

Dear Friends & Investors,

There is a saying in football that “offense sells tickets, but defense wins championships.” The same can be said for investing. Everyone wants good returns and many are willing to employ the newest investment strategies in hopes of beating the market. As in football, when the offense is struggling, teams turn to their defense – a good one will keep you in the game, while a weak one will only make matters worse.

Investors needed a good defense in the third quarter. Our “no surprises” investment philosophy did its job and beat the market once again. Core fixed income had a great quarter, beating the Barclays Aggregate 3.95% to 3.83%. This brings the YTD return to an impressive 6.80% versus 6.67% for the benchmark. Intermediate fixed income enjoyed a great quarter also. It returned 2.57% compared to 2.39% for the Barclays Intermediate Government/Credit Index and now has a YTD return of 5.23% compared to 4.93% for the index. In addition to 2011, both of these strategies have beaten their benchmarks in **each of the last five calendar years.**

It’s nice to outperform the S&P 500 Index when the market is going up. It’s even better to beat it during down markets. Our Enhanced Index strategy has been doing just that. It beat the index by 0.09% in the third quarter and is now 1.19% ahead of the index YTD. Add that to its past performance and you have an investment strategy that is comfortably beating the S&P 500 over the past 1, 3, and 5 year time periods. If you’re a fan of index funds, you need to consider this compelling alternative for your portfolio.

How did your team do? Get a good defense, win a championship...you’ll sell more tickets then. If you have any questions on our approach or desire additional information, please don’t hesitate to contact me.

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September 30, 2011	Q3	YTD	1 Year	3 Year	5 Year
Core Fixed	3.95%	6.80%	4.95%	10.04%	7.80%
Net of Fees	3.89%	6.61%	4.70%	9.79%	7.55%
Barclays Aggregate	3.83%	6.67%	5.29%	7.99%	6.53%
Intermediate Fixed	2.57%	5.23%	3.64%	8.69%	6.99%
Net of Fees	2.51%	5.04%	3.39%	8.44%	6.74%
Barclays Int G/C	2.39%	4.93%	3.42%	7.02%	5.92%
Enhanced Index	-13.77%	-7.48%	2.11%	4.26%	0.44%
Net of Fees	-13.86%	-7.74%	1.76%	3.91%	0.09%
S&P 500 Index	-13.86%	-8.67%	1.15%	1.23%	-1.18%

Third Quarter Market Commentary

Fixed Income

Economic worries and sovereign credit fears drove down interest rates during the quarter to their lowest level this cycle – and their lowest point since WWII. As rates declined, the yield curve substantially flattened, with the spread between 2 and 30 year Treasuries contracting by 125 basis points. Though it is still historically steep, the Treasury yield curve is now the flattest it has been since early 2009. The Fed’s announcement of “Operation Twist” clearly had an impact on this shift as a new and substantial buyer of long-term securities entered the market. But weakening global growth and the possibility of recession also contributed to the impressive drop in yields on long duration bonds. Meanwhile, credit spreads continued to widen during the quarter with higher quality outperforming lower quality. This shift in spreads led to the second worst quarter for excess returns in the corporate market since the inception of the indices. Only the height of the 2008 financial crisis fared worse. As a result of the escalating European problems, financials were the hardest hit credit sector. The ECB continues to struggle to find a systemic solution to the burgeoning debt problems in Europe and default by one or more sovereigns grows more likely. This has had a negative impact on all credit spreads and it remains essential to be discerning in name selection. Surprisingly, many bond investors were caught off guard by both the shift in rates and the widening of spreads. We have maintained for some time that the curve was far too steep and that it needed to adjust – whether by long rates declining as the economy softened or by short rates rising as the Fed stepped off the gas. As a result, we have built a barbelled portfolio structure with neutral duration, reducing the weight in intermediates relative to both long and short duration securities. This was a positive to performance in the quarter. Despite an overweight posture in credit, our quality bias and strong name selection also helped us to outperform. We continue to avoid exposure to Europe and emphasize high quality corporates. While the economic outlook is murky, we expect that modest positive growth is the most likely outcome going forward.

Equity

As interest rates declined and credit spreads widened, the equity market fell during the quarter. Volatility has also picked up and the average intraday price swing of stocks has recently been more than twice what it was the prior four quarters. The S&P 500 has fallen nearly 17% from its recent highs, approaching bear market status. The weaker outlook for the economy and the growing problems in Europe has clearly contributed to this weakness. Strong corporate earnings growth the past few years has been a key driver of higher stock prices and investors are growing anxious about the prospects for profits going forward. But, fear and uncertainty are also negatively affecting this market. The last minute politics with the federal debt ceiling and the subsequent downgrade of the U.S. by Standard & Poors illustrate this issue. There is no doubt that fiscal restraint is coming, but how it will be implemented will be highly dependent on the next election. In recent months, defensive sectors have performed better than their cyclical counterparts, higher quality companies have begun to outperform, and largecap stocks are holding up better than smallcap – all signs of a struggling equity market. Valuation is reasonable and averting a recession could lead to a market rally. Our Enhanced Index strategy continues to perform well, outperforming during the quarter and year-to-date as the market suffered. The low cost of carry in the futures contracts, the attractive yield spreads available on high quality corporate bonds, and the still relatively steep yield curve remain viable reasons why this approach can continue to add value over the index.

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