

Economic & Market Review

~ Third Quarter Investment Newsletter ~

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Executive Summary

Capital markets were weak during the quarter on European sovereign debt concerns and slowing global growth. Standard & Poor's downgrade of the U.S. government's credit rating added to turmoil and global uncertainty. The rating agency took this unprecedented action after consideration of U.S. debt and deficits along with a dysfunctional, uncooperative political environment in Washington.

Global stock markets were down double digits for the quarter. International shares, particularly those of emerging markets, had added pressure from strength in the U.S. dollar. As a testament to the wisdom of a well-balanced portfolio, high quality domestic fixed income performed reasonably well. Interest rates plummeted on a flight from risk, driving U.S. Treasury yields to lows last seen in the 1940's. For the first time in the past 50 years, the S&P 500's yield exceeds that of the 10-year U.S. Treasury bond. The lower credit end of the fixed income markets was hurt. High yield spreads over comparable Treasuries expanded dramatically from a below average 5.4% to 8.4%. Following quarter-end, these spreads rose above 9.0%, closer to recessionary levels.

Growth in the domestic economy remains slow and U.S. economic productivity was negative in the first half of the year. Weakness in the overall labor market persists and the unemployment rate remains high. Household spending has increased at only a modest pace although business investment in equipment and software continues to expand. Inflation has moderated as energy and some commodities have declined from peaks. Expectations are for inflationary pressures to continue easing in future periods. Housing prices remain at lows and the two year rebound in commercial real estate is stalling.

In light of domestic and global challenges, the Federal Reserve assured markets of a low Fed Funds

rate for the next two years and began a program to replace \$400 billion of its short-term Treasury holdings with longer dated maturities. The intent of this program, dubbed Operation Twist, is to drive down long-term interest rates to help stimulate the economy.

European and IMF leaders agreed in principle to a second bailout program for Greece, although hammering out the details and achieving parliamentary approval across all 17 euro-zone countries has been problematic. Central to this plan are: 1) additional funds for Greece, 2) a private sector exchange of Greek government bonds to include a 21% haircut, and 3) an expansion of the European Financial Stability Facility's ("EFSF") size, mandate, and capabilities. While debate continues, contagion has spread to Italy and Spain and the link between bank balance sheets and sovereign creditworthiness has become more evident.

Beyond Greece's second bailout package, there are further actions that can be taken, and tools being discussed, that may dramatically ease sovereign debt pressures and halt contagion. These include further expansion of the EFSF as well as issuance of euro-bonds. Unfortunately, European policymakers have been hesitant and appear to lack an appropriate sense of urgency. While this may appear bleak at times, the situation can change on a dime through rapid and efficient deployment of appropriate strategies and tools. Strong leadership and policy responses hold the key to a brighter future for Europe and its impact on the global economy.

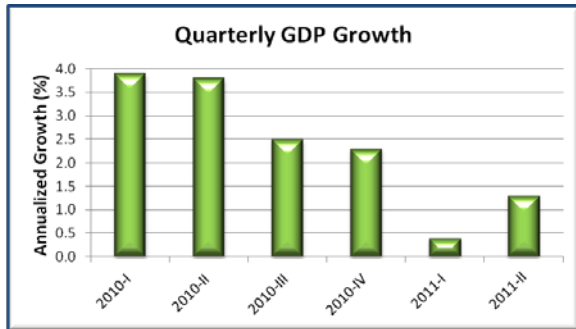
We believe investors have developed a greater appreciation for global challenges and, importantly, have more fully discounted these issues into asset prices. This provides a better foundation for the potential of decreased volatility and attractive portfolio returns in the future.



Economic Review and Outlook

Economic Growth

Following a paltry 0.4% annualized rate of growth in the first quarter of 2011, U.S GDP grew by 1.3% in the second.



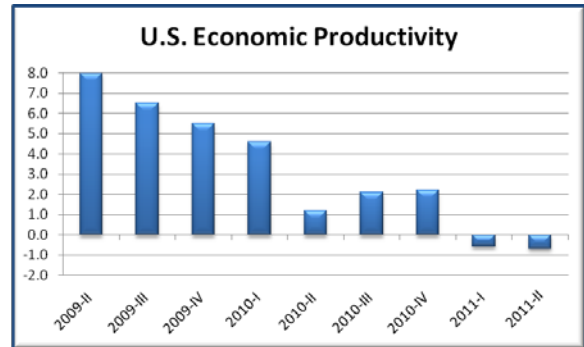
Data Source: U.S. Department of Commerce

Consumer spending rose slightly but was held back by a decrease in durable goods purchases. Government spending at the state and local level declined and inventory adjustments were negative. The graph's generally downward trend is largely due to a winding down of favorable inventory adjustments. On the positive side, the economy has not slowed down as much as it appears. Of course, the negative is the economy was never that strong either.

