COMMENTARY 2012 Q3

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During the quarter, equity markets reached new highs for the year as the prospects for increased government stimulus became a reality. However, the underlying fundamentals continue to be mixed. Ultimately, we think that an acceleration in economic conditions will be required to support further near-term equity market appreciation.

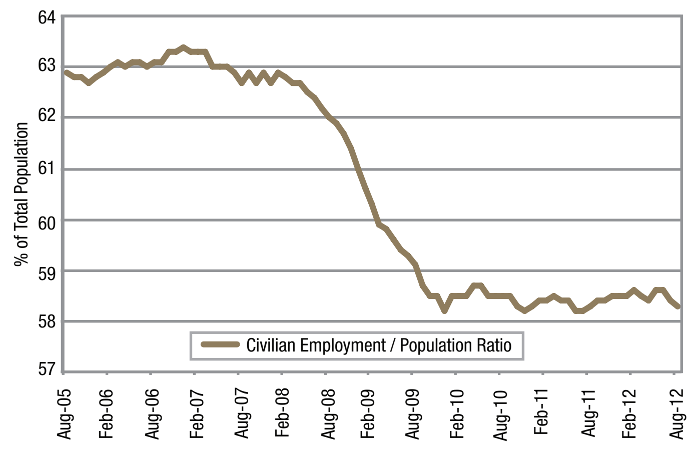
The S&P 500 gained 6.4% for the quarter and is up 16.4% year-to-date. On a total-return basis (including dividends), the S&P 500 has now surpassed its prior, October 2007 peak. From a sector perspective, growth-oriented sectors (Technology and Consumer Discretionary) led the way, with the Energy sector generating the strongest returns during the quarter as oil prices rebounded from their June lows. Defensive sectors (Consumer Staples and Utilities) underperformed the broader index.

Central Banks around the World Orchestrate a Market Rally

Since midsummer, equity markets have appreciated as the prospects for additional government liquidity increased. The U.S. Federal Reserve, the European Central Bank, the Bank of Japan, and The People's Bank of China have all increased their government-sponsored capital deployment programs in an effort to stimulate their respective economies. Central banks across the world are coordinating their actions in order to provide a highly accommodative economic environment.

In the U.S., although the unemployment rate has declined to 8.1% from its October 2009 peak of 10%, job formations as a percentage of the total population remain stagnant. As indicated in Figure 2, the number of people unemployed or underemployed has yet to show improvement, and these individuals are becoming increasingly frustrated with current job market prospects. The Federal Reserve's latest quantitative easing action (QE3) is a clear signal that job creation is now its top priority and that it will likely delay any rate increases until the economy has demonstrated sustainable job creation.

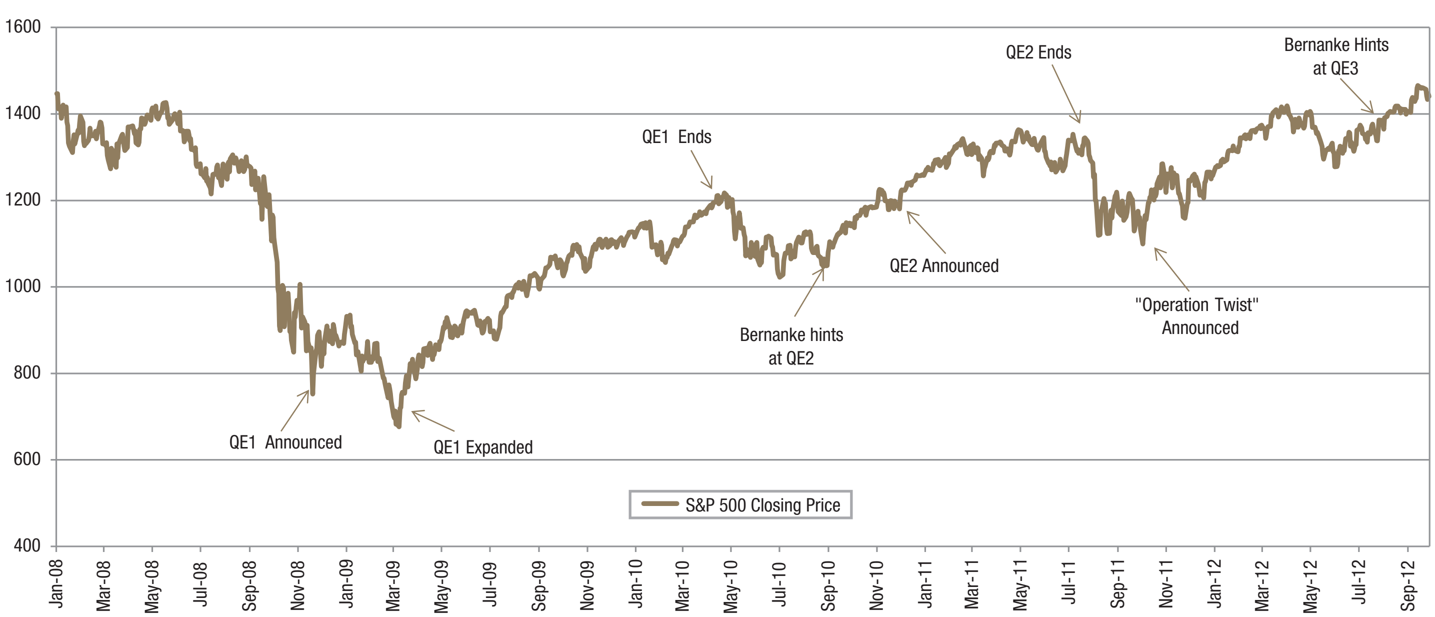
Figure 2: Civilian Employment to Total Population Ratio



Source: Federal Reserve Bank of St. Louis

Even though the economy failed to flourish under previous monetary programs, time will tell whether QE3 is truly able to have a positive impact on employment or keep interest rates at or near current historic low levels. However, unlike each of the prior two quantitative easing programs initiated by the Federal Reserve, QE3 is "open-ended" with no official end date or total capital deployment restriction. Equity markets continued to appreciate as speculation of additional easing started to build. Following the formal announcement of QE3 on September 13th, the S&P 500 has since declined as we think equity markets are waiting for confirmation that the program is beginning to meet its desired goals.

