

P E R S P E C T I V E S

October 31, 2011

Executive Summary

At the end of the second quarter, while maintaining a longer-term positive view on risk assets, we noted concerns about the increasing risks to the strength and timing of the global recovery. As such, on a tactical basis, we favored strategies designed to benefit from our expectations for higher volatility and downside risk. Our concerns were largely borne out during the third quarter.

Markets fell globally during the quarter as the economic outlook darkened amid fears that the recent “soft patch” might be the harbinger of a contraction. Market weakness was driven primarily by three issues: (1) the inability of policymakers to take the necessary steps to resolve the European sovereign debt crisis; (2) fear of a “double-dip” recession in the U.S. based on seemingly ineffectual monetary policy and political gridlock preventing the effective fiscal policy necessary to address the deficit and provide economic stimulus; and (3) the perception of increased risks of a hard landing in China, where attempts to moderate growth to fight inflation have combined with slowing exports, a potential burst of the real estate bubble, and overleveraged banks.

In light of the current conditions, our outlook extends over three distinct horizons. In the short-term, if the markets have anticipated too dire or too immediate an outcome from the foregoing issues, then a rally in the fourth quarter is possible if downside expectations are not met. Nevertheless, we believe that the necessary structural changes to promote economic growth and calm the markets will take time and require both political leadership and voter acceptance. While we hope, and ultimately expect, these changes to occur, hope is not the basis of a strategy. As such, we anticipate range-bound markets over the intermediate term, with heightened volatility, lower liquidity, and episodes of downside risk. We therefore believe that a defensive posture remains warranted until there is greater clarity on the resolution of the above issues. Our longer-term view is that with the resolution of these issues the markets eventually should be poised for an extended period of growth.

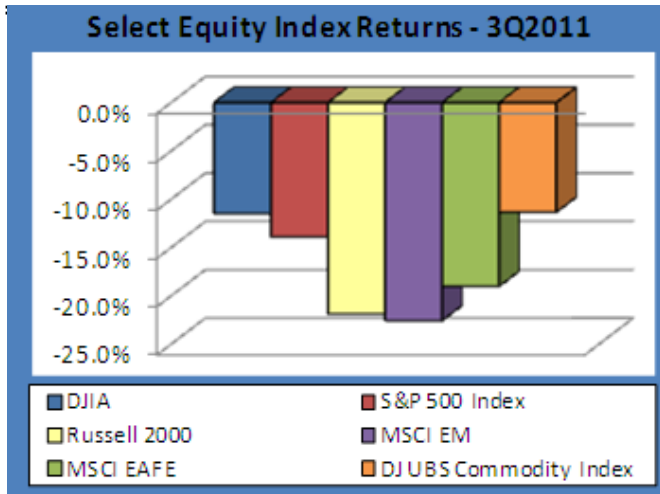
Review

Equities. Our outlook for the third quarter, while forecasting elevated volatility and downside risk, favored domestic equities relative to international developed-market equities, with a neutral allocation to emerging-market equities. Our volatility and risk expectations were borne out, as equity markets were down around the globe and volatility spiked to levels last seen at end of the 2008 financial crisis. The U.S. equity markets generally outper-

formed on a relative basis over the quarter, with the Dow Jones Industrial Average down -11.5%, the S&P 500 Index falling -13.9%, the NASDAQ Composite Index declining -12.7%, and the Russell 2000 down -21.9%. By comparison, the MSCI EAFE Index of global developed economies fell -19.0%, and the MSCI Emerging Market Index lost -22.6%. Core European markets fell, with the German DAX down -25.4% and the French CAC down -24.7%, as economic statistics showed slowing growth and raised fears of recession in Europe. In Asia, the Shanghai Composite was down -14.3%, India’s Nifty Index was down -12.1%, and Japan’s Nikkei Stock Average finished down -10.7%.

Fixed Income. Our view at end of the second quarter was that, over the longer-term, the path of least resistance for yields was upward but that we would not be surprised to see lower yields in the shorter-term, as slowing eco-

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economic growth eased inflation concerns, made risk assets less appealing, and potentially resulted in a flight to safety. What was surprising was the strength of the Treasury market during the quarter, as the yield curve pulled in and the 10-year yield dropped from 3.18% to 1.92% by quarter end. As expected, QE2 passed quietly, with yields easing lower, but yields then moved markedly lower as the safe-haven status of Treasuries and Fed policy announcements (low rates for the foreseeable future and the launch of Operation Twist) overwhelmed the U.S. downgrade by Standard & Poor's. As a result, corporate debt generally underperformed government debt, while municipal bonds continued to rebound as demand improved on limited supply and unrealized fears of default. For the quarter, the Barclays Capital Intermediate Government/Credit Index of government and corporate bonds rose 2.4%; the Barclays Capital Intermediate Government Bond Index rose 3.2%; the Barclays Capital Intermediate Credit Bond Index of corporate bonds was up 0.9%; and the Barclays Capital 1-10 Year Municipal Blend Index rose 2.4%.