The government's initial estimate of third quarter growth is due in late October. As a precursor, the Federal Reserve's Beige Book provides a window into the period's economic activity. Published in September, the document reported slow but positive growth and few signs of marked deterioration. Consumer spending was up slightly, driven by autos, and the pace of manufacturing slowed. Labor markets are steady and price pressures have cooled.

During the quarter, the Department of Commerce embarked on its periodic review of past estimates of U.S. GDP. Interestingly, resulting revisions revealed that the recent recession was actually worse than originally portrayed and that the recovery has been weaker. Following these revelations, we find that U.S. economic output has yet to fully recover to the pre-recession peak.

Economic growth is a combination of employment growth (which has been weak) and productivity.



Data Source: U.S. Department of Labor

As the graph above shows, the economy has had an unfavorable trend in productivity which actually turned negative this year. This poses a challenge to economic growth as well as corporate profitability and can lead to inflationary pressures. Monitoring the unfavorable trend in economic productivity will be important.

The U.S. is obviously not the only economy experiencing economic challenges and weaker growth. Even India's macro fundamentals are weakening and China's combined service and manufacturing purchasing managers' index flashed contraction in both August and September.

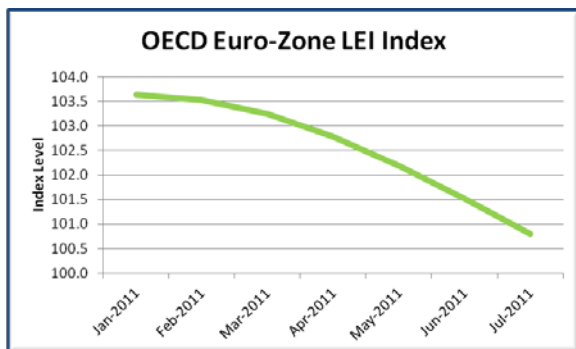
Japan is returning to normal following the tragic events from earlier this year. However, deflationary forces have once again taken hold and consumer prices began falling in the second quarter. Higher budget deficits and government debt levels, exacerbated by the disasters, led Standard & Poor's to downgrade the nation's debt.

France had no economic growth in the second quarter while growth in Germany slowed sharply. Total euro-zone growth was only 0.7% for the period. In August, France and Italy joined Ireland,



Spain, and Greece to report manufacturing contraction.

Our review of this and other data suggests a reasonable possibility that Europe will fall into recession during the second half of this year. This forecast is in-line with the expectations of the Organization for Economic Cooperation and Development (“OECD”) which sees fourth quarter weakness in the euro-zone’s three largest economies. The group expects a combined GDP contraction of 0.4% for Germany, France, and Italy.



Data Source: OECD

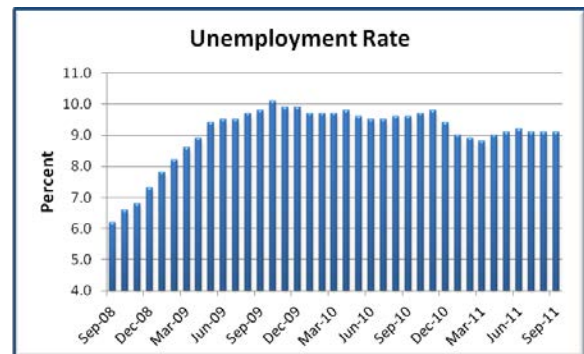
As for other countries, the OECD’s leading indicators of economic activity show weak signs coming from Canada, the U.K., the U.S., Japan, and each of the BRIC countries (Brazil, Russia, India, and China).

As the quarter drew to an end, the International Monetary Fund (“IMF”) also weighed in by cutting its global growth forecast on virtually every country on the planet and warned of the possibility of Europe and the U.S. slipping into recession in 2012. The IMF expects global growth of 4% next year and warned of “severe repercussions” to the global economy unless euro-zone nations strengthen their banking system and the U.S. gets its fiscal affairs in order. All signs point to a period of slower global growth ahead.

