“Our fears are more numerous than our dangers, and we suffer more in our imagination than in reality.”

~ Seneca

During trying times such as we have been experiencing in the last quarter, it’s important to keep our sights on the big picture and remember the fundamentals. Unfortunately, research indicates that when left to their own devices, average investors tend to shoot themselves in the foot and make knee-jerk reactions that are detrimental to their portfolios. Dalbar research shows that the average equity investor generated an average annual rate of return over a 20-year period of 3.83% compared to the S&P 500 during the same time period returning an average 9.14%.¹ That’s more than 5% lost each year to unfortunate investing choices!

Of course, during times like these, it can be very difficult to remain calm and rational. Investment anxiety can be mastered by understanding the difference between what really matters in your portfolio and what is just useless noise and confusion. So let’s start first by looking at what doesn’t matter.

Many people seem to assume that successful investing is based on being able to predict the future. In my opinion, this is, by far and away, one of the most dangerous ideas that is propagated by Wall Street. Money managers with high-powered degrees have developed countless programs, models, and systems of analyses that are all focused on trying to predict the future. They sell these ideas to the investing public for millions of dollars a year. Regrettably, the majority of these actively traded systems for predicting the future don’t perform as expected.² The future is unknowable and attempts to guess at what markets and economies will do is a failing game.

If the future is unknowable, how do we then make decisions about the future? There are a variety of issues that you can focus on that are within your control. In this review, I’d like to look at some of the biggest and most influential component.

¹ Source: Dalbar, Inc.; 2011 Quantitative Analysis of Investor Behavior; March 2011
² Sources: How a Second Grader Beats Wall Street: Golden Rules Any Investor Can Learn; Allan S. Roth; 2009; Standard & Poor’s Indices Versus Active Funds Scorecard
The only research that I have found that is able to demonstrate with consistency a way to tangle with the unknown future is to look at the historic past and attempt to learn from it. While the past cannot predict the future, it does give us clues to how we might behave. And the past would tell us that we should focus on managing risk in the form of assets to which we expose ourselves, and the research indicates that this choice will dictate about 92% of performance over time. In short, asset allocation is the #1 issue you can control in your portfolio. It’s not sexy and it won’t make headlines on the 24/7 media circus. But, it should allow you to sleep easier at night because what is in the headlines today, doesn’t really matter.

“Peace rules the day when reason rules the mind.”

~ Wilkie Collins

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At a Glance

- **Scary Quarter:** worst quarter for equities since 2008
- **Greek debt crisis:** keeping us up at night
- **Manufacturing:** sector is expanding
- **“Operation Twist”:** introduce by the Fed
- **Consumer Confidence:** better than expected
- **Top two** performers by asset class: TIPS and Municipal Bonds
- **Bottom two** performers by asset class: International Small-Cap and Emerging Markets
The third quarter saw an intensification of the issues that we saw in the first two quarters. Keeping us on the edge of our seats were issues ranging from continued civil unrest in the Middle East, ongoing European economic concerns and global inflation fears. The fears of debt default by Greece dramatically increased throughout the summer and ushered in a period of panicked trading sessions, bringing about the worst quarter for equity returns since 2008.\(^4\)

As if this wasn’t enough for the markets to worry about, fears cropped up surrounding a slowing Chinese economy with Chinese manufacturing contracting throughout the summer.\(^5\) Many look to China to be the engine that will drive the global economy forward, so investors have been closely monitoring data from China.

The Federal Reserve was quite active over the summer and hinted they would implement further measures to support the economy. Dubbed “Operation Twist” by the media, the Fed announced that they would begin selling short-term treasuries and purchase longer-term treasuries.\(^6\) Sure enough, we saw mortgage rates drop to their lowest rates ever.\(^7\)

Media pundits have been actively promoting the concept that emerging markets are the only source for global growth at the moment. As frequently happens, these pundits were on the wrong side of that guess as both emerging markets and international markets fell further than U.S. markets.\(^8\) The U.S. dollar and U.S. treasuries appear to have retained their status as a safe haven throughout the negative headlines.

While it is difficult to find any bright spots in the third quarter, there are a few items to take note of. Corporate balance sheets are strong as many companies are reporting record levels of cash on hand.\(^9\) Prior to the crisis that began in 2008, many companies were highly leveraged. But, as the financial crisis unfolded, companies reacted by retaining cash as a buffer against

\(^4\) Source: BlackRock, Interactive Data Corp. and Lipper  
\(^5\) Source: HSBC Purchasing Managers’ Index™ Press Release, September 1, 2011  
\(^8\) Source: BlackRock, Interactive Data Corp. and Lipper  
\(^9\) Source: AFP Corporate Cash Indicators™ Third Quarter 2011
political and economic uncertainty. Despite the dire predictions by the media, we have not seen an onslaught of bankruptcies.

