

## **Market Summary**

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The S&P 500 declined 13.9% during the third quarter. The index declined in all three months and experienced upticks in day-to-day and week-to-week volatility. Growth stocks (-13.1%) held up better than Value stocks (-16.2%), while small-cap stocks underperformed (-21.9%).

During the quarter, seemingly intractable political differences in the U.S. over the debt ceiling and in Europe over country solvency threatened the global economy. Political wrangling over the U.S. federal debt ceiling came down to the wire in early August, temporarily sparking fears of a government shutdown. Shortly thereafter, Standard & Poor's cut the U.S. long-term credit rating by one notch to AA-plus. The Federal Reserve Bank reiterated its concern about the strength of economic activity, pledging to keep long-term interest rates low and stepped in to flatten the yield curve and to support the mortgage market. Despite all the fiscal and political turmoil, U.S. Treasury yields continued to decline as investors abandoned risky assets and sought the safety of the U.S. dollar and Treasury issuances.

The best performing sectors included the more defensive Utilities (1.6%), Consumer Staples (-4.2%), and Telecommunications (-8.0%) sectors, as investors flocked to areas of perceived stability and growth. Information Technology (-7.7%) stood out among the cyclical sectors given the outperformance of bellwethers such as Apple and IBM. The cyclical Materials (-24.5%), Financials (-22.8%), Industrials (-21.0%), and Energy (-20.5%) sectors lagged the market.<sup>i</sup>

In the quarter, a composite of our Core Equity accounts lagged the S&P 500, while a composite of our Value Equity accounts outperformed the Russell 1000 Value modestly.<sup>ii</sup> Relative to their benchmarks, our portfolios were helped by their underweight to the Financials sector, yet they were hurt by not having enough exposure in the more defensive Utilities and Consumer Staples sectors. Our stock selection dragged on relative returns: our choices in the Materials, Technology, and Financial sectors added value, but our choices in the Energy, Consumer Discretionary, and Healthcare sectors held us back by more.

## **Economic Outlook**

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The economic outlook for the United States suggests slow growth in the 1-2% range, with core inflation expected at—or below—the Federal Reserve Bank's target of 2%. In such a slow growth environment, economic reports should be mixed, with alternating evidence of both strength and weakness in manufacturing activity, consumer confidence, and retail sales. In the near term, housing continues to be a drag, with the Case-Shiller Home Price Index hovering close to its March 2011 lows. The unemployment rate remains elevated at 9.1%, a number that doesn't reflect the underemployed and those who have given up looking for work.

The long term challenges to our economy come from demographics, high debt levels, and looming entitlement obligations. However, current conditions warrant a near-term focus on supporting economic demand through fiscal stimulus alongside the Federal Reserve's monetary initiatives. Well-placed government spending on research, education, and infrastructure has paid off at different times by fostering societal productivity and risk-taking. However, policy makers in the U.S., acting in response to political pressures, have put

deficit reduction in the spotlight without offering support for demand growth.

As we have previously discussed, concerns about U.S. government solvency are misplaced. Creditworthiness, for business and government alike, results from the productive deployment of borrowed resources, rather than from debt levels alone. Lenders make complex judgments about costs of debt service, future needs for capital, and spending plans. In the prevailing, toxic environment of poor demand growth, pessimism about the future of the United States, and high levels of risk aversion, many simplistic and sometimes extreme solutions are finding favor. The list includes a balanced budget amendment to the Constitution, no-tax pledges, and anti-immigration laws. In place of these reactive measures, we need to set in motion a credible, nuanced, political process to begin addressing long-term fiscal challenges without losing sight of the stimulative policy that nonetheless will be needed in the near term.

For solace from these problems, we need only to look to Europe's struggles to build a "united states," a larger and more stable economic region. As we witness Europe's challenges, it should reinforce our confidence in our United States, a continental economy with vast land and water resources, unique strengths in the rule of law, contractual integrity, and civic participation. The divisiveness engendered by regional inequities in Europe may help focus our attention on shoring up our own state and local economies and our fiscal resources.

### **Portfolio Strategy**

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Despite tepid revenue growth, we believe corporations will benefit from modest cost pressures. We expect that a deceleration in

emerging market growth will help moderate commodity price inflation. We also look for little to no increases in wage costs, as unemployment remains high. With this backdrop, corporate profitability can continue to outpace revenue growth, particularly as productivity gains continue.

Unsavory political theater has shaken confidence in the long term and made markets volatile. Risk aversion and the fear of contagion have made investors flee the equity markets in favor of cash or U.S. Treasuries. At current levels, market valuations provide a margin of safety. With cash and bonds earning next to nothing, potential equity returns will continue to look attractive. JP Morgan has done work estimating that today's equity market risk premium is the highest in 55 years, higher than the bleak conditions of 1974, 1980, and 2009. With this degree of fear and pessimism in the market place, we remain close to fully invested, favoring quality companies characterized by their participation in growing end-markets, with strong balance sheets and business models that generate free cash flow.

Our portfolios remain balanced between cyclical and defensive sectors and underweight financial and interest rate sensitive sectors. For balanced portfolios, we continue to maintain our tilt in favor of equities.

New positions initiated this quarter include EMC Corp., a leading provider of information storage products and software, and Spectra Energy, a leading North American natural gas infrastructure and pipeline company.

We like EMC's growth prospects. Demand for its products is expected to expand at a faster rate than the anticipated 5-6% growth

in overall corporate IT spending. EMC is uniquely positioned to benefit from the shift towards virtualization and cloud computing through its majority ownership in publicly traded virtualization leader VMware. We believe EMC's base business is undervalued when adjusted for the market value of its stake in VMWare. With strong cash flows, EMC has been buying back stock.

Spectra runs a stable, regulated gas pipeline and distribution business, which is benefitting from network effects and the increasing infrastructure demands of the North American gas production boom. We like the company's valuation and dividend payments, as well as its strong sustainability profile. Spectra has a proactive stance on climate change and supports economy-wide climate legislation. Spectra is ahead of many peers in transparency, having produced its first sustainability report in 2008. The company was named to Corporate Responsibility Magazine's prestigious "100 Best Corporate Citizens List" for 2011 and was among the highest-rated energy companies.

**From the Commons**

We added two members to our client service team this quarter: Andrew (Drew) Thompson joined the Boston team, while Kellee Livingston rounded out our team in California. We appreciate your continued confidence in our work and welcome your comments and questions.

<b>Market Index Returns</b>			
	<b>3<sup>rd</sup> Qtr. 2011</b>	<b>YTD 2011</b>	<b>Year 2010</b>
<b>Stocks</b>			
<i>Large Cap:</i>			
S&P 500	-13.9%	-8.7%	15.1%
S&P 500 Growth	-11.6%	-5.6%	15.1%
S&P 500 Value	-16.3%	-11.9%	15.1%
Russell 1000 Value	-16.2%	-11.2%	15.5%
<i>Small Cap:</i>			
Russell 2000	-21.9%	-17.0%	26.9%
<b>Fixed Income</b>			
Barclays Govt/Corp.	4.7%	7.5%	6.6%
Barclays Municipal	3.8%	8.4%	2.4%
Citigroup 3M T-Bill	0.0%	0.1%	0.1%

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*The S&P 500 Index is a broad market index of the 500 largest U.S. large cap companies. The Russell 1000 Value Index is a capitalization-weighted index of the largest publicly-traded US companies that have a low price-to-book, price-to-earnings, and price-to-cash-flow valuations relative to a broader universe of companies. Indexes do not incur transaction costs or other fees incurred by separately managed accounts.*