

**October 2011**

## Monthly Investment Commentary

It was a rough three months for risk assets. Stocks around the globe saw percentage declines from the mid teens to low twenties in the third quarter. Meanwhile, the dollar and Treasuries climbed as investors fled to safety. In considering our investment positioning and our strategy going forward, it is helpful to briefly look backward for context.

Since 2008, we have been working through a period where forces such as the debt crisis in the developed world are particularly influential and must inform our portfolio strategy. Because we've written repeatedly on these issues—and because they are the ongoing focus of the media—we will keep our macro-economic comments brief. Our goal in this commentary is to focus on our investment views and our portfolio strategy as we move ahead.

<b>September Benchmark Returns (Preliminary)</b>			
<b>Large-Cap Benchmarks</b>	<b>Sep</b>	<b>3Q</b>	<b>YTD</b>
Vanguard 500 Index	-7.0%	-13.9%	-8.8%
Russell 1000 (iShares)	-7.5%	-14.7%	-9.3%
Russell 1000 Growth (iShares)	-7.4%	-13.2%	-7.3%
Russell 1000 Value (iShares)	-7.5%	-16.2%	-11.3%
<b>Mid-Cap Benchmarks</b>			
Russell Midcap (iShares)	-9.6%	-18.9%	-12.4%
Russell Midcap Growth (iShares)	-10.1%	-19.4%	-11.7%
Russell Midcap Value (iShares)	-9.2%	-18.5%	-13.1%
<b>Small-Cap Benchmarks</b>			
Russell 2000 (iShares)	-11.2%	-21.8%	-17.0%
Russell 2000 Growth (iShares)	-11.5%	-22.2%	-15.5%
Russell 2000 Value (iShares)	-10.9%	-21.5%	-18.6%
<b>Other Benchmarks</b>			
Vanguard Total Int'l Stock Index	-12.3%	-20.9%	-18.0%
MSCI World ex USA Index	-2.0%	-11.8%	-7.3%
Vanguard Emerging Mkt Stock Index	-16.2%	-24.0%	-23.4%
Vanguard REIT Index	-11.0%	-14.6%	-5.9%
Vanguard Total Bond Mkt Index	0.9%	4.0%	6.6%
Merrill U.S. High Yield Cash Pay	-3.5%	-6.2%	-1.6%
Barclays 7 Yr Muni Bond Index	0.1%	3.1%	7.2%
S&P/LSTA Leverage Loan Index	0.4%	-3.9%	-1.4%
Citigroup World Govt. Bond Index	-2.0%	2.4%	6.5%
JPMorgan GBI-EM Global Div. Index	-9.8%	-8.5%	-2.2%
DJ-UBSCI (Commodity Futures)	-14.7%	-11.3%	-13.6%

There are two themes we have repeated since we began to emerge in 2009 from what has been termed “the Great Recession.” First, is the point that this is not like other business cycles. The huge debt load that precipitated the 2008 financial crisis will take many years to work through. So, during this recovery, we expect economic growth to be below levels seen in past recoveries (as has been the case so far). Second, even as financial markets recovered (and investors flocked to riskier assets), we continued to see significant risks, such as Europe’s debt problems.

Nonetheless, since March of 2009 stocks rose sharply – and given our expectation that the global economy faced continued risks, we deemed it prudent to take some equity risk off the table. In short, we felt that any missed opportunity from having less equity exposure was likely to be modest relative to the “insurance” in the form of downside protection and dry powder in the event these risks drove markets sharply lower. So, although it’s been an eventful and highly volatile quarter, nothing is really new in terms of our broader viewpoint. What is new is that markets have begun to react to the likelihood of slower global growth. This has contributed to stocks and other risk assets falling in value – in a sense resetting to a lower level to take this slower growth (and possibly a near-term recession) into account.

## Where does that leave us now, and looking ahead?

At Align Wealth Management, we've never believed that we could add value using an investment strategy that relied on accurately forecasting the direction of the economy over the near term. And, we are not aware of anybody who can do this accurately and consistently. Instead, we focus on the application of investment science and empirical research to help each individual client make the most of their investment portfolio. Forecasting big-picture outcomes isn't one of those areas, but applying ourselves to understanding the overall investment environment and assessing the ways it might affect the investments owned by each client is an important part of our process.

This quarter's developments—in which we saw heightened concerns about a global economic slowdown, political gridlock, and serious concerns about European and U.S. debt problems—are consistent with the risk scenarios we have been discussing for the past several years. Our balanced portfolios have been positioned relatively defensively, with below-benchmark equity exposure. In the meantime, we had invested in other areas—such as emerging-markets local-currency bonds, and flexible and/or absolute-return-oriented fixed-income funds—that we believed would generate at least acceptable returns with lower risk than equities.

Ironically, concern about a U.S. credit downgrade contributed to risk-averse investors' flocking to Treasuries. This flight to Treasuries was further fueled by concerns about Europe's financial system. As a result, already-low Treasury yields were driven even lower (and Treasury prices higher) while other assets sold off. Knowing we could see periods of fear is the reason that – despite being confident that bond returns would be low over the next five years – we didn't underweight core bonds further. (Similarly, we didn't underweight equities further because we can't be sure a more positive scenario won't play out.) The result has been that while our equity underweight helped, it did not (and was not expected to) completely insulate portfolios from the third quarter declines.

