

Walden Capital Newsletter

Walden Capital Advisors

Third Quarter 2011

Concerns about Europe's debt woes and negative global economic news sparked recession fears and drove stock markets down steeply in the third quarter.

On the equity side, U.S. mid cap, U.S. small cap, developed international and emerging markets all underperformed the S & P 500. As the stock market has declined, stocks have become more attractive in terms of higher five-year expected returns.

Returns from bonds are likely to be lower than from stocks, especially after investors' recent fear-driven flight to Treasuries. All other fixed income categories lagged Treasury returns despite the fact that yields are unattractive.

These shorter-term market swings could well continue in both directions for a long time to come given the ongoing macro challenges and uncertainties we face. For this reason we invest with a long-term time horizon.

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Quarterly Investment Commentary

This quarter was marked by extreme volatility as fear returned to the markets. The Dow Jones Industrial Average (DJIA) moved more than 100 points in either direction on 56% of the trading days, more than 200 points on 28% of the trading days and more than 300 points on 14% of the trading days. The DJIA's closing values during the quarter spanned a 2,000 point range. The increased volatility resulted from heightened concerns about a global economic slowdown, political gridlock, and serious concerns about shorter-term European and longer-term U.S. debt problems.

Spooked by macroeconomic events, investors have flocked to Treasuries, forcing their prices even higher and their yields lower. Concerns about Europe's debt woes and negative global economic news sparked recession fears and drove stock markets around the world down steeply in the third quarter. Large-cap domestic stocks fell 13.9% during the third quarter and have lost 8.7% year to date. Smaller-cap stocks suffered larger losses, down 21.9% for the quarter, and 17% for the year through September. International stocks also suffered double-digit losses, with developed market equities losing 19% for the quarter and 15% year to date. Emerging markets stocks were hit hardest, losing 22.6% for the quarter and 21.9% year to date. Our diversifying strategies funds helped the portfolios' returns as they lost only 3% for the quarter and 1% year to date. Real asset funds were down 14% during the third quarter and 12% year to date, underperforming the S & P 500 but outperforming all of the other equity categories. On a combined basis, the latter two categories were down only half as much as the S & P 500 during both periods.

Domestic high-quality, intermediate-term bonds gained 3.8% in the third quarter and are up 6.7% year to date, driven by investors' flight to the relative safety of Treasuries. Developed market international bonds were up 2.4% for the quarter and have gained 6.5% year to date. Local currency emerging markets bonds dropped significantly in September as capital flowed out of emerging-market currencies, and ended the quarter down 8.5% and are now in the red by 2.2% year to date. Floating rate loans fell 3.9% in the quarter and have lost 1.4% year to date.

Scary headlines and market volatility, while unnerving, can also create buying opportunities for disciplined investors. These shorter-term market swings could well continue in both directions for a long time to come given the ongoing macro challenges and uncertainties we face. For this reason we consider multiple scenarios and invest with a long-term time horizon.

Challenges Facing the Markets

Politics and Policy

One of the challenges for investors today is that government policy is likely to determine the path taken by the global economy. This creates tremendous uncertainty because not only is it impossible to predict what will be decided by legislative bodies, it is also difficult to have confidence in what the ultimate effects of those decisions will be.

The past three months saw much debate and little progress on the U.S. fiscal deficit, as topics like tax policy continue to be very polarizing. The debt ceiling showdown earlier in the summer was the quarter's most dramatic example of politics contributing to general uncertainty. Despite an 11th hour agreement, the contentious process and lack of meaningful action seemed to drive down consumer confidence and were specifically cited as part of the reason for Standard & Poor's subsequent decision to downgrade the U.S. sovereign debt rating from AAA to AA.

Overall, we continue to view policy mistakes, or simply inaction, as a major unknown and a potential risk factor. Too much austerity too soon could prove counterproductive (as was the case in 1937 when austerity measures tipped the country back into recession) and reduce tax receipts by a greater amount than spending cuts, thereby worsening the deficit problem. But, failure to address the deficit and debt in a meaningful way runs the risk of markets forcing the issue: investors demanding higher returns for taking on the risk of owning U.S. debt, forcing interest rates higher and further choking off growth, not to mention raising the cost of servicing our debt.

Meanwhile, with fiscal policy stalled by politics, monetary policy has been more aggressive with the Federal Reserve deploying a range of experimental tactics for boosting the economy. The quarter began with the end of QE2, the

Fed's second bond-buying campaign, and it ended with Operation Twist, by which the Fed will in effect exchange short-term debt on its balance sheet for long-term debt in an effort to reduce long-term interest rates and encourage lending and investing. The Fed has also made an unusually explicit commitment to keeping rates low until at least 2013. All of these efforts represent extraordinary measures intended to further the Fed's dual mandate of ensuring price stability (which today means fending off deflation and avoiding runaway inflation down the road), and fostering full employment.

