

October 28, 2011

Dear Client:

The ambivalence that took root in the spring blossomed into fear in the third quarter as the euro zone's decaying fiscal situation, combined with the contentious U.S. budget debate, left global investors sickened by risk. While stock and commodity markets retreated, money flowed back into the relative safety of Treasury debt—despite the high-profile downgrade of U.S. credit—so that by quarter's end, the Federal Reserve was forced to “twist” its strategy of intervention in the Treasury market.

Fortunately, the fourth quarter is beginning on a brighter note. As of mid-morning yesterday, the Standard & Poor's 500 stock index had gained 12% for the month of October, its highest monthly percentage gain since January, 1987. In addition, its gain of 139 points marks its highest monthly point gain of all time. For that reason, we are including portfolio reports as of October 27 along with your third quarter reporting, for your reference.

### **Equity Markets**

After a spectacular two-year rally, U.S. stocks may have been due for a correction, but the somewhat mild selling that began in May turned savage by August. With volatility gauges spiking, global equity benchmarks delivered their worst three-month performance since late 2008, in the wake of the harrowing Lehman Brothers collapse.

The Dow Jones Industrial Average, based on the performance of shares in 30 top U.S. corporations, sank a stark 11.49% during the quarter including dividend payments. The broader market, as represented by the S&P 500, was down 13.87% after dividends. The technology-rich NASDAQ Composite also suffered, dropping 12.70%.

While these losses almost entirely erased the market's gains for the year, long-term investors took some comfort in realizing it could have been worse—such as during the fourth quarter of 2008 when more than 20% of the value of the entire U.S. market evaporated. Moreover, despite the reversal, most of the accumulated appreciation from the 2009-2011 rally remained intact.

The S&P 500, for example, ended the quarter with a scant 1.14% gain to show for the trailing 12 months, but remained 67% above its 2009 trough and 27% below its record high of 2007. The Dow, too, held on to a 3.83% gain since September 2010, leaving the blue-chip index up 66% for the previous two and a half years. Having soared 90% above its low in 2009, the NASDAQ ended the quarter just 15% below its 2007 high (though still vastly below its all-time pinnacle of 5,048 attained on March 10, 2000).

A palpable sense that the U.S. and global economies were slowing drove investors out of recession-sensitive small-cap shares in disproportionate numbers. The small-cap Russell 2000 Growth Index, considered especially vulnerable to a decline in new commercial activity, plunged 22.25%, while the slightly more defensive Russell 2000 Value Index sank 21.47%. Once again, the nation's largest corporations held up slightly better, but with the Russell 1000 Value Index dropping 16.20% and the Russell 1000 Growth Index down 13.14%, even the bluest of blue chip companies were in retreat.

Remarkably, U.S. corporations kept finding ways to squeeze additional profitability out of existing businesses even as the economic outlook clouded. Final results from the second quarter saw members of the S&P 500—which accounts for more than 70% of the total capitalization of the U.S. market—report 18.92% higher operating profits per share, a bit above the 16.40% growth they had delivered three months previously. Still, compared with the 27% growth U.S. corporations enjoyed during the final quarter of 2010, the trend pointed downward, and analysts suspected the summer's numbers would show still slower growth.

Profitability remained a sore spot for financial companies, whose earnings were expected to rise less than 1% during the third quarter amid increased regulation and stagnant lending. Signs of weakness also emerged in telecommunications, while volatile energy prices continued to strain the profit margins of utilities. But energy producers should benefit, seeing their earnings expand by as much as 50% when third-quarter numbers are released later in the year.

Investors might have spent the quarter's darkest days worrying that a repeat of the grim winter of 2008-2009 was coming, but the massive amount of cash U.S. corporations are generating—and passing on to shareholders—should put those fears in perspective. Another 350 publicly traded companies expanded third-quarter payouts while only 23 cut dividends. The aggregate increase came to \$9.6 billion for the quarter, one bright spot for income-hungry investors.

### **International Equities**

Once again, developments overseas were both the source and the primary symptom of much of the quarter's angst. Western Europe's worsening debt situation generated endless speculation that political inertia could doom at least the region's weaker economies to a deep recession. At the same time, though, hints of persistent inflation in emerging markets led to worries that central bankers in Asia might be losing control of their recently booming economies.

While the United States spent much of the quarter reeling from its own eroded credit rating and faltering economic climate, its risks must have seemed less dire than most to the investors who flooded into the perceived relative safety of dollar-denominated assets.