Employment

Employment is weak, which is not new news. What does appear new is an almost fatalistic acknowledgement by various governmental agencies that the labor market will remain weak for quite some time. For example, the White House expects unemployment to be “persistently high”. Federal Reserve governors have echoed similar comments. The Congressional Budget Office recently projected unemployment will exceed 8.5% through year-end 2012 and expects levels to stay greater than 8% through 2014. According to this nonpartisan federal agency, the economy will not return to full employment until 2017!

While these forecasts may or may not come to pass, what is certain is the fact that unemployment has already been elevated for an extended period - three years and counting.



Data Source: U.S. Department of Labor

As a matter of fact, the rate of unemployment, currently at 9.1%, has exceeded 8% for the longest stretch of time in 70 years. Nearly one in three unemployed workers has been out of work for over a year, translating to 4.4 million individuals. Ben Bernanke declared long-term unemployment as a national crisis and advocated [fiscal] action to combat the problem.

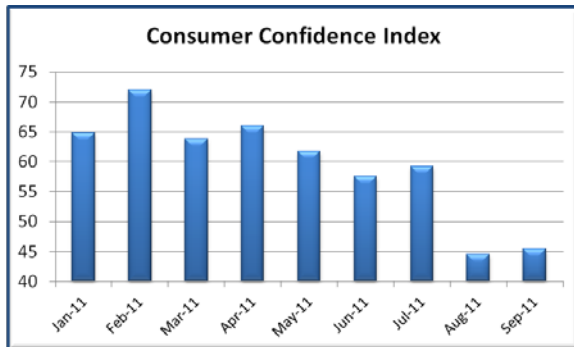
Following quarter end, a relatively positive nonfarm payrolls report was released indicating 103,000 net new jobs were created in September along with positive revisions to previously reported periods. While we are pleased with the uptick, much greater job growth is necessary.



The Consumer

Weak real income growth is a problem for the U.S. consumer. Inflation adjusted income for a typical family dropped in 2010 for the third year in a row. Living standards are now back to where they were in 1996.

During the summer, Americans spent more cautiously than earlier in the year. The partisan debt ceiling debate coincided with a major drop in August's consumer confidence level. A recent poll showed that Americans feel worse about the economy than at any point this year with 68% believing the worst is yet to come.

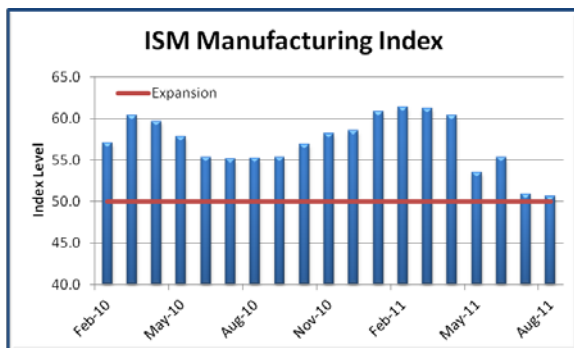


Data Source: The Conference Board

Considering weak income growth, cautious spending, and diminished confidence, the upcoming holiday shopping season is expected to be muted.

Manufacturing and Service

Manufacturing, previously a particular bright spot in the post-crisis economy, has shown marked global deterioration in recent months. U.S. manufacturing still appears to be growing, but at a diminished rate.



Data Source: Institute for Supply Management

Euro-zone manufacturing slowed to a near standstill as the third quarter got underway. Greece and Spain are well into contraction territory.

Chinese manufacturing, already showing contraction readings in August, slowed further in September.

Taking their cue from weakening growth and slowing manufacturing, economically sensitive commodities pulled back during the quarter. Tin, nickel, and zinc performed poorly. Copper's decline throughout the quarter accelerated in September with a 23% drop to reach a low for 2011. As might be expected, steel and mining companies were challenged this quarter.

Real Estate

A poll of economists this quarter revealed expectations for housing prices to remain depressed for years. Following an expected drop of 2.5% this year, the group forecasted prices to rise about 1% per year through 2015. As debate continues as to how involved the government should be at this point in the housing recovery, one in five mortgages are underwater and equity ownership as a percent of home value has dropped to 38.6% from 59.7% in 2005. This translates to seven trillion dollars of home equity having been lost over the past 6 years.

