncertainty and as time passes in regard to the debt challenges in Greece, uncertainty is being replaced with fear.

Fear is an emotion that surfaces when uncertainty is high and is typically not rooted in rational thought but in hasty conclusions built upon theory, guesses, or previous experiences. Today, a good portion of the fear in the markets can be attributed to fear of another recession, given the recent downward adjustments in gross domestic product (GDP), as well as the debt contagion concerns in Greece. The media has contributed to this fear, with vivid pictures of people rioting in Greece and individual story lines of families facing hardship here in the US. Based upon what we can see from the economic indicators, there is nothing that indicates to us that we are headed for another recession.

With regard to the debt contagion in Greece, many people are wondering whether a default will ignite contagion similar to what happened here in the US after Lehman Brothers. Since the fall of Lehman is still fresh on most investors' minds, it is easy to understand how parallels can be drawn, but we believe effective policy actions can easily prevent a similar outcome. Unlike Lehman where the liabilities were unknown, most of the owners and their exposures to Greek debt are known, so it's just a matter of giving those owners extra capital so they can write-down the value of their Greek debt without the European banking system going into a tizzy. This is precisely what we did here in the United States with the TARP program, which gave capital to banks so they have some breathing room to write-down bad mortgage loans. Ultimately, the cost of any Greek debt restructuring will be shared by Greek citizens, banks & institutional investors in Greek debt, the European Central



Bank, and the European taxpayer. Although debt restructuring is difficult and painful, as long as it's done in a coordinated, orderly fashion, contagion should be contained.

On a portfolio level, this year has continued to confirm the value of a diversified portfolio. The concept of diversification and asset allocation is to have assets inside a portfolio that are not perfectly correlated with each other, so that if one asset class underperforms, others will at least hold their value. The great aspect of diversification is that it provides the investor with flexibility to hold underperforming assets until they are more appropriately priced. If I own a home and have it up for sale and don't like the offers I am receiving, I ignore them because I have the flexibility to wait until I receive an offer that resembles the home's fair value (assuming I can continue to make the monthly mortgage payment). With a diversified portfolio, as long as the investor has enough liquidity parked in CD's, money markets, & high quality bonds to cover their income needs for the next 5-7 years or so, they have the flexibility to wait until the economy improves and stocks are more appropriately priced to their fair value. Thus, the only investors who are truly at risk in market downturns are those that have short-term liquidity needs that have no other choice but to sell undervalued assets. Willingly selling undervalued assets when one has the flexibility of time to wait until better conditions arise is an act of fear that, historically speaking, has not served investors well.

With each client relationship, determining an appropriate asset allocation is the first and most important step of the investment process. Although the outputs of what percentage to invest in stocks versus bonds/cash are relatively straightforward, the inputs required to determine those percentages involve a combination of both objective and subjective conclusions that can only be formed upon an honest & open dialogue between the client and the advisor. If you'd like to see how your assets are allocated or have questions about your allocation, please feel free to call our office and schedule an appointment.

As we mentioned in last month's letter, the challenges the economy faces are structural in nature and it will take time to remove the excesses, both in consumer debt and in housing. This will require some patience on the part of investors. Our best guess is that the economy is stable enough to avoid a recession, but sluggish enough to keep us from reaching typical growth rates of 3+%. Volatility in stocks will continue, but we're confident that as time absorbs excesses and as individuals and businesses continue to act in their own best interest, free market capitalism will once again have its day in the sun.

Thank you for your continued trust and support. We hope this discussion has been helpful. If you have any questions or would like to sit down for a conversation, never hesitate to call.

Sincerely,

Scott Smith



- 1 *Bond performance measured from the Vanguard Total Bond Market Index (VBMFX)*
- 2 *International performance measured from the I Shares MSCI EAFE Index (EFA)*
- 3 *Gold performance measured from the Spider Gold Shares (GLD)*

The S&P 500 consists of 500 stocks chosen for market size, liquidity and industry group representation. Each stocks weight in the index is proportionate to its market value. The S&P 500 is one of the most widely used benchmarks of US equity performance.

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Diversification can be thought of as spreading your investment dollars into various asset classes to add balance to your portfolio. Although it doesn't guarantee a profit, it may be able to reduce the volatility of your portfolio.