Against this backdrop, the MSCI EAFE Index, a leading gauge of blue chip stocks in the developed markets of Europe, Australasia, and the Far East, plunged 15.68% on a local currency basis, or 18.95% when repatriated into dollars.

The long-dreaded prospect of fiscal decay spreading from Greece and other debt-weakened members of the European Union finally came home to the industrial superpowers of Western Europe. In dollar terms, the third-quarter losses of European equity benchmarks ranged from 16% to a nightmarish 46%, with only Switzerland and the United Kingdom—the strongest economies on the borders of the euro zone—falling less than 19%. Even in once-stable France and Italy, sovereign credit ratings began to deteriorate and stock markets in those nations lost almost a third of their value.

As nation after nation scaled back its targets for consumer spending and growth, capital poured out of the emerging world, leaving key markets in Asia, Latin America, Eastern Europe, and the Near East down by as much as 45%. While relatively robust growth saved Chinese and Indian stocks from the worst of the selling, those governments' increasingly desperate efforts to contain inflation unnerved investors, pushing down the nations' markets by 25% and 20%, respectively. In Brazil and Russia, whose economies are tied closely to the plight of commodities, the retreat was even more pronounced, with stocks ending the quarter 27% and 31% lower, respectively.

### **Currency and Commodities**

Thanks to the long debate in Washington about raising the Treasury's borrowing limit, the U.S. dollar spent much of the quarter on the defensive. However, while Standard & Poor's elected to strip the United States of its cherished "AAA" credit rating, investors soon flocked to the dollar anyway. By September, currency markets had priced in the likelihood of at least a technical default in a euro zone country, and Europe's shared currency was on the run. The Japanese yen, Swiss franc, and the dollar surged in value, and the greenback fared particularly well, ending the quarter up 5.6% against a basket of other monetary units.

Amid falling targets for global economic growth, estimates of how much oil, metal, and other raw materials the world's industrial consumers would need also dropped. The widely-quoted R/J CRB Total Return Commodity Index sank 11.8% in the quarter, led by much larger declines in copper and other key industrial materials. Oil prices continued their retreat, falling another 17% to \$79.20 a barrel for West Texas Intermediate crude as supply disruptions in war-ravaged Libya were resolved.

Gold, considered the ultimate hedge against currency weakness, political instability, and inflation, fared much better. Amid the downgrade of the U.S. debt rating and ensuing market turmoil, bullion soared an almost unprecedented 27% in a matter of weeks to a new peak of \$1,908 an ounce on August 22 before quickly giving back much of that gain. By quarter's end, gold was still up 7.26% from its price at the end of June, reflecting the depth of investors' desire to protect themselves from risk.

### **The Bond Market**

Amid heightened worries that Greece would have to default on its obligations, even downgraded U.S. debt was much in demand, leading to the best performance for U.S. bonds since late 2008. By comparison, the Federal Reserve's decision to shift \$400 billion of its U.S. government bond portfolio to longer-term securities—the controversial “Operation Twist”—was at best a sidelight to the flight of capital to Treasury debt.

Once again, with scant progress in the housing and labor markets, no one expected that the Federal Open Market Committee would raise its target for overnight interest rates. Indeed, Fed chair Ben Bernanke and his colleagues hinted after their August meeting that short-term interest rates could effectively stay at zero or otherwise “exceptionally low levels” through at least mid-2013. Investors looking for other hints about the economic outlook scrutinized the language in Fed statements, noting that “deterioration” in the job market in August gave way to “continued weakness” in September, although consumer spending shifted up from “flat” to “increasing at a modest pace.” But inflation remained stable throughout the quarter, and by September, the Fed confessed that with foreign markets unsettled and commodity costs waning, pricing pressure was actually too low—too deflationary—for comfort.

As represented by the Barclays Capital Government Bond Index, the total return on Treasury securities was a breathtaking 24.66% during the quarter—higher than in any three-month period since Lehman Brothers' messy demise generated unprecedented demand for U.S. bonds. While the market greeted Washington's long stalemate over the federal budget with trepidation, not even the resulting downgrade of the Treasury's credit rating dampened global hunger for these securities. By late September, short- to mid-term Treasury yields were back at record lows, with the Federal Reserve's decision to buy longer-term bonds actively depressing yields of bonds of all maturities.

Investors avid for Treasuries had little room in their portfolios for most other fixed-income investments. Even high-grade corporate bonds generated only a 2.9% total return in the quarter, while rapidly sinking demand for high-yield or “junk” debt pushed its returns into negative territory in September. Despite high-profile warnings of a looming meltdown in the tax-advantaged municipal bond market, there was no wave of state and local government defaults and munis rose 3.81% for the quarter.