Meanwhile, a two year rebound in the U.S. commercial real estate industry is stalling. Property sales are flat and commercial property prices are stuck at 10% below the August 2007 level. Retail vacancies in the top 80 markets remain near multi-year highs and the vacancy rate for office buildings (18%) has not improved from the post-bust peak.

Fiscal Policy

The U.S. deficit for the just completed fiscal year came in at \$1.3 trillion, or 8.5% of GDP. Spending at 23.8% of GDP was above historical average, revenue of 15.3% of GDP was below average, and



the net deficit relative to GDP was the third highest out of the past 65 years.

Despite staggering debt and deficits, the U.S. economy needs a combination of short-term stimulus and long-term deficit reduction. In a highly leveraged economy, fiscal policy is the only thing that works to spur growth as monetary policy will not create final demand. In his speech at Jackson Hole, WY in late August, Ben Bernanke alluded to as much when he pointed to structural economic problems, particularly in housing, that are limiting the normal effect of monetary policy on the economy. At that time, he argued that appropriate use of fiscal policy is more critical at this juncture. One week later, President Obama appeared to take the hint when he announced the “American Jobs Act” and asked Congress for \$447 billion in tax cuts and spending initiatives.

Despite Bernanke’s textbook approach of countercyclical government spending, most U.S. policymakers are intent on doing just the opposite. Obama’s jobs act was dead on arrival. Furthermore, during recently completed debt ceiling discussions, “cut, cap, and balance” became the mantra for many. Cut the federal budget, cap future spending, and agree on a balanced budget amendment before raising the debt ceiling.

While falling short of cut, cap, and balance, the debt ceiling debate did conclude with an 11th hour agreement sufficient to raise the debt ceiling and sidestep a default. That being said, for all the hemming and hawing, very little was actually accomplished. A roadmap of sorts was laid out to cut \$2.4 trillion over 10 years, but details were left in the hands of a 12 member special committee. The group, unidentified at the time, is tasked with delivering a final plan by November 23. Failure of Congress to subsequently pass this plan by December 23 will result in pre-defined, automatic, somewhat draconian spending cuts from various programs. The lack of nonpartisan cooperation along the way to this shank of a punt undermined global confidence in U.S. lawmaking to a sufficient

enough degree that Standard & Poor’s downgraded long-term U.S. government debt to AA+ with a negative outlook.

Monetary Policy

The Federal Reserve’s characterization of the U.S. economy indicates heightened concern. Previous talk of “deteriorating economic conditions” has been replaced by “significant” downside risks and “strains” in global financial markets.

Unfortunately, while their concern has grown, their policy options have shrunk. During the quarter, the Fed announced two policy initiatives. The first came in early August when they took the unprecedented step to assure markets that short term rates would be held at today’s low levels for the next two years. The second, Operation Twist as it is called, came late in the quarter. These efforts were greeted by skeptical markets, dubious as to the ultimate benefits of either program.

The goal of Operation Twist is to drive down long-term interest rates by the Fed selling \$400 billion of its shorter term Treasury holdings and replacing them with longer dated bonds. Economic realities, however, limit the plan’s potential due to the following:

- Interest rates are already very low.
- Firms have ample cash but are reluctant to expand.
- Home buyers are hesitant to purchase and underwater homeowners are unable to refinance.
- Households are actively *decreasing* what are still elevated levels of debt.

Furthermore, the program introduces a number of systemic risks and consequences such as:

- Flattening the yield curve hurts the fundamentals of an already challenged financial services industry.
- Overt manipulation of yields eliminates the ability to draw valuable economic insights from the yield curve.



- Investors, particularly retirees, may be forced to take imprudent portfolio risks.
- The Fed's grasp at straws essentially reveals its state of impotence while risking fears that they are monetizing the nation's debt.

The need for stimulus, the lack of available options, and the consequences of action have caused the Federal Reserve Board to be deeply divided. An already battered Ben Bernanke has the added pleasure of enjoying the stiffest internal opposition a Fed chairman has had in almost 20 years. Unfortunately, the challenge is not unique to the U.S. The fact of the matter is that central bankers worldwide are concluding the global economy is still in a precarious position yet policy options are limited. Debt is still too high, growth is stalling, and fiscal policy is in retreat.

