

Market Commentary

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Worst Quarter for Stocks in Years. Our Advice: Hang in There!

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Stocks tumbled in the third quarter with the S&P 500 finishing down 14%. Global indexes suffered their largest percentage decline since the first quarter of 2009.

The damage was worst in Europe, where French and German stock indexes both lost more than 25% of their value, their biggest quarterly declines since 2002.

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Quarterly Performance Benchmarks

Passive Benchmarks*	Q3-2011	YTD	1 Year	3 Year†	5 Year†
S&P 500 Index	-13.9	-8.7	1.1	1.2	-1.2
MSCI KLD 400 Social Index	-13.2	-8.7	0.5	1.9	-0.7
DJIA (reinvested dividends)	-21.4	-14.9	-3.2	0.6	-0.2
S&P MidCap 400	-19.9	-13.0	-1.3	4.0	2.2
Russell 2000 (Small Cap)	-21.9	-17.0	-3.5	-0.4	-1.0
MSCI EAFE (Europe, Australasia, Far East)	-19.0	-15.0	-9.4	-1.1	-3.5
MSCI Emerging Markets	-22.6	-21.9	-16.2	6.3	4.9
Barclays Capital Aggregate Bond	3.8	6.7	5.3	8.0	6.5
Lipper Mutual Fund Benchmarks*					
Average US Diversified Equity	-16.7	-11.9	-2.3	0.9	-1.2
Large Cap Growth	-14.9	-10.2	0.3	2.5	0.3
Large Cap Value	-16.9	-12.6	-3.5	-1.7	-3.6
Mid Cap Growth	-20.1	-13.4	-0.8	4.2	1.6
Mid Cap Value	-20.7	-15.9	-4.8	1.9	-1.4
Small Cap Core	-21.3	-19.0	-2.9	1.0	-0.8
International Equity	-20.5	-17.1	-11.0	-1.3	-3.3
Real Estate	-14.6	-6.1	0.5	-0.3	-2.8
Intermediate-term Bond	1.9	4.7	3.8	8.4	5.7

Performance data quoted represent past performance and are not guarantees of future results. Investing involves risk, including loss of principal. Passive benchmarks are unmanaged groups of stocks and are not directly available for investment. Lipper Mutual Fund Benchmarks are compiled by Lipper, Inc., a Thomson Reuters company. Information has been obtained from sources considered to be reliable; however, neither First Affirmative nor its agents guarantee the accuracy of the numbers reported.

* Sources: *The Wall Street Journal*, *The Financial Times*, and MSCI.

† The 3-Year and 5-Year returns are average annual returns for that benchmark.

Flight to Quality Continues. How High Is Up?

Charles Sandmel AIF®, CFP®

The bond markets both surprised observers and confirmed the long-standing pattern that uncertainty drives investors to high quality. The surprises were 1) that Treasuries rallied despite the downgrade of the USA credit rating while stocks declined; and, 2) that longer-term bonds, which are inherently riskier than shorter-term bonds, outperformed.

Since bond prices and yields move in opposite directions, two questions emerge (again)—how high can bonds go and how long will bond market interest rates remain so low?

The Barclays (formerly Lehman) bond indices continued to rally; the US Aggregate returned 3.8% as did the Municipal Aggregate. The Barclays US Treasury Index, returning 6.48%, was the big winner for several reasons:

- Despite the downgrade, U.S. government debt is still one of the world's safest investments and is therefore a preferred refuge from uncertainty.
- Chaos in Europe limited the attractiveness of European bonds as alternatives.
- Long U.S. government bonds rallied in anticipation of the proposed Federal Reserve "twist" program, under which the Fed will sell shorter-term bonds and buy longer-term ones.

The U.S. municipal market, dominated by individual (high tax bracket) investors, nearly matched the prior quarter's high return, but lagged the Treasury Index. It's useful to look at AAA municipal yields in comparison to Treasuries of equal maturity. At the end of June, yields on 10-year AAA munis were about 87% of the yield on 10-year Treasuries (2.7% vs. 3.1%). This is roughly in line with the long-term average yield ratio. By September, the ratio inverted. The yield on Treasuries fell to 1.97%, while the yield on AAA-rated munis fell to 2.18%.