### **The Economy**

Whether investors took their cues from the Federal Reserve or regularly scheduled data releases, their outlook on the U.S. economy cooled in the third quarter. While the data failed to support claims that an outright disaster was upon us, hope that trillions of dollars of government stimulus would trigger a robust expansion faded, leaving fear of a period of stagnation or outright recession.

Gross domestic product, the widest gauge of U.S. economic strength, expanded at a lower-than-expected annualized rate of 1.3%, and earlier estimates of “real” first-quarter growth were revised down to a scant 0.4%. Despite scattered bright spots—notably a surge in exports, business investment, and corporate profits—few economists anticipate that the third quarter's numbers will be much better as government spending slows.

As the Federal Reserve noted in its monetary policy decisions, U.S. household spending leveled out in the third quarter. Retail sales kept edging upward, reaching a record \$390 billion in August, but while that figure represented a 7% year-over-year improvement, month-to-month gains were negligible. Gas prices remained high and spending at filling stations soared 19%.

Gloomy headlines translated into a steep decline in the U.S. public's opinion of economic conditions. By August, one key gauge of consumer confidence had retreated to 45, the lowest level since April 2009, when the global economy was still recovering from the credit crunch. The Conference Board, which tracks this statistic, attributed the decline to uneasiness over lawmakers' fragile compromise over the federal budget and ongoing angst about the job market.

The pace of U.S. job creation continued to slow during the third quarter, with companies filling a scant 287,000 new positions from July through September. Meanwhile, as even extended unemployment benefits expired for many workers, they returned to the difficult job market, leaving the broad unemployment rate elevated at 9.1% in September.

Even though wage increases proved elusive, the cost of living accelerated during the third quarter. As manufacturers and refiners passed along higher commodity prices, retail inflation increased to historically normal levels, rising 3.8% in August on an annualized basis. But most of the gain was fueled by an 18.4% year-over-year increase in energy costs. Not counting energy and food, prices edged up 2.0%, feeding the Fed's argument that if anything, inflation remains too weak to help fuel economic growth.

Ultimately, investors with a long-term perspective managed to take some comfort in the knowledge that while the third quarter may have disappointed, it was far from disastrous. Though the economic picture dimmed, the primary engines of wealth creation remained active, albeit at more subdued levels. U.S. businesses hired fewer people, but the mass layoffs that plagued the economy and unnerved the public in 2008 and 2009 haven't returned. Housing markets continued to drift, neither rebounding nor worsening appreciably. In early October, the euro zone's finances were fragile but intact. And perhaps most importantly, the long-dreaded downgrade of U.S. credit failed to trigger the apocalyptic consequences that market commentators had eagerly predicted. On the positive side, corporate profits remained resilient, the Federal Reserve was still poised to intervene aggressively if the situation worsens, and as always, life in America goes on.

### **Your Portfolio**

In early September, we substantially reduced Treasury Inflation Protected Securities ("TIPS") exposure in taxable bond portfolios from 24% of the fixed income segment to 14%. For the first time since we added TIPS to client portfolios several years ago, the interest rate component dropped below zero to -0.1%, effectively undermining the ability of the CPI component to help total returns keep pace with inflation. TIPS have done very well this year, returning 10.4% year-to-date through August, compared to 4.9% earned by the Barclays Capital Government/Corporate Bond Index over the same period. However, TIPS have become expensive in relation to other fixed income options. Yet because inflation remains a threat, we will continue to hold a TIPS position to help hedge against inflation and aid portfolio diversification. We did not make any changes to municipal bond portfolios.

With the proceeds from the reduction in TIPS exposure we purchased the PIMCO Foreign Bond fund (hedged) and the Vanguard GNMA fund. The PIMCO Foreign Bond fund is hedged to the U.S. dollar, which means the fund does not fluctuate with changes in the value of the dollar. Historically, foreign bonds have had a low correlation with U.S. bonds. Thus, including foreign bonds in a dollar-based investor's portfolio may help reduce portfolio volatility. The Vanguard GNMA fund primarily holds high-quality, U.S. government (Fannie Mae)-backed mortgages with an average AAA credit rating. Historically, this fund has had very low volatility and consistent returns, even during years when interest rates increased. This fund also has low correlation with other funds in client portfolios so should further improve diversification.