Governments, Politicians & World Events

Much attention has been focused on sovereign debt issues in Europe, particularly in Greece. In July, euro-zone leaders agreed in principle to a second bailout for the country as well as modifications to enhance the capabilities of the European Financial Stability Facility ("EFSF"). Key provisions include:

- An additional €109 billion in bailout money for Greece.
- Ninety percent of private sector creditors need to agree to a Greek bond exchange to include and 21% discount to face value.
- Modification will be made to the EFSF to eliminate limitations that currently prevent its ability to achieve nameplate capacity of €440 billion.
- The EFSF will gain the ability to buy bonds in the secondary markets and to lend directly to countries before they lose access to private funding.

Tremendous uncertainty remains regarding these initiatives. Winning approval in various euro-zone capitals has been a challenge and the political timetable is uncertain. Additionally,

even with improved capacity, the EFSF is far too small to intervene credibly in the bond markets. It needs to be either expanded, leveraged, or both. Lastly, Finland's incessant demand for collateral in the second round of financing has nearly ground the process to a halt. Considering the market is pricing in a 90% probability of a Greek default, collateral may not be unreasonable. Yet, it is still amazing that a country accounting for less than 2% of total euro-zone economic output can virtually dictate this process.

While the second bailout program and EFSF modification remain up in the air, continued funding of the *first* bailout has become equally nebulous. Recent economic results out of Greece have left euro-zone and IMF officials scratching their heads as to whether Greece has both the capability and the resolve to implement necessary reforms. More specifically, the Greek economy, down an annualized 6.9% in Q2, is on track to contract by over 5% this year. Next year's expected decline of at least 2% will mark the country's fourth consecutive year of recession. In the face of a deeper than expected economic contraction, Greece will miss its budget deficit goals this year and the country's total debt is expected to hit 172% of GDP next year. For Greece, austerity looks more like a problem than the solution.

Considering the heightened level of risk, funding of European banks, particularly in Greece, is an increasing concern. LIBOR rates are up, depositors have withdrawn funds, and U.S. money market funds have quietly shortened durations and reduced total exposures to European institutions. In response, five major central banks moved in concert to pump dollars into the European banking system and established three new funding operations.

As would be expected, the capital markets have developed an extreme sense of urgency for resolution of Greek and other immediate European challenges. Curiously, aside from the ECB, European leadership has not demonstrated



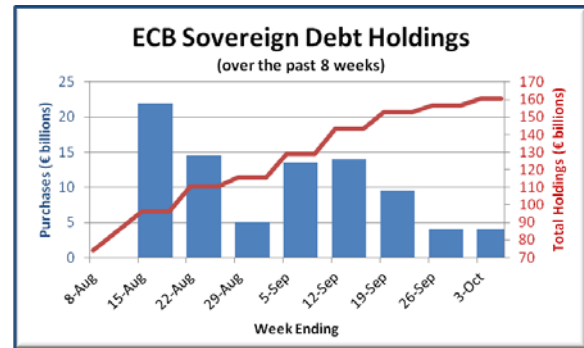
the same urgency. Germany and France are hesitating on euro-zone bonds (discussed below) and appear more focused on long-term governance issues and new taxes. Investors are thoroughly unimpressed and belief is rising that officials will not be able to get a handle on the crisis.

On that note, efforts to insulate other countries from a Greek default have failed. Contagion has spread from peripheral nations to Italy, Spain, France, and to European banks. Italian and Spanish bond yields spiked to records and the euro traded down sharply.

Expanding concerns are not without merit. Italy recently slashed its growth forecasts, its total debt exceeds GDP, and its recent budget plans were declared insufficient by economists and the markets. Bearing this in mind, as well as significant near-term debt maturities, Standard & Poor's downgraded the country in late September. Italy, the euro-zone's third largest economy, has evolved into a new and highly meaningful pressure point in Europe's debt crisis.

France is increasingly under the microscope as well. Investors grew anxious during the quarter regarding the nation's exposure to Greek debt and the potential for rating agency action. For now, the rating agencies have affirmed a AAA rating. On a positive note, the scare has prompted French government considering fresh tax increases, spending cuts, and other budget measures to ensure fiscal responsibility. France's AAA rating is critical to the success and ultimate capacity of the EFSF.

