



The Colony Group, LLC
Two Atlantic Avenue
Boston, Massachusetts 02110
800-758-8200 617-723-8200
fax: 617-723-6338
www.thecolonygroup.com

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Dear Client:

Given the continued volatility of the financial markets, we wanted to keep you apprised of our perspective on the current circumstances. As always, we remain available to speak with you at any time regarding the financial markets and our economic outlook.

Review of Recent Events

After months of protracted debate, Congress passed a compromise bill on Tuesday, August 2nd, raising the nation's debt ceiling. Nevertheless, the equity markets proceeded to decline dramatically on fears of slowing global growth, worsening conditions in the Italian and Spanish debt markets, and an overall lack of confidence in U.S. and E.U. political leadership. Then, on Friday, August 5th, after the markets closed, the rating agency Standard & Poor's lowered the U.S. long-term debt rating from AAA to AA+ with a negative outlook.

S&P issued its downgrade based on its view of the trajectory of U.S. public debt over the next decade and its concern regarding the discipline of U.S. policymakers. It noted that, "the political brinkmanship of recent months highlights what we see as America's governance and policymaking becoming less stable, less effective, and less predictable than what we previously believed. The statutory debt ceiling and threat of default have become political bargaining chips in the debate over fiscal policy."

Ironically, the initial market response resulted in lower Treasury yields, as Treasuries remain the lowest-risk, most liquid security for investors seeking safety. The equity markets, however, declined precipitously on Monday, with the S&P 500 Index falling -6.7%, the Dow Jones Industrial Average dropping -5.5%, and the NASDAQ Composite Index declining -6.9%.

In our opinion, the reaction of the financial markets reflects a general lack of confidence in global leaders. Yet, the potential silver lining is that the S&P downgrade and market response may force global policymakers to react in a more responsive and prudent manner.

Investment-Related Observations

Overall, we expect that the financial markets will remain volatile in the near-term, as retail investors act indiscriminately, guided by fear. We do not advocate selling into near-term panic, as being part of such emotional selling typically is not a rational or, for that matter, effective strategy. Ultimately, we expect the markets to find a new equilibrium, as they adjust to the downgrade and reassess the fundamental economic outlook. We also anticipate that global policymakers will be active in attempting to bolster the markets.

While we have for some time cautioned investors to brace themselves for volatility, and recent activity confirms this outlook, there are reasons to remain constructive on risk assets:

1. The recent debt-ceiling legislation mitigated the risk of a U.S. default in the near term.
2. At present, Moody's and Fitch, the other two major ratings agencies, continue to rate U.S. debt at the highest levels.
3. The equity markets already have moved into correction territory, and current valuations appear reasonable by historical standards.
4. Corporate earnings remain strong and continue to exceed expectations.
5. Corporate balance sheets also remain strong, and cash levels remain historically high.
6. In comparison to 2008, the U.S. financial system is stronger in certain respects, including in terms of liquidity, the quality of loans, and financial regulation.
7. The recent fall in oil prices is likely to support the U.S. consumer.
8. The negative effects of the Japan earthquake and the resulting supply-chain constraints, the instability in the Middle East and North Africa and the resulting rise in energy prices, as well as other temporary shocks have abated to a significant extent.
9. As a result of the increased uncertainty in the financial markets, the Fed announced that it expects to maintain its accommodative monetary stance through mid-2013. The Fed previously had said that it would keep its key interest rate near zero for "an extended period."

Of course, we are attuned to the heightened risks and continue to implement tactical and lower-exposure strategies to address these risks. In client stock portfolios we have sought to add defensive names within the consumer staples and healthcare sectors and trimmed exposure in the financial and industrial sectors. With regard to our fixed-income portfolios, we continue to recommend shorter durations and look to hold portfolios of municipal and corporate bonds that are sound and stable credits. Within our mutual fund portfolios, we generally have increased our allocation to alternatives and gold, helping to broaden diversification and provide a hedge for the portfolios. We also are prepared to take additional steps to hedge our client portfolios should the need arise.

If you have any questions regarding your personal circumstances, please do not hesitate to contact your financial counselor.

- Brian Katz, CFA, Chief Investment Officer
- Jeffrey Heisler, PhD, CFA, Market Strategist

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