Real Assets. Along with our forecast for slowing economic growth, we anticipated declines in commodity prices in the third quarter, but, given our long-term positive view on commodities, we generally remained neutral on commodities. Commodities did decline during the quarter, with the Dow Jones UBS Commodity Index falling -11.3% and oil prices dropping -17.0%. The Dow Jones UBS Agriculture TR USD Index fell -9.0%. Real estate generally remained weak.

Alternative Investments. In anticipation of higher volatility, we have been overweight relative-value alternative strategies, compared to our neutral view on hedged strategies and our underweight position on directional alternative strategies. As expected, the HFRI Fund of Funds Composite, which was down -4.96%, underperformed

the HFRI FoF: Conservative Index, which fell -4.09%, and the HFRI FoF: Defensive Index, which rose 0.43%.

Currency. Our expectation has been that the U.S. dollar would balance between appreciation on the one hand, bolstered by its status as the global reserve currency, and depreciation on the other, weighed down by lower yields and the potential for more accommodative monetary policy. As such, we have been neutral on the dollar and have favored gold as a hedge to potential additional quantitative easing.

The U.S. Dollar Index rose 5.7% over the quarter, as the dollar's safe-haven status provided support on changing expectations for the global recovery and concerns about European sovereign debt. Silver ended the quarter down -13.7%, while gold rose 8.2% despite a decline of -11.1% in September.

Analysis

Heightened market volatility makes it easy to focus on the day-to-day fluctuations of the markets and lose sight of the longer-term issues and potential solutions. In our view, one of the major themes driving the markets is that the global monetary framework does not provide for a rebalancing of capital accounts between consumption-oriented economies and savings-oriented economies. Export-driven economies, such as Germany and China, have an economic incentive to link their currencies to net-import nations in order to maintain price competitiveness. China pegs its yuan to the U.S. dollar, and Germany is linked to Europe by the euro. These imbalances have been sustained through private-sector debt, accommodative monetary policies, and asset bubbles. After the bubbles burst, however, the debt was assumed by the public sectors in the U.S. and Europe. The problem now is that attempts to deleverage by debtor nations, without offsetting consumption by creditor nations, are likely to result in slower growth. Without growth, the debt burden is likely to grow, potentially pushing unsustainable debts higher and making already large debts unsustainable. The risk, therefore, is that in the absence of a clear policy solution there will be a forceful, and potentially disruptive, market response.

So, what is delaying a clear policy solution? To us, it appears to be the differences in ideological views on how best to proceed. To put it in overly simplistic economic terms, for Keynesians the solution is to utilize additional stimulus and liquidity to allow the economy to grow out of the deficit. The Keynesians believe that austerity will only hinder what little growth there is. In contrast, the Austrians believe that a debt problem cannot be solved

with more debt. They believe that there is no painless way out of a balance-sheet driven recession and that the solution is to deleverage.

This dichotomy is exemplified in the U.S., where Democrats broadly support additional stimulus, while Republicans generally argue for spending cuts. Similarly, in Europe, France advocates expanding ECB-issued credit, while Germany favors fiscal austerity and transfers of hard assets.

As a result, politicians have had difficulty finding the compromises and consensus necessary to respond to the task at hand and forestall a more severe market response. As such, until policymakers rise to the task, we expect a continuation of the pattern whereby markets tend to decline in response to the realization that policy responses may be inadequate and then tend to rise on the announcement of the next policy response. While we are optimistic that progress ultimately will be made, we view it prudent to remain cautious over the intermediate-term.

United States. The U.S. continues to benefit from recent positive economic signals and, on a competitive basis, weakness in Europe and concerns over a hard landing in China. Yet, a slow domestic recovery, concerns over European contagion, weak wage and employment growth, and negative sentiment have businesses and individuals putting spending and hiring decisions on hold. Therefore, there is a risk that without clear and meaningful fiscal and regulatory policy that does not inhibit growth, the pullback becomes self-reinforcing, resulting in a contraction rather than slow growth. Again, our concern is that the capacity for additional fiscal stimulus and accommodative monetary policy to act as a catalyst appears limited. Political differences suggest that meaningful progress may not be possible until after the 2012 elections unless the financial markets force the issue.

While valuations are relatively attractive after recent weakness, without clear signs of economic growth we expect range-bound markets with marked volatility and episodes of downside risk. We currently see the risk/reward trade-off as skewed to the downside. As such, it seems prudent at this point to forego some upside to protect against the downside.