Although we rebalanced the domestic equity segment of most client portfolios in January, and the fixed income segment of taxable bond client portfolios in September, we have maintained our strategy of not rebalancing the commodities segment of client portfolios. As a result, clients with commodities exposure have seen that portion of their portfolios grow from an initial minimum allocation of 5% to an average of 7.5% or more of portfolio value.

### **Thoughts from Towneley**

Continued market volatility and rampant economic uncertainty has spawned a new wave of doomsday predictions from so-called “experts” pitching their latest product, book or consulting services. Time and again we’ve seen how during periods of extreme market volatility those seeking to profit off the fears of others are able to do just that. We urge you to remain focused on your financial goals and stick with your investment plan; try not to give into fear or hype. However, if your employment, health, or family situation has recently changed, or if you are within a year or two of making a major life change that will impact your income, expenditures or invested assets, please contact your portfolio manager so that we can reevaluate your portfolio allocation. Likewise, if you are so concerned about recent market volatility that you are having health or lifestyle issues (such as sleep interruption) as a result, we recommend you discuss with your portfolio manager whether a lower equity objective may be appropriate for your portfolio.



### **News from Towneley**

In June we mailed our annual client update questionnaires to our private clients. Most of you have completed and returned them to us and we wish to thank you. These summaries are very useful. If you haven’t returned your questionnaire, we encourage you to do so.

For the seventh year in a row, *AdvisorOne* magazine (formerly known as *Wealth Manager* magazine) listed Towneley Capital Management, Inc. as one of the nation’s top 100 investment advisors as measured by assets under management per client. Of 370 firms participating in the wealth manager survey, Towneley ranked in the top 20 percent.

As always, if you have any questions, please do not hesitate to contact your portfolio manager.

Best regards,

Tracy Kuntz, MBA, CFP®  
President

Enclosures

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**GLOBAL EXCHANGE TRADED FUND STRATEGIES**  
**3rd Quarter 2011 Performance Review**

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***Global Balanced Strategy***

Our Global Balanced Strategy, which invests in bonds, stocks, and commodities around the world, lost 8% during the third quarter, but gained 1.7% over the past 12 months.

The third quarter was a very gloomy one for most asset classes. U.S. 10-year bond yields suffered most. Despite market uncertainties, the U.S. 10-year bond yield benchmark hovered near 3% until late July. However, after the U.S. debt ceiling debate, and despite the Standard and Poors' downgrade of U.S. Treasuries, the 10-year yield plunged to near 2% in early August. The yield continued its downward spiral until it bottomed out at a 60-year low of 1.72% on September 22, the day the Fed began to purchase long-duration Treasuries.

The severe decline in bond yields reflected investors' growing intolerance for riskier assets and flight to the relative safety of Treasuries. By quarter's end, U.S. bonds had gained 4.4%. U.S. bonds' performance helped prop up global bonds, which gained 0.7% during the quarter as measured by the Barclays Capital Global Bond Index. In contrast, foreign bonds lost 1.7% as measured by Barclays Capital International Treasury Bond Index, due primarily to currency weakness.

In a time of crisis, investors often flock to the perceived safety of U.S. dollars. The U.S. Dollar Trade Weighted Index, which measures the value of the U.S. dollar against other major currencies, rose 5.7% during the quarter. The U.S. dollar gained more than 9% compared to both the Australian and Canadian dollar, and over 7.7% versus the euro. However, the value of the greenback declined 4.9% against the Japanese yen.

Amid growing uncertainty, global stocks and commodities plunged. Global stocks reported their worst quarterly return since the end of 2008, dropping 16.5% as measured by the MSCI World Index. The steep decline was led by severe losses in both developed market stocks (down 19%) and emerging market stocks (down 23.2%), as measured by the MSCI Developed Markets Index and the MSCI Emerging Markets Index, respectively. In contrast, U.S. stocks lost only 13.9% during the third quarter, as measured by the S&P 500 Index.

Commodity prices declined 10.4% due to a steep drop in the price of base metals and energy. In particular, copper plummeted 29%, while crude oil fell 17%. As a group, commodities' losses were mitigated by a spectacular third quarter gold rally during which the price of gold rose 7.3%. Like U.S. debt and currency, gold was again a safe haven for nervous investors. In July, gold prices rose above \$1,600/oz as investors dumped riskier assets. At the end of August, however, the yellow metal traded at slightly less than \$1,900/oz. before plunging more than \$200 over three days during the last week of September to finish the quarter at \$1,629/oz.

