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~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

This past quarter has been treacherous for equity investors, both here and abroad. In recent conversations with clients, we have talked about market volatility and the effect it has had on our outlook. We would like to review these thoughts with you.

First, we would note that even with the current correction, and the equally severe correction of last year, the stock market has doubled from its March 2009 low. The economy has been growing, albeit slower than in past cycles, for the last two years. The companies that led the recovery are beneficiaries of inventory rebuilding and the price increases associated with higher demand and constrained supply.

As supply and demand attains equilibrium, economic growth decelerates from the relatively rapid pace of a cyclical recovery to the more sustainable pace of a secular economic expansion. Unfortunately, as we have discussed before, this economic cycle has been and will probably continue to be characterized by slower than normal growth. **In this environment, stock prices are more vulnerable to disappointment, earnings misses and media commentary.**

This summer, with slowing economic growth and seasonally low market volume, pessimistic headlines combined with unrestrained trading strategies created a toxic investment environment. Last year, the stock market experienced the so called Flash Crash, in which the market plunged dramatically in minutes. After months of research, regulators were unable to fully understand what happened and how to prevent it from recurring. For a brief period, in early August, the stock market again experienced extreme volatility. **While the characteristics of this year's volatility was somewhat different, it continues to be driven by high volume algorithmic trading (orders placed by computers),** something regulators seem incapable of understanding, much less controlling.

It doesn't take much to trigger these programs and this summer's headlines produced the catalysts. **Many of these headlines described transitory economic events; they had a chilling, but temporary, effect on the equity markets.** We would include the earnings impact of the supply chain disruptions and Standard and Poors' downgrade of U.S. Treasury debt, in this category.

Short term market volatility weighs on investor psychology and can influence consumer and investment spending**. But, we are much more concerned with the long term impact on the market from the apparent inability of governments to resolve ongoing financial issues.** Whether it is the European sovereign debt/banking crisis, the philosophical polarization of solutions to the U.S. debt/unemployment situation, or inconsistent regulatory policies due to turf battles between various agencies of government, **it is increasingly apparent that markets are quick to react to financial crisis while democracy is slow**. Until there is clarity and transparency of policy, financial markets and the economy will deliver less than optimal results.

We continue to believe that stocks are, and should be, a major element in any investment strategy. We also understand that stocks are volatile and that volatility can be a high price to pay for equity returns. How do we resolve this paradox?

First, **we maintain objectivity through a disciplined approach.** Our valuation screening models help us to buy good companies based on reasonable fundamentals. We don't respond to emotion.

Second, **we work to set an appropriate asset allocation, with sufficient reserves**, in order to avoid being forced to sell when the market is down. You don't lose money in an investment until you sell it.

Finally, **we never stop thinking about diversification.** With markets linked globally it is increasingly difficult to diversify risk, but it can be done.

Our economic forecast continues to view slow growth with gradually rising inflation as the most likely scenario. The risk to this outlook is split between an overheating economy with high inflation, due to the large amount of sidelined cash versus deflation and recession due to low confidence and policy mismanagement.

Fixed Income Market

The United States is experiencing one of the lowest interest rate environments in decades. The 10 year U.S. Treasury yield rate dipped to a low of 1.67% on September 23rd and although it has bounced back, remains at levels not seen in 60 years. The U.S. Treasury yield curve has also flattened with the spread between the 2 year and 10 year Treasury at around 175bps (it was over 100bps higher just six months ago). There are two primary factors affecting the yield curve and interest rates. First, with continuing concern related to European debt/banking conditions and possible slower global growth, U.S. Treasuries have seen a "flight to safety" benefit driving up its prices and in turn lowering yields. Second, the Federal Reserve recently announced its "Operation Twist" to help spur domestic growth which entails purchasing long dated Treasuries.

The premise behind much of the Fed's actions lies in promoting growth through lower rates. With lower mortgage rates, houses become more affordable and current homeowners could refinance. Lower corporate borrowing rates encourages investment that leads to higher stock prices. Higher stock prices boost consumer wealth and confidence that leads to spending which helps corporations be more profitable and the cycle continues.

