



QUARTERLY UPDATE | THIRD QUARTER 2011

It's been quite a quarter in the investment markets. You may have noticed the results of the significant market volatility in your portfolio values already. Declines in stock prices, coupled with a reduction in value for many other assets (including commodities and many bond categories) have combined to push the value of investment accounts much lower than we're likely to be comfortable with.

As a species we call ourselves *Homo sapiens*, which means wise man. We certainly haven't been acting very wise lately. Many investors are panicking on an almost daily basis. First they flood out of stocks, commodities and other longer-term assets, the so-called "risk-off" trade. Then they buy back into these longer-term assets and out of cash, Treasury bonds and gold, the "risk-on" trade. These waves of risk-on and risk-off largely describe the massive volatility we have seen on an almost daily basis. Each bit of news, good or bad, leads to a violent reaction in the markets. We've seen more gains and losses of 100 Dow points or better lately than is typical. Volatility has been very high. Why?

The simple answer is uncertainty. Investors are uncertain as to what is going to happen on several fronts; political, economic and social. Though we see aspects of all these uncertainties here at home, most of the impact is actually overseas.

A recurring theme in the volatility lately has been whether or when Greece will default on its debts. We first faced this issue over 18 months ago in March 2010. Since then, we've had one rescue plan after another, one scheme after another. In the interim, the Greek economy has hit the skids, collapsing by some 5% from what it used to be. This doesn't help their chances of meeting their obligations. It actually makes things worse for their creditors.

The debate about Greece has shifted recently to how it will default, not when. There are several plans which would lessen the blow to creditors from a Greek default. A controlled default looks likely at this point in time. Default will free Greece from some of its obligations, though not all. Default will affect the principle of Greece's creditors, who are largely multi-national banks. The plan to deal with the turmoil will almost certainly involve a mechanism to help the large European banks cope with the loss of value of the Greek bonds they own but until that plan is at least roughed out we'll likely continue to deal with the uncertainty that's been plaguing the world markets of late.

Closer to home we've been facing the situation of our own weak economy, and that news has continued to be compounded by the spectacle of our political leaders wrangling over the best way to address our deficit spending. On the economic front we think the odds of another recession to be small. We're still growing even if that growth is slower than we'd like. The mainstream economic view has called for slow, almost anemic growth as we work through the hangover from our last recession. And that is precisely what we've been seeing. Sooner or later things will pick up, but in the meantime this uncomfortable economic environment will persist.



What has really amazed us is the resilience of corporate America during this period of slow growth. Profits have continued to grow at a good pace even with uneven economic growth. There are several reasons for this; inflation boosts prices and thus adds to profits, many sales come from overseas where growth is better and most companies have strict control over their costs. In your portfolio we have focused more on the largest companies in the equity universe even while underweighting the small companies. In your foreign stock holdings we have far more invested in Asia than in Europe and quite a bit in the developing nations. At last check, you had no exposure to Greek debt, though in at least one of your funds you own small slivers of multi-national banks.

We usually provide a detailed discussion of your asset classes at the end of the 4th quarter. However, in light of current events, we thought you would appreciate a review of them right now.

Government Bonds

Like many others, our research led us to the conclusion that the already-low Treasury yield of 3.0% had no place to go but up, resulting in the value of Treasury bonds dropping. Just the opposite happened, as rates on 10-year Treasuries fell to 1.8% after the S&P downgraded the U.S. credit rating and the European crisis caused a stampede to safety. Fortunately our positions in government agency mortgage-backed securities have offered better yields and valuations. We recently shortened the duration in that portion of the portfolio while keeping that agency exposure and yield similar. We are still underweight in this asset class as these historically low rates push us to other areas where the opportunities are better.

Corporate Bonds

Valuations and interest rate spreads in corporate debt have caused them to look much more attractive to us than other portions of the bond market. Your current positioning reflects allocations to intermediate-term corporate bonds, floating rate bank loans, high yield bonds and convertibles. High yield and convertible debt suffered a bit during the recent volatile weeks, but fundamentals remain strong. Defaults have continued to improve, which has been a tailwind for lower-quality debt of all kinds. Higher coupons (the interest rate at which particular bonds are issued), such as those in investment-grade corporate bonds and high yield corporate bonds, tend to act as a bit of a buffer against rising interest rates (a significant risk in all bond holdings) and we think that these sorts of bonds will continue to benefit from those higher coupons even in a flat or falling interest rate environment.