In response to the spike in Italian and Spanish government bond yields mentioned above, the ECB restarted its program to buy sovereign debt in the open market. By quarter end, and over only an eight week period, the central bank had more than doubled its holdings of sovereign bonds to a current level of €160 billion. Clearly, the ECB satisfied its pledge to buy on a large scale.



Data Source: European Central Bank

ECB buying of sovereign debt is a controversial strategy that treats a symptom but not the cause of the crisis. Furthermore, the strategy faces legal and political challenges and exposes the bank to greater economic risk. To that point, disagreement with the purchase of Italian and Spanish sovereign bonds was reportedly the driver behind the recent resignation of the ECB's chief economist, Jürgen Stark. There is little wonder why the ECB has urged the euro-zone members to quickly ratify changes to the EFSF and implement Greece's second aid program.

Europe needs a new way to restore country access to markets and put a floor under the crisis. The concept of euro-zone bonds is an elegant solution gaining in popularity. The consolidated financials of the euro-zone member countries are reasonably attractive. Relative to this year's euro-zone GDP, the 17 countries have a respectable fiscal deficit of 4.4% and total debt of 87%.

Successful implementation of a euro-zone bond would be a game changer, and has the power to halt crisis and contagion in their tracks. Common liability without political union, however, is enormously difficult. Greater fiscal and political integration are necessary and will take time. For now, the first step is to get holdouts such as Germany, and to a lesser extent France, onboard with the approach.

Monitoring, understanding, assessing, and acting upon the moving parts in Europe can be a daunting task. To assist in filtering out noise and media hype, we suggest focusing on the following key issues:



- **Policymaker Focus:** A greater sense of urgency needs to be demonstrated by European policymakers.
- **ECB Support:** Continued ECB support including a cut in the short term policy rate. Look for this prior to year-end.
- **EFSF Expansion:** Ratification of changes to the EFSF is critical. However, the facility is far too small. Efforts to dramatically increase the fund's effective war chest, through use of leverage, guarantees, etc. from €440 billion to as much as €2 trillion would be a major positive. Likewise, failure to expand the facility will be a problem.
- **Euro bonds:** Perhaps the most powerful tool if it can get done. Serious discussion and movement in this direction would be a positive. Full implementation would be a homerun.
- **Contagion Firewalls:** Greece will likely default sometime within the next year. Look for firewalls to be put in place to protect against contagion. This is the whole point to "kicking the can down the road" with Greece. It needs to get done. Key possibilities: Shoring up capital at European banks, expanding the EFSF, and establishing a euro-bond.
- **Greek Aid Part I:** A decision on the next Greek installment of €8 billion has been postponed. Greece needs this money by the second week of November. Failure to receive this funding will likely trigger a default.
- **Greek Aid Part II:** Full ratification of Greece's second bailout package.

Capital Markets Review and Outlook

Overview

Risky assets pulled back during the quarter on European sovereign debt concerns and slowing global growth. Volatility spiked in the period as the market's fear gauge, the VIX, rose to levels last seen during the financial crisis.



Data Source: Yahoo! Finance

Considering slowing growth, record profit margins, and rising unit labor costs, investors have come to realize that stocks may not be as cheap as P/E multiples suggest. Indeed, negative earnings guidance is on the rise and analyst growth estimates for Q3, Q4, and 2012 have been dialed back. Most strategists believe there is more to come. The drop in economic productivity illustrated earlier in this newsletter does not bode well for corporate profits. In short, the earnings recovery, based on profit margin expansion, may be getting long in the tooth.



Fixed Income Markets

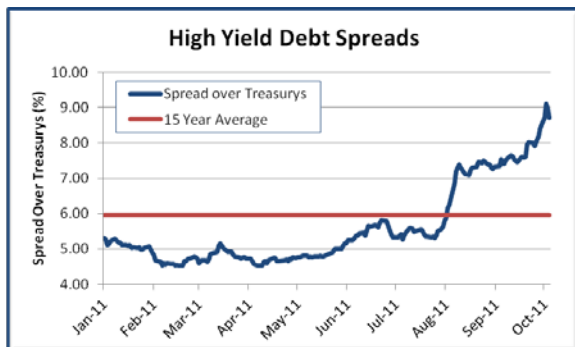
High grade bonds performed well during the quarter as yields contracted dramatically to levels not seen since the 1940's. The 10-year Treasury yield dropped by a staggering 130 basis points to end the period at a mere 1.9%. On the heels of this rally, the Barclay's Aggregate index delivered a 3.8% return. It should be noted, however, that heavy U.S. Treasury issuance has skewed the composition of this index. Resulting distortions diminish its effectiveness to truly capture performance of the broader fixed income market. The multi-sector fixed income segment, for example, was down 3.3% for the quarter.

