



Investment Commentary
October 2011

The “risk-off” sign flashed ever more brightly as the third quarter progressed, culminating in a very sharp and broad sell-off in September. Asset groups that had shown relative resilience during the initial U.S. and European stock market falls in August – including commodities, non-U.S. bonds, and even emerging market stocks – fell prey to a crowded rush for the exits and move to U.S. Treasuries in September. This pushed the dollar up 7% versus the euro, and even more against several emerging market and commodity-related currencies. Treasury prices broke through 2008 levels, as did numerous other fear gauges. Volatility reached levels not seen since early 2009.

	Sept. 2011	Third Quarter	Year to Date
S&P 500	-7.0%	-13.9%	-8.7%
EAFE	-9.5	-19.0	-15.0
Emerging Markets	-14.6	-22.6	-21.9
Treasury Bonds	1.8	6.5	8.8
Municipal Bonds	1.3	3.9	8.9
U.S. Taxable Bonds	0.7	3.8	6.7
High Yield Bonds	-3.3	-6.3	-1.7
Global Bonds	-2.0	1.3	5.6
Commodities	-14.7	-11.3	-13.6

The broadening of the sell-off in September put added and very quick pressure on diversified, RINET-advised portfolios, even with conservative and hedged positioning already in place. At the same time, notwithstanding the somewhat indiscriminate selling, the behavior of individual managers varied. Some kept or increased hedges while others that were less hedged in fact took the opportunity to add commitments, believing that the selling pressure was driven not by fundamentals but by short-term speculators and window-dressers. The latter group suffered more in September, while showing glimmers of improvement when the overall mood lifted a bit in early October.

We expect volatility to persist in the near term, but feel that fundamentals have become somewhat mispriced, creating opportunity for the longer haul, to which our investment program is geared. Equities have become more attractive in our view, compared to their own history as well as other asset classes. Going into the fourth quarter, we have made a few changes in

recommended allocation, including a moderate increase in equity exposure. While still underweighted to small and mid capitalization U.S. managers, we in fact have reduced that underweighting, on attractive valuation as well as a belief that there are pockets of life in the U.S. economy. The smaller names are more domestically-driven than their larger counterparts.

As for the third quarter, investor confidence was shaken by the combination of fragility in the economic recovery and rising doubts about the ability of fiscal policymakers to respond, particularly in the U.S. and in Europe. While there have been brief bouts of optimism, it has become clear that Greece's public debt problems cannot be readily dispatched, with so many interests in the Euro-zone competing under halting leadership. Meanwhile, the debt ceiling process here had remarkably little affect on markets as the August 2nd deadline approached, but the post-mortem was harsh, casting very unflattering light on Congressional leaders as well as the White House. The ceiling spectacle then phased into the deficit reduction exercise, including a first round of budget cuts of around \$1 trillion over the next ten years and an upcoming second round, still to be delineated, in the \$1.2-1.5 trillion range.

The post-ceiling, S&P downgrade of the U.S. Treasury carried only symbolic import, having no input into perceived credit standing as normally would be the case with bond downgrades. The Treasury in fact surged in price, as a perceived safe haven, driving yields to unprecedented depths. It ended the quarter at 1.92%, down from 3.00% three months earlier. The low during the 2008 financial crisis was 2.04%, reached in December of that year. At current prices there in fact is little safety for short-term holders (only by holding until maturity is the investor assured of no loss). If rates were to rise 100 basis points, where they were just a few months ago, the 10-year Treasury would trade down by 8.8%. A 30-year Treasury would drop by 18.7%. This type of sharp reversal in fact happened in the six months following December 2008, over which Treasury prices dropped more than 20%.

Economic weakness in the U.S. was crystallized by downward restatement of output both during the 18-month recession that ended (officially) in July 2009, as well as the period of recovery since then. A 5% loss of GDP instead of the previously reported 4%, easily the worst drop since the Depression, has been followed by a tepid, and ebbing, recovery. Our economy expanded only 0.9% over the first half of 2011, following negative revisions. This represented a slowdown from earlier growth in the 2-3% range. These trends have prompted economists to increase recession odds, though in most cases the number still is less than 50%.

In our view, a significant downturn is unlikely, for two key reasons. First, much of our economy already is in a sluggish state, having stayed near the floor from the last recession. Auto sales, for example, are beginning to recover off lows, but only to a 12.1 million annual rate compared to a 14.6 million 30-year average. Housing starts, meanwhile, remain at levels below any other since 1975, at a seasonally adjusted 571,000 units compared to a 1.46 million average over this period. Home prices remain about 28% lower than 2005 levels. The combination of lower prices and historically low mortgage rates means mortgage payments now account for just 10.8% of household income, about half the percentage from four years ago and a third of 1980s levels. For the first time in decades, it is significantly cheaper to own than to rent. At some point, price points matter, and this should incentivize renewed buyer interest.

Secondly, there are more recent signs of actual improvement, and this has led economists to edge up their GDP forecasts in recent weeks. For example, reports from the U.S. Department of Commerce as well as the Census Bureau indicate a new upsurge in nondefense capital goods shipments, including a 15% annualized third quarter gain, the second fastest rate over the last ten years. This may reflect a combination of years of pent-up business demand for new machinery and some restoration of an early-2011 recovery that had been impacted by Japan's earthquake in March, along with sharply rising energy costs.

Moreover, in the same way that painful setbacks in house prices eventually will attract buyers, the dire state of our labor markets could begin to accrue to our advantage as well. Because wages in the U.S. have been stagnant at the same time that they significantly risen in many emerging economies, the labor cost advantage has begun to shift back toward the U.S. Domestic productivity and technology improvements, along rising logistics costs overseas (including transportation and taxes) are reinforcing this trend. As a result, we are beginning to see a series of announcements regarding new plans for manufacturing investment in the U.S., from American companies such as General Electric, Intel and Ford and foreign companies such as Samsung, Bridgestone, and BMW.

Following the sharp third quarter weakness, selling at around 11 times trailing twelve month earnings, stocks appear to be pricing in a significant recession, one that would reverse a two and a half year earnings rally. At this point, we feel this can be avoided, but there certainly are risks, as always. A possible mismanagement of the European debt crisis poses the most immediate threat, because it is on this issue that investors and bankers alike seem most poised to cultivate their fear. The fact that Greece is beyond the saturation point with regard to its debt burden is widely understood, as expressed by sovereign bond rates above 20%, a default projection level. For loss recognition at banks and other entities to be least disruptive, it will be essential that the process be shepherded within a concerted plan by Euro-zone leaders, notably Germany and France. Given the stakes, we think all efforts will be made, but it will not be a smooth ride.

While the combination of lower prices and some signs of fundamental improvement justify a moderate addition to equities, in our view, we also remain mindful of the challenges at the policy level both here and abroad. Portfolio positioning continues to factor in these issues, and put a premium on managers with an ability to hedge against risk but also to exploit opportunities that can be laid bare in volatile markets. Generally, these strategies are geared to longer term success. This also remains the chief goal of the investment program as a whole. As indicated by a recent sharp increase in the frequency of 100 point daily moves in the Dow index, emotions are running very high. We feel it is very important to guard against running with the emotion, and to always keep the long term mission in mind.

We greatly value the trust you place in us in all market environments, not least the difficult ones. Please feel free to contact me at any time with any questions or concerns.

David S. Beckwith, CFA
Chief Investment Officer

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