Figure 1: S&P 500 Closing Prices and Quantitative Easing Announcements



Source: Bloomberg

Global Economic Weakness Threatens an Anemic U.S. Recovery

We think prior expectations for an acceleration in global economic growth through the end of the year could prove difficult to fulfill. Although the U.S. remains on the road to recovery, Europe continues to contract and has yet to show signs of bottoming, while China seems to be slowing further despite recent government stimulus.

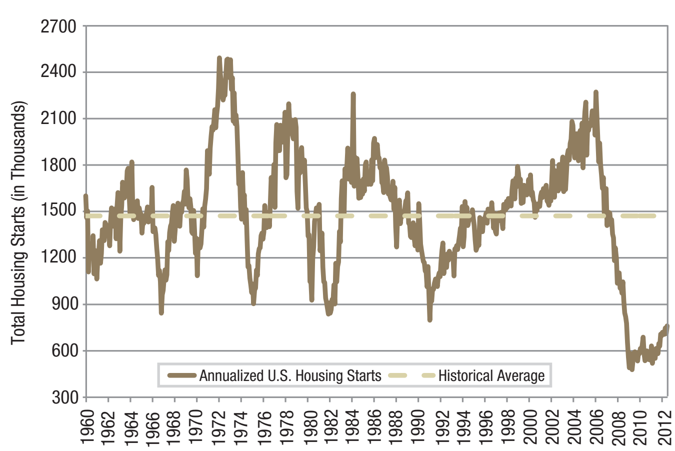
In the U.S., underlying economic data continue to paint a mixed picture, with consumer confidence and service-oriented business improving while broader manufacturing activity tapers off and job creation remains lackluster. As we look forward to next year, the domestic economy faces multiple hurdles, including the looming "fiscal cliff" and potential global economic slowdown.

On the positive side, the housing market has turned out to be one of the bright spots in the U.S. As Figure 3 indicates, housing starts are beginning to show improvement but are still well below their historical average. Home prices have started to rebound in some areas, and refinancing activity has also been quite strong as existing home owners take advantage of historically low mortgage rates.

Conversely, the environment overseas does not appear to be improving. In Europe, austerity measures continue to weigh on economic activity in the peripheral countries. Although interest rates have declined for these nations, sovereign debt balances are still exceedingly high and could still prove to be unsustainable. Eurozone unemployment now exceeds 11% (it is as high as 25% in Spain) and is expected to increase to over 12% by the end of 2013 as capital continues to exit the region.

In China, manufacturing activity is at its lowest level since 2009. Internal demand for goods and services has markedly slowed, with total import activity actually declining 3% on a year-over-year basis in August. Initial government stimulus measures provided earlier in the year could prove to be insufficient to reaccelerate growth.

Figure 3: Annualized U.S. Housing Starts



Source: Bloomberg

Elections' Impact on the Taxation of Wealth

As Election Day approaches, all eyes are focusing on the U.S. presidential race and the potential implications of either a second term for President Obama or a Romney victory. In addition, the outcome of the congressional elections (one-third of the Senate seats are up for election and all 435 seats in the House of Representatives are up for reelection) will likely determine the balance of power in Washington.

Beginning in 2013 we could see a considerable increase in current tax rates, as the "Bush-era tax cuts" are set to expire at the end of this year. The top income tax bracket would increase by 4.6%, the tax rate on long-term capital gains would increase by 5%, the qualified dividend tax rate would increase by 24.6%, and new surtaxes (as part of the 2010 health care act) could add an additional 4.7% in taxes to the top income brackets.

Meaningful increases in tax rates on dividends could change their appeal to investors and ultimately have an impact on how companies return capital to their shareholders. Management teams could begin to seek alternative means to increase returns on capital, resulting in accelerated share repurchases, special one-time dividends, or increased merger and acquisition activity.

Course of Action

Since the market correction in the summer of 2011, portfolios have benefitted from our significant shift towards Consumer Discretionary, Industrial, and Energy stocks. With equity markets up sharply since then, we have rotated portfolios to a more balanced approach with less exposure to these areas and increased exposure to Health Care, Consumer Staples, and Utilities.

We continue to seek to identify investments in secular growth trends that are more insulated from the current macroeconomic volatility. Areas we think could offer compelling long-term opportunities include the renaissance in American manufacturing, the downstream implications of record cash balances, the emergence of a global middle class, and the implications of living in a constantly connected world.

The advent of new communication devices (smartphones) and applications (Facebook, Twitter) has dramatically increased the amount of available information and transformed the way in which that information is accessed. Today's mobile devices have more computing power than desktop PCs had just two to three years ago. Tasks such as accessing corporate data, searching for a new restaurant, or posting photos can all be done instantly from almost anywhere. This capability in turn has resulted in increased demand for information security and storage, as well as networking infrastructure to support the latest applications, which require robust data transfer speeds. Ultimately, we think mobile innovation is only beginning and should continue to expand globally over the next decade.

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