Foreign Bonds

Compared to many slower-growth areas in the developed world, such as Japan and Europe, higher interest rates, improving market breadth and liquidity, as well as underlying/increasing fundamental strength of several nations in the emerging world - in both fiscal balance sheets and currencies - have resulted in conditions that have the potential to offer ongoing attractive bond returns. We've tilted the foreign bonds in your portfolio in this direction with the balance of the bond exposure in this asset class invested in Asia and other parts of the developed world.

US Stocks



In the large company stock world, we have discussed many times the attractiveness of well known blue chip companies such as Procter & Gamble, Johnson & Johnson and others. With underlying fundamental strength, large amounts of cash held on the books and strong earnings, we feel this area offers compelling value from a risk-to-reward standpoint. These characteristics alone should help provide us better “all-weather” performance if the current period of slow overall growth continues. Factoring in the volatility and market fear over the recent months, we’ve seen the dividend yield on the S&P 500 rise above the 10-Year Treasury yield which is unheard of in recent decades. What this tells us is that stocks overall are pricing in a dire environment (that we do not foresee occurring) and based on these valuations the upside is extremely compelling.

We are currently overweight in large company stocks in your portfolio. We continue to feel that the fundamental quality of these companies is not being appropriately recognized. Additionally, a slow growth environment should point to outperformance of these more diversified, globally-focused firms.

Medium sized company stocks have been a strong growth engine in your portfolio for several years and fit a unique niche. Earnings growth on a company-specific basis has been strong, debt levels have improved from where they were in 2008 and financial stability overall is better than its been in years.

Foreign Stocks

The international stock universe can also be divided into developed and emerging nations. European markets, particularly financials, have been hurt by fear due to the uncertainty surrounding the debt crisis, namely with Greece, and of policy decisions. We are currently at a normal weight in foreign equities overall, with a significant tilt to emerging markets, which is where global growth is and has been centered.

Real Estate

Increased transaction activity and improved sentiment (possibly due to the notion that real estate can act as an inflation hedge) spurred U.S. REIT returns upward significantly from trough levels. Foreign REITs lagged for a variety of reasons; in Europe, political uncertainty and the pessimistic climate; in Asia, economic slowing and higher interest rates. We have minimized exposure to this asset class in your portfolio overall based on valuation concerns as this asset class has looked quite expensive to us over the last year.

Commodities

Despite volatility over the summer, relatively strong commodity prices from a variety of geopolitical and weather factors in 2011 have helped returns here overall and we expect that if inflation pressures build, the case for commodities exposure will continue to be strong. Despite the volatility of that asset class individually, its usefulness as a diversifier in your portfolio is significant and we expect to continue to have modest exposure to this asset class in your account.



Final notes

Volatility, while unnerving, also provides us opportunity to “reset,” take a step back and determine how things look right now and from a forward-looking basis.

Sometimes we are asked the question of what we are “doing” in portfolios in times like this when news events and conditions get challenging. It is important to keep in mind that in diversified portfolios like yours the “big picture” guides positioning more than do short-term events. Short-term trading offers folks the excellent opportunity to be wrong as often as they are right since following the herd often feels right at the time but can result in missed opportunities. If the decision includes “going to cash,” folks have the further opportunity to make a knee-jerk/possibly wrong decision twice rather than just once, as the second decision to jump back into “the markets” often occurs after a recovery has long since begun. We believe that valuations are a fundamental component of any diversified portfolio strategy, and these tend to move in a contrary manner—as certain assets become cheaper, they become more attractive. It’s darn near impossible to get every asset class or position correct, but over time, a diversified strategy based on valuation will help to enhance returns and minimize volatility.

Well diversified investment portfolios give us the opportunity to earn returns in excess of those we could obtain in more stable investments like savings accounts or CD’s. The price we pay for these returns is the volatility that comes when uncertainty in the economic world causes otherwise rational investors to sell their stock and bond positions, causing prices to temporarily fall. We do our best in times like these to minimize portfolio declines, but when markets fall as they have, even diversified portfolios like yours are affected significantly. The assets in your portfolio, in our estimation, are worth significantly more than the price we see in today’s worried marketplace. We believe time will bear this out as fear is replaced by brighter outlooks as the economic pictures become clearer.

We certainly appreciate your trust in us and we take this trust very seriously. Just as the last financial crisis gave way to rising prices and higher levels of optimism we are confident that this situation will resolve itself in a similar manner. Until then we look forward to speaking with you and working with you to help quantify how this will impact your situation in the near term and over time.

Optimistically yours,

A handwritten signature in black ink that reads "Scot Thigpen".

Scot A. Thigpen

A handwritten signature in black ink that reads "Travis Woods".

Travis B. Woods