Capital Market Returns		
	3 rd Qtr 2011	Year-to-Date
U.S. Treasury Bills	0.0 %	0.1 %
Barclays Aggregate Bond	3.8 %	6.6 %
Barclays Municipal Bond	3.8 %	8.4 %
Multi-Sector Bond	-3.3 %	-0.2 %
S & P 500	-13.9 %	-8.7 %
Russell 2000 (Small Cap)	-21.9 %	-17.0 %
MSCI EAFE (Int'l Equities)	-19.0 %	-15.0 %
MSCI EAFE Emerging Mkts	-22.6 %	-21.9 %
DJ UBS Commodity Index	-11.3 %	-13.6 %

Data Source: Morningstar

For the quarter, municipal bonds rose 3.8% while international bonds lost 0.7% due largely to a dramatic strengthening of the U.S. dollar.

Junk bonds remained in favor for much of July as investors sought opportunities for yield. At that time, the segment's lower sensitivity to rising interest rates added further to its appeal. As August progressed, however, slowing economic growth was apparent and credit risk became a more urgent focus. Investment flows reversed dramatically and the credit markets got pummeled.



Data Source: BofAML High Yield Master II

In the two week period ending August 11, high yield spreads over comparable Treasuries jumped 2%. In total, spreads for the quarter rose from 5.4% to 8.4% leaving the segment with a loss of 6.1% for the quarter and 1.4% for the year.

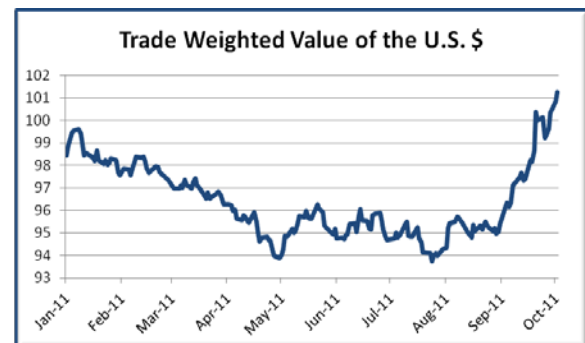
Following quarter end, high yield spreads, historically a very good leading indicator of economic growth, rose above 9%. Notably, the probability of recession implied by this level is well in excess of 50%.

Equity Markets

The S&P 500 index fell 13.9% for the quarter and is now down 8.7% for 2011. Remarkably, the dividend yield on the S&P 500 now

exceeds the 10-year U.S. Treasury yield for the first time in 50 years.

Internationally, the MSCI EAFE Developed Markets index dropped 19.0% for the quarter while the corresponding Emerging Markets index gave up 22.6% for the period. Year-to-date, these markets have lost 15.0% and 21.9%, respectively. Dollar strength during the quarter significantly contributed to weak international equity returns.



Data Source: U.S. Federal Reserve



Emerging market currencies, in particular, were hurt on expectations of slower growth and an end to interest rate hikes. Commenting on the emerging markets, the IMF warned that these countries are being pulled down by economic malaise and they face the risk of “sharp reversals” due to weaker growth, sudden capital outflows, or a rise in funding costs.

Hedge Funds and Alternatives

Hedge funds, while off less than market averages, had difficulty navigating the third quarter. The HFRI Fund Funds index lost 4.7%. The quarterly decline was the fourth largest in the industry’s history. Losses were widespread across both investment strategies as well as

geographic focus. The index is down 5.0% for the year.

The DJ UBS Commodity index, with a staggering 14.7% loss in September alone, was off 11.3% for the quarter. Many economically sensitive commodities fell precipitously on slower economic growth and weak manufacturing numbers from China. Oil was down 8% in September, 14% for the quarter, and 11% for the year. Copper, often a reliable indicator of economic cycles, fell 23% in September. The DJ UBS Commodity index is down 13.6% for 2011.

The DJ US Real Estate index of publicly traded REITs, another former high flyer, was down 15.3% for the period and is now down 6.8% for the year.

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