On the equity side, we believed our "opportunity cost" from being underweight was pretty low, and given the risks that were out there we wanted some dry powder to put to work if we saw market declines bring stocks to levels that suggested longer-term returns were significantly better. Indeed, this happened during the third quarter. So, we began gradually putting money back to work in equities. We know that this can increase short-term risk at a time when it feels most uncomfortable. Nonetheless, being successful in the long term requires buying when valuations are more attractive. This entails buying following declines - even as headlines are most disturbing.

## Investing is a Marathon Not a Sprint

We are not short-term investors (i.e., we are not speculators or gamblers). And, we are not market timers. We have little confidence in forecasting (i.e., guessing) what will happen to interest rates or the stock market over the next few days, weeks, or months. And, we would certainly never base investment decisions on such guesses.

What we do have confidence in (tempered by a strong dose of humility and intellectual honesty) is our analysis of scenarios and potential asset class returns when we extend the time horizon out to five or so years *because we believe at some point, over that long of a time frame, economic fundamentals and valuations converge*. Coupled with our 12-month downside-risk analysis and portfolio stress testing, this analytical framework forms the basis for our portfolio allocation decisions. (As an aside, it is very important that our clients have a similar time horizon and are psychologically and philosophically aligned with our approach to assessing return and managing risk. If clients are judging us based on short-term results, and our approach is driven by an analytical framework with a

longer-term focus, at some point we're likely to see a mismatch in expectations and disappointment on both sides.)

As one investor we respect put it, "You need to be a marathon runner when investing. Investors should never judge their decisions based on a moment in time." So, for example, earlier this year when markets were shooting higher, some of our decisions and portfolio positions may have looked overly pessimistic or defensive (and some clients told us they were worried we were becoming too conservative). More recently, as markets tumbled and headlines blared about the possible collapse of the euro zone, perhaps our positioning looked overly optimistic or risky. But, in our opinion, that type of short-term thinking is what leads most investors to get whipsawed, chasing the market (or asset classes or fund managers) on the way up and then riding them down before jumping into the next hot asset class or manager. In other words, buying high and selling low—the path to investment failure.

Conversely, we believe sticking with a process that has been successful over time and using an appropriate time horizon to assess the success or failure of one's investment decisions is critical to winning the marathon of investing. Again, the time frame matters. Don't anchor your analysis to a single period, and particularly not a short-term one. Never forget that when markets are volatile, as they certainly have been, the long-term cost of overreacting to short-term swings is potentially devastating.

## **Speaking of Volatility . . . It Creates Opportunities**

Scary headlines and market volatility, while unnerving, can create buying opportunities for disciplined investors who are able to keep their heads when most others are losing theirs. Good investors are able to ignore emotion by having careful, rational analysis on which to base their decisions. In the third quarter, we took advantage of stock market declines on two occasions. Once to simply rebalance portfolios back to target stock/bond ratios. Early in the quarter we rebalanced portfolios and reduced exposure to some of our fixed-income positions in favor of domestic stocks. And, more recently, we took advantage of market declines to conduct tax loss harvesting to capture valuable tax benefits for our taxable clients. Both of these moves were proactive actions driven by objective reasoning – not by panic over temporary price declines.

Furthermore, our analysis continues to demonstrate that equities' longer-term return potential is becoming more attractive. Accordingly, we plan to add roughly 3-5% to equities in our more risk-tolerant balanced and equity portfolios, trimming our positions in emerging-markets local-currency bonds. We are not increasing equity exposure in our conservative balanced portfolios as these are owned by our less risk-tolerant clients.

As part of this process, we plan to add a small position in the Gateway fund (GTEYX). Gateway uses a hedged strategy that seeks to capture the majority of stock market returns with less exposure to stock market risk. If stocks go up, Gateway should deliver positive returns - but it will likely lag an unhedged strategy. If stocks go down, declines should be less severe. This will add yet another dimension of diversification to our managed portfolios. As a result of these portfolio moves, we will be roughly one increment (5%) underweighted to "equity risk," with less equity exposure in our more conservative models.

These portfolio moves demonstrate our scenario-driven & disciplined approach to asset allocation. With recent declines, stocks have become more attractive in terms of higher five-year expected

returns. In previous commentaries, we have explained that this is how we would likely respond to a meaningful stock market decline. So, our hope is that these moves come as no surprise.

## **Portfolio Changes Increase Expected Return, But Also Expected Risk**

We want to reiterate (yet again) one other very important point. We have added to our equity exposure at what we believe are relatively attractive entry points in terms of their expected five-year returns. However, with the increase in potential longer-term returns also comes increased short-term downside risk. For example, in our worst-case, 12-month stress-test scenario, where we assume stocks decline 25%–30%, our estimate of the potential loss for our Balanced portfolio is now about two percentage points worse than it was before these changes. Again, we think we are being compensated for this additional short-term risk with more attractive long-term return potential.

A final note on risk and expectations: We think we do a very good job analyzing and weighting possible outcomes, but it's worth a reminder that no one knows for sure how things will play out. Intellectually honest advisors know what can and cannot be analyzed with confidence and are straight with their clients. We want clients to know that we are making the best long-term allocations based on thorough, careful analysis, taking risk and return into account. But we aren't investing based on a worst-case scenario because we would be giving up too much return in order to protect against what we consider to be an unlikely outcome. That said, this is a particularly complex environment and we can't be sure a worst-case won't happen. If it did, we could violate our 12-month downside targets. If being able to ride out that level of short-term loss would be difficult for you, we should revisit and discuss your risk tolerance to make sure you are in an appropriate portfolio.

We appreciate your continued confidence during these challenging times. If you have any questions or concerns about your particular situation, we encourage you to contact us.

Best regards,

Align Wealth Management