Gold's gains helped trim the loss in the equity portion of the strategy to 13.8% for the quarter. The fixed income portion of the strategy gained 0.3% over the same period, trailing global bonds by 40 basis points. At quarter's end, the equity and commodity portion constituted 54% of the strategy, while bonds accounted for the remaining 46%. Specifically, 21% of strategy assets were invested in U.S. equities, 18% in foreign equities, 24% in U.S. bonds, 22% in foreign bonds, and 15% in commodities.

***Developed Markets Strategy***

Our Developed Markets Strategy, which invests in equities and fixed income securities of industrialized countries, declined 12.7% in the third quarter, and 5.6% in the last 12 months.

Developed market bonds and stocks both underperformed their U.S.-based equivalents. Developed market bonds dropped 1.7%, lagging U.S. bonds by more than 6% due to the rising dollar. Widening currency losses easily erased modest gains from higher bond prices, which caused the bond portion of the strategy to lose 4.3% over the course of the quarter. Bond performance was also affected by our addition of lower quality corporate bonds and inflation protected Treasuries to the strategy, which we anticipate will help boost returns once investors return to riskier assets, and help hedge against future inflation, respectively.

Government bond prices rose as yields in major government bond markets continued to slide, an occurrence at odds with rising sovereign risk in Europe. Average yields were squeezed by the European Central Bank's attempt to stop the region's debt crisis from spreading by purchasing bonds.

Developed market stocks fared poorly during the third quarter, as represented by the MSCI EAFE Index which sank 19%, 5% lower than the S&P 500 Index. Most developed market countries suffered double digit losses, particularly those in Europe, where stocks plunged 23%.

The eurozone's debt crisis, along with some unpopular social changes, put the region's economy in the spotlight. In early August, a riot in the United Kingdom developed into rampant looting and arson attacks, resulting in over 3,000 arrests. In continental Europe, thousands protested austerity measures in Greece, Portugal and Spain. As a result, even other markets not in crisis experienced panic sell-offs. Both the Australian and Canadian stock markets lost nearly 20%, and markets in the Pacific region declined an average of 16%. Japan, supported by its strong yen, lost only 7%.

The surprisingly resilient Japanese stocks contributed to the 21.4% loss experienced by the stock portion of the strategy. Despite having reduced exposure to Europe last August, we continued to underweight Japan compared to the MSCI EAFE Index.

At quarter's end, roughly 45% of the strategy was invested in equities, of which 17% was allocated to Asia, 24% to Europe, and 4% to North America. The remainder of the strategy was invested in fixed income securities.

### ***Emerging Markets Strategy***

Our Emerging Markets Strategy, which invests in less-developed economies, declined 15.7% in the third quarter, and 10.8% in the past 12 months.

Emerging market assets had a very disappointing quarter; both emerging market bonds and stocks reported deeper losses than their global peers. During the summer, investors had faith in the sector's stronger fundamentals: faster growth rates, lower debt levels and richer foreign reserves. However, when global investors fled to safety during the third quarter, emerging market bonds, as represented by J.P. Morgan's USD Global EMBI Index, lost 2% in part because of the strong dollar.

Emerging market currencies were very popular during the dollar slump. Until last month, their collective value against the dollar was appreciating. However, investors' fears about debt, growth and inflation caused them to discard emerging market currencies. Large losses among the sector's currencies dragged down returns of the bond portion of the strategy, which lost 3.6% during the quarter, in part because we added two local bond funds in early August.

Since early this year, emerging market stocks have been out of favor because of higher inflation and monetary tightening by central banks in China, India, Brazil, and Russia. The region's stocks peaked in May before slumping through September. During the third quarter, the MSCI Emerging Market Index lost 23.2%.

The stock portion of the strategy also lost 27.3%, lagging the market index by 4.1%. The strategy's underperformance resulted from a sharp decline in the Eastern European markets. Besides the European debt crisis, Russia, the largest emerging economy, was also affected by a steep drop in crude oil prices and the sharp devaluation of the ruble, which tumbled close to 30% during the third quarter.

Their recent slump may have made emerging market stocks more attractive than a year ago, and presents a buying opportunity. From a fundamental point of view, emerging economies with less fiscal strain are likely to lead global growth. During the third quarter, we added 5% to the stock portion of the strategy, increasing it to 55%. At quarter's end, the stock portion of the strategy was invested as follows: 22% in Asia, 11% in Latin America, 13% in Eastern Europe, and 7% in the Middle East and South Africa. The balance of the strategy was invested in fixed income securities.

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