How could this happen, and what does it tell us? In our view, there are two reasons. First, when there is a flight from risky assets, Treasuries are the obvious destination for those "flight assets." As money poured into Treasuries, prices moved higher, which caused yields to fall.

The second reason why munis were not as popular a destination for "flight assets" is that the Administration's jobs bill proposed in August includes a limitation on the

amount of income from municipal bonds that would be exempt from taxation. Passage of that provision (which does not look promising today) would reduce the after-tax advantage of large municipal bond portfolios.

On the other hand, if the Bush-era tax cuts on high incomes are ended at the end of 2012, the value of tax-exemption will rise. These uncertainties around tax-exempt status and future tax rates overlay the fundamental questions of credit quality arising from the weak economy and the effect of national government austerity on local governments.

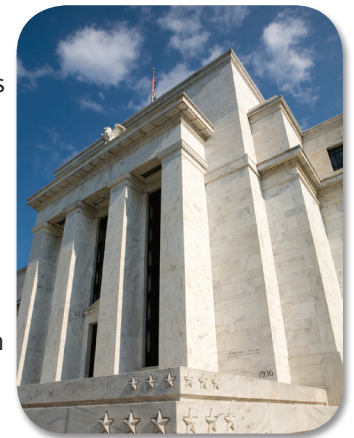
The Federal Reserve recently announced that it would hold short rates at near-zero levels through 2013, which will probably limit movements in short yields. They are equally unlikely to "go negative" or to increase significantly.

Long-term bond yields, which reflect increased uncertainty and price risk, have been quite volatile of late—the 30 year Treasury yield ranged from 2.77% to 3.56% during September, after dropping from 3.75% at the end of June.

Inflation, largely driven by health care and food costs, poses a risk; until the economy kicks up demand, fuel price risk is likely dampened.

While it's hard to simultaneously derive interest income and preserve capital in this market, the ability of bond holdings to reduce overall portfolio volatility continues to offer good value to the diversified investor. Since First Affirmative's bond strategies focus on the lower risk sectors and shorter-term maturities, we recommend staying the course. Bond investment does not favor the bold.

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Four Big Stories

1. The European debt crisis: The ongoing problem with high indebtedness by several eurozone nations (primarily Greece, Portugal, Italy, Ireland and Spain—listed in order of severity) has been causing tremendous uncertainty. The question is whether debt levels are so high that only a major restructuring or bailout will solve the problem. The big losers in a restructuring or bailout would be the big European banks.

The unique circumstances of each country involved indicate that the solutions will be different for each. A common thread, however, is that economic productivity in these countries has been declining for many years, while their governments have lacked the political capacity to undertake the necessary reforms. Until there are satisfactory resolutions, there will continue to be elevated risk (and worry) that a resulting failure of European banks would inflict collateral damage in the United States.

2. Growing doubts about the economic recovery: U.S. and European economies stalled. In just three months, hopes for a second-half rebound from the spring's "soft patch" have given way to worries over whether developed economies are headed into a double-dip recession. Despite nearly \$1 trillion in economic stimulus, record low interest rates, and "quantitative easing" by the Federal Reserve, unemployment is stuck at 9.1%, the housing sector remains depressed, and overall economic growth is anemic. The problem isn't that economic outlook has worsened substantially; it just hasn't been improving of late.

3. Political stalemate in Washington resulting in a credit downgrade of US Treasury bonds:

Early in the quarter, the debt ceiling showdown took the U.S. to the brink of default. Ultimately, Congress came to an agreement that was sufficient to avoid a default, but the process revealed a deeply divided governing body whose inability to compromise sheds doubt on whether fiscal reform can be accomplished. Then, Standard & Poor's threw a sucker-punch into an already fragile market when it downgraded the U.S. coveted AAA credit rating.



4. Heightened volatility in the stock market: The stock market lurched one way and then the other on a daily

(or sometimes even hourly) basis—based by the latest news from Washington or from Europe. In August and September, the Dow Jones Industrials rose or fell by more than 1% in 29 days. There were 15 days with moves of more than 2%.