The Institute for Supply Management reported manufacturing continued its growth in September as the PMI (Purchasing Manager’s Index) registered 51.6%, which is an increase of 1% over the previous month.\(^\text{10}\) A reading above 50% indicates that the manufacturing economy is generally expanding; below 50% indicates that it is generally contracting. Additionally, a PMI in excess of 42.5 percent, over a period of time, is generally seen as an indication of expansion of the overall economy. Therefore, the PMI indicates growth for the 28th consecutive month in the overall economy, as well as expansion in the manufacturing sector for the 26th consecutive month.\(^\text{11}\)

Despite the negative headlines and continued gloomy outlook, the latest Reuters/University of Michigan consumer sentiment survey also came in better than anticipated.\(^\text{12}\)

\(^\text{10}\) Source: September 2011 Manufacturing ISM Report On Business®

\(^\text{11}\) Source: September 2011 Manufacturing ISM Report On Business®

\(^\text{12}\) Source: http://www.reuters.com/article/2011/09/16/us-usa-economy-idUSTRE78C33C20110916
**Assets in Your Portfolio**

As investors react emotionally to the headlines, equity prices have declined and many have taken to selling out of their equity holdings, which presents us with rebalancing opportunities.

The disciplined rebalancing process we use in your portfolio attempts to mechanically take advantage of market movement by moving money out of asset classes that have been performing well and repositioning into asset classes that have been undervalued. That may seem counterintuitive at first. But, we strategically sell assets that have done well (prices have risen, we’re tending to sell higher here) and we are buying assets that have not done as well (prices typically have fallen, we’re likely buying lower here). Simply put, we are trying to “Buy Low, Sell High.”

An example of how this concept has worked in your portfolio can be seen in this quarter’s rebalancing cycle. As investors sold their equity holdings and drove prices downward over the summer, high quality bonds in turn rose. Therefore, we sold down some of the fixed income gains in your portfolio to achieve the neutral risk-adjusted target weights. The proceeds were then used to reallocate to equities, with a significant portion going into the hardest hit areas such as International and Emerging markets. As I write this review, the MSCI Emerging Markets Index is up 8.5% and the MSCI EAFE Index (Developed International) is up 8.1% in the few weeks since the third quarter ended.13

We must embrace the fact that the future is unknowable. But, I believe that if we consistently look to buy into assets when everybody else is selling, and we sell down assets when everyone else is buying, we may be able to mitigate the downfalls of the fear and greed cycle that plague many investors.

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13 Source: Bloomberg, 9/30-10/25/2011
<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Index</th>
<th>Q3 Return$^{14}$</th>
</tr>
</thead>
<tbody>
<tr>
<td>TIPS</td>
<td>Barclays TIPS Index</td>
<td>4.51%</td>
</tr>
<tr>
<td>Municipal Bonds</td>
<td>S&amp;P National Municipal Bond Index</td>
<td>3.95%</td>
</tr>
<tr>
<td>Aggregate Bonds</td>
<td>Barclays Aggregate Bond Index</td>
<td>3.82%</td>
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<tr>
<td>Short Term Municipals</td>
<td>S&amp;P Short Term Municipal Index</td>
<td>0.76%</td>
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<tr>
<td>Short Term Treasury</td>
<td>Barclays Short Term Treasury Index</td>
<td>0.04%</td>
</tr>
<tr>
<td>High Yield Bonds</td>
<td>iBoxx High Yield Index</td>
<td>-6.23%</td>
</tr>
<tr>
<td>Commodities</td>
<td>S&amp;P GSCI Total Return Index</td>
<td>-11.69%</td>
</tr>
<tr>
<td>Large Cap Growth</td>
<td>Russell 1000 Growth Index</td>
<td>-13.14%</td>
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<tr>
<td>Domestic REITs</td>
<td>Dow Jones U.S. Real Estate Index</td>
<td>-15.33%</td>
</tr>
<tr>
<td>Large Cap Value</td>
<td>Russell 1000 Value Index</td>
<td>-16.20%</td>
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<tr>
<td>International REIT</td>
<td>S&amp;P Developed ex US Property Index</td>
<td>-17.64%</td>
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<tr>
<td>Mid Cap</td>
<td>Russell Mid Cap Index</td>
<td>-18.90%</td>
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<tr>
<td>Developed International</td>
<td>MSCI EAFE Index</td>
<td>-19.01%</td>
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<tr>
<td>Small Cap</td>
<td>S&amp;P Small Cap Index</td>
<td>-19.83%</td>
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<tr>
<td>International Small Cap</td>
<td>FTSE Developed Small Cap ex-North America Index</td>
<td>-20.52%</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>MSCI Emerging Markets Index</td>
<td>-22.56%</td>
</tr>
</tbody>
</table>

$^{14}$ Source: BlackRock, Interactive Data Corp. and Lipper, 6/30 – 9/30/2011
Using diversification/asset allocation as part of your investment strategy neither assures nor guarantees better performance and cannot protect against loss of declining markets. Indices shown are for illustrative purposes only and frequently are used as a general measure of market performance. Past performance does not guarantee future results. It is not possible to invest directly in an index.

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