Monetary policy is not likely to help the economy much in the long run. We continue to believe the problem isn't that we have overly tight monetary conditions, but that we have stalled liquidity as banks, corporations, and consumers hang onto their dollars rather than spending or lending them into the economy.

Debt Reduction Update

Despite the increasingly heated rhetoric of recent months, little progress has been made toward bringing down the government deficit and debt. The compromise agreement that enabled Congress to raise the debt ceiling promised some deficit reduction, mostly coming after the 2012 election. Nearer term, the budget reduction it effected is minimal and the plan puts off the inevitable decision to raise taxes, cut entitlements (Medicare in particular), or some combination of both, without which the deficit will reach unsustainable levels.

There has been some progress in bringing down the level of consumer debt relative to income, which is necessary for the economy to again grow at a healthy rate. But, government debt continues to grow. Ultimately, it could be close to a decade before overall household and government debt levels are reduced to a point where we can expect a more normal level of ongoing economic growth.

Debt and the Eurozone

European government debt problems are one of the other big-picture issues with potentially huge ramifications for the economy and financial markets. Investors grew increasingly concerned about Greece in recent months but also, more worryingly, about the larger economies of Italy, Spain, and even France, as well as European banks due to their exposure to European government debt. Most experts believe that Greece cannot repay its debt without some kind of restructuring, which is a deliberate euphemism for default. The question comes down to whether it is an orderly default, which can be managed in a way that avoids a damaging contagion effect that brings down other governments and/or banks, or a disorderly one, in which all bets are off.

As has been the case all along, there is concern that markets may essentially force a resolution to Europe's debt issues by driving up bond yields (and therefore funding costs) to a level that would push the weaker Eurozone nations (Greece, Portugal, Ireland) toward default and could also force Spain and Italy into a liquidity crisis and potential insolvency. We expect central banks to step in to provide liquidity but, even with support, this scenario (or a less severe version of it) would be a harsh economic shock at a time we can ill afford it.

China

China is experiencing unsustainable real estate growth which, once the balloon is pricked, may result in a sharper and quicker slowdown in economic growth than what investors are expecting. It is also the case that China, like emerging markets overall, is not immune to the slowdowns in the U.S. and Europe as these markets are key sources of demand for goods produced there. Recently, investors have seemed to recognize the potential for slower economic growth and emerging markets equities have taken a beating. Our long-term positive view of emerging markets, however, remains intact

even as the nearer-term period may see slower growth. Even at lower future growth rates, the emerging markets economies are likely to experience higher growth than those of the developed world.

Investing is a Marathon Not a Sprint

As one investor put it, "You need to be a marathon runner when investing. Investors should never judge their decisions based on a moment in time." Earlier this year when markets were shooting higher, some of our decisions and portfolio positions may have looked overly defensive. More recently, as markets tumbled and headlines blared about the possible collapse of the Eurozone, perhaps our positioning looked overly optimistic. But that type of short-term thinking is what leads most investors to get whipsawed, chasing the market (or asset classes or fund managers) on the way up and then riding them down before jumping into the next hot asset class or manager. Conversely, we believe sticking with a process that has been successful over time, if not all the time, and using an appropriate time horizon to assess the success or failure of one's investment decisions is critical to winning the marathon of investing.

Our equity portfolio decreased more than the S & P 500 year to date due to the fact that we have a diversified equity portfolio and all other equity categories, including U.S. mid cap, U.S. small cap, developed international and emerging markets were outperformed by the S & P 500. It should be noted that in 2010, the reverse occurred as all of these sectors outperformed the S & P 500 and added value to the performance of our portfolios. The presence of the diversifying strategies funds we had added to the portfolios helped mitigate the losses from the allocations to small and mid cap U.S. equities and international equities, as they outperformed the S & P 500 by almost 8% year to date.

Our diversified fixed income portfolio was underweight Treasuries because of the unattractive risk-reward tradeoff they offer. As the indices were driven by the Treasury returns, active managers generally underperformed as a result of the “flight-to-safety” we saw play out. This is what can happen in the short-term. We believe our actively managed bond funds can generate at least low- to mid-single-digit returns over the next five years, while managing interest rate, credit, and currency risk. This contrasts with the investment-grade bond index, which has lower return potential and significant interest rate risk.

At Walden Capital we don't believe in using an investment strategy that relies on accurately forecasting the direction of the economy over the near term as no one knows for sure how things will play out. Instead, we focus our efforts on the areas where research, analysis, and common sense can add value over the long term. Understanding the overall environment and assessing the ways it might affect financial markets and various investments we own is an important part of our decision making process. In order to advise clients best in these volatile times, we encourage an open dialogue about goals, time horizons and levels of risk tolerance so that risk and asset allocation decisions are appropriate and comfortable for each situation.

Please contact Walden Capital Advisors promptly if there are any changes in your financial situation or investment objectives, or if you wish to impose, add or modify any reasonable restrictions to the management of your account.

Our current disclosure statement is set forth on Form ADV Part 2 and is available for your review upon request.

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