The last time the stock market saw such high volatility was in March and April of 2009. Extreme market volatility is not only unsettling to those who watch their account balances gyrate wildly, but it has the more pernicious effect of undermining confidence in the system. When it appears that only short-term traders are benefiting, long-term investors increasingly suspect that the markets are being manipulated. Confidence in the integrity of the system is necessary for healthy financial markets.

Stampede to Safety

For better or worse, many investors have become focused on safety. The volume of stock-fund redemptions accelerated last quarter, according to estimates from the Investment Company Institute. 2011 is on pace to be yet another year of significant outflows for U.S. stock funds.

To a large degree, the fate of global financial markets is perceived to be in the hands of government officials in Europe and the U.S., which makes risk management especially difficult. With the 2008 financial crisis a recent painful memory, many investors and portfolio managers are understandably cautious. And yet, with so many investors preparing for a worst-case scenario, anything better than that could reverse the trend.

While few expect an easy remedy for Europe's problems, pleasant surprises could come in other areas—for example, a strong bipartisan agreement by the congressional budget panel assigned with the task of reducing the U.S. budget deficit, or perhaps more encouraging economic reports. When expectations are as low as they were at the end of the quarter, surprises are more likely to be on the positive variety.

Prepare for Risk, But Don't React to It

Data from the Investment Company Institute show that shareholder redemptions from stock funds reached a peak in the week ended Wednesday, August 10th (the ICI

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Worst Quarter for Stocks. Hang in There!

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records publishes fund flow data on Wednesdays), which was the week the S&P 500 Index touched its recent low.

Certainly most of these investors believed they were acting prudently. Unfortunately, however, reacting to market downturns by selling during declines has historically hurt investor performance. Data from Ibbotson Associates shows that since 1926, when stock returns for any three-month period have been worse than -5%, the subsequent 12-month return was, on average, up more than 10%.

Of course, history never repeats exactly: It's always a little "different this time." Past performance is never a guarantee of future results, and there is no certainty that buying stocks after a decline will produce double-digit percentage returns in the future as it has usually done in the past. But numerous studies have shown that selling stocks or stock mutual funds in reaction to market declines does not improve returns, it only detracts from them. The conclusion reached by market research firm DALBAR: "Investment results are more dependent on investor behavior than on fund performance. Mutual fund investors who hold on to their investments are more successful than those who time the market."

The stock market is a forward-looking mechanism, and a diversified portfolio is actually composed of highly differentiated individual companies, whose future earnings prospects do not change very significantly from one day to the next. This may help explain why reactive selling of stocks following market declines is often detrimental. Those who sell their stocks based on spikes in market volatility or macroeconomic uncertainty are either forgetting or simply ignoring the unique valuation, earnings, and growth outlook of the individual companies that comprise the fund(s) whose shares are being sold.

It is our belief that a disciplined approach makes an enormous difference in the likelihood of investment success. This is why we adhere to our investment process regardless of the short-term volatility and emotions sweeping through the financial markets.

We know it has been difficult for investors, and not just recently—it has been a difficult millennium (thus far). And we know the financial system is far from perfect; indeed we are engaged on many fronts in efforts to improve corporate responsibility. We also know that corporate balance sheets are stronger than they have been in many years, and that productivity is at an all-time high. Stock valuations are reasonable. The rational investor does not sell in such conditions.

We also understand that investors are human, and that it is not easy to be patient and steadfast during stressful, volatile markets. This is why we at First Affirmative deliver our services through professional investment advisors. They play a critical role in the process; they are indispensable, and their value should not be underestimated. If you ever sense that your confidence in your investment plan is wavering, reach out to your advisor and let them know. They want to help you reach your financial goals, and sometimes that means helping you stick to your plan when it is most difficult to do so.

What every excellent advisor knows is that successful investing is much less about finding the best stocks or the best stock funds than it is about having a well-designed plan and sticking to it in difficult times.

Kevin O'Keefe, Managing Member and Chief Investment Officer of First Affirmative Financial Network, LLC, is responsible for due diligence and monitoring of mutual funds and separate account managers.



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