To achieve this lower rate environment, the Fed announced the commencement of "Operation Twist". The program entails purchasing long term (6-30 years maturity) Treasuries while at the same time selling current holdings with maturities of three years or less. The total amount of this "Operation" will be $400 billion over the next nine months**. It will not add any money to the current Fed balance sheet, but will in effect be shifting the current portfolio from shorter maturities to longer maturities, and hopefully "twist" the yield curve lower**. Additionally, to further support lower mortgage rates, the Fed will continue to replace its maturing mortgage backed securities with like-kind holdings versus using those funds for Treasuries. Although the effects of this program are already being hotly debated, it seems apparent the Fed will continue to keep pressure on interest rates until economic activity picks up.

Surprisingly, the implications for our bond portfolios and the opportunities we see in fixed income, have not changed significantly. We hold our individual bond holdings to maturity and focus on safety and enhancing overall investment portfolio stability. Given these guidelines, we continue to seek reasonable yield with quality corporate bonds, safety in the agency backed offerings, and the tax-exempt benefit of municipals for our higher tax clients. **While overall rate levels have shifted downward, the benefits of a laddered-portfolio of quality fixed income holdings remain important in an overall diversified portfolio.**

International Market

International investing has been a challenge this year due to the relentless negative news headlines undermining investor confidence. It's natural to worry at times of market volatility, but the impact from headlines is generally transitory in nature. Therefore, despite the fact that major international markets have underperformed the U.S. year-to-date, **international investing is still an essential part of total asset allocation because of its higher growth potential, reasonable valuation levels, and diversification benefits**.

Main stream media loves dramatic headlines; recently there has been plenty to exploit. Concerns regarding the impact of the Japanese earthquake and tsunami on the global supply chain, worry about the Chinese government's effort to cool inflation and its impact on growth, and the fear that the Greek sovereign debt issue would become another "Lehman Brothers", all cast an ominous shadow over international equities. Without a doubt these concerns add to the volatility of the markets; but the validity of these claims warrant closer examination.

The Japanese earthquake and the tsunami that followed were devastating natural disasters. In addition to the irreplaceable human loss of life, the disaster caused parts and power shortages, disrupting global production. The media had a field day analyzing the event and some even claimed it would be years before the supply chain was restored. However, companies are addressing the disruption at a faster pace than expected; **Japan's industrial manufacturing production is almost back to its pre-disaster level in 6 month's time!**

Stabilizing consumer prices remains the Chinese government's top priority. Various measures have been undertaken to keep the economy from overheating. Despite this "controlled" slowing of China's growth, the media still portrays its economy as heading for a "hard landing". Recent economic data releases have pointed to the contrary, both exports and imports are showing signs of continued growth, indicating that although the Chinese economy is transforming it is not experiencing a slow down beyond what is desired by the government. **After all, China's GDP is still expanding at a 9.5% year on year pace**.

Although the PIIGS nations' ability to service their sovereign debt still remains the focus, it is really the health of those European banks holding bonds issued by these weak countries that matters most to the global markets. **That is why the rescue efforts quickly shifted from simply bailing out troubled countries like Greece, to the ECB buying sovereign debt and thereby creating a price floor for these troubled bonds.** Although the situation is still somewhat chaotic, European countries are working together to address the issue. For example, an agreement was recently reached to allow the European Financial Stability Facility (EFSF) to buy bonds of distressed governments on both the primary and secondary markets. It also allows for preemptive credit to be given to governments before they are cut off from markets. More promising is the ongoing discussions for a long-term solution to the fundamental problem of using a single monetary policy to service the needs of widely divergent fiscal policies – it involves the concept of a "European Economic Government" to achieve fiscal integration among all member nations and the issuance of a common "Eurobond".

We certainly do not anticipate the situation in Europe to turn around immediately. In fact, it will be a long process that could entail continued market pain as separate European nations' commitment to hold the union is tested. There will also be volatility related to continued headline news including the possibility of a Greek default on its debt obligation. **However, just as in the case of Japan, these events will eventually get resolved and markets will respond to the next opportunity**.

We see such an investment opportunity in the rising "middle-class" of emerging markets. The population designated "middle class" in emerging markets is expected to surpass that of the developed world by 2015. This population gap is expected to continue to widen over time. By 2020, this group is expected to reach 1.4 billion in population. Their rising discretionary income levels will increase the region's share of global consumption and emerging markets will become increasingly important, not only on the supply side of the global economy but also on the demand side. We are currently exploring various proxies to participate in the increased spending of this new found wealth.