Over the intermediate-term, we expect yields to reflect the balance among the relative attractiveness of other assets, inflation expectations, accommodative monetary policy (the possibility of QE3, near-zero yields through 2013, and Operation Twist), and concerns surrounding the deficit. Our long-term expectation is for higher yields, as monetary policy and markets normalize, with

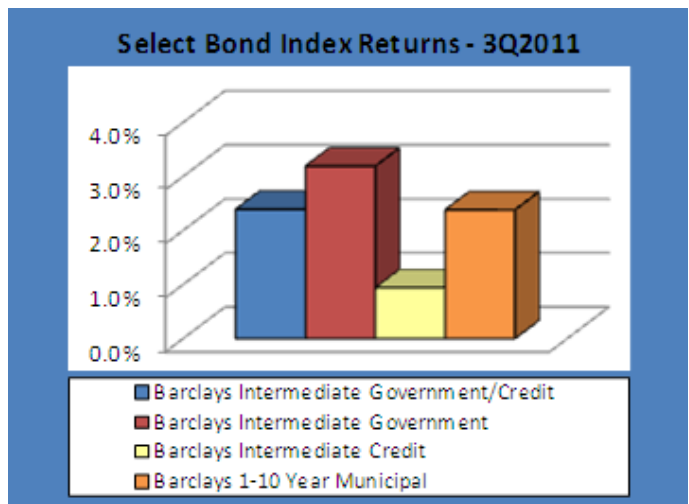
potentially higher inflation if the Federal Reserve is unable to remove liquidity fast enough.

Europe. As we outlined in greater detail last quarter, the survival of the euro may ultimately require the creation of some form of Eurobonds, or their equivalent, backed by the full faith and credit of the EU and, in turn, the taxpayers of Germany. Without an explicit guarantee of sufficient size, the debt crisis is likely to continue, with European markets cycling between optimism on news of any potential new rescue package and pessimism as investors realize that the package may only be a temporary reprieve rather than a solution.

This pattern reflects the underlying dynamic between policymakers and voters. Politicians can only move as fast as taxpayers allow, and taxpayers appear to need a market scare in order for them to allow politicians to take the next step forward. The necessary treaty revisions are likely to take some time to complete, and, as a result, the ECB likely will retain the role of lender of last resort, purchasing sovereign debt in the secondary markets, until a more permanent solution is found.

Overall, Europe appears to be approaching a critical decision point, where Germany needs to decide on the nature and extent of its commitment. As previously stated, we expect that Germany will support the euro. In our view, Germany benefits too much from the EU to let it fail. For the peripheral economies, however, exiting would be painful but may be unavoidable.

Emerging Markets. Longer-term, the emerging markets remain structurally attractive, but there are short- and intermediate-term risks. Not long ago, the consensus appeared to be that Chinese policymakers could do no wrong and would manufacture a soft landing. The consensus now appears to be that the odds of a hard



landing have increased. The reasons for this increased risk are several: cracks are appearing in the Chinese property markets; exports have slowed with economic weakness in the U.S. and European import markets; and Chinese banks are overleveraged with potentially large portfolios of bad loans.

Chinese policymakers face a delicate balancing act. Growth is necessary to maintain social harmony, but growth can drive inflation. In turn, sharp increases in the cost of living have been linked to social unrest, but actions that control inflation can hurt exports, which, especially in China, drive growth. To avert recession during the global financial crisis, China increased bank lending to provide stimulus and maintain growth. The resulting credit boom, which seemed to burnish the image of policymakers, gave rise to many of the reasons now cited for the potential of a hard landing.

While we believe that China's current export-growth model is unsustainable and that China needs to move toward a more consumer-driven economy, this type of transition will take time. It is also worth noting that China is in the process of a 2012 power transfer. As such, there would seem little inclination to change policy now. Our view is that China has the resources and ability to buy the extra time that it needs. It holds a large sovereign wealth fund to support the banking system; its exports have not crashed; and there are signs of tightening credit.

The risk of a hard landing would seem higher during an eventual transition from an export-driven economy to a more domestic-consumption-driven economy. For now, we expect China to maintain its current policy of promoting growth, with policy tightening applied when inflation concerns arise.

Conclusion

Despite the " Sturm und Drang" of the markets over the third quarter, relatively little changed fundamentally. As a result, our outlook has not changed dramatically. We anticipate range-bound markets with volatility and episodes of downside risk as the markets react to a lack of policy progress. We remain overweight U.S. equities relative to an underweight stance for international developed-market equities and a neutral stance for emerging-market equities. Tactically, however, given the continued uncertainty in the financial markets, we recommend diversifying overall equity exposure with more defensive and uncorrelated strategies.

While higher yields remain the path of least resistance over the longer term, this does not appear to be a high risk in the shorter term. We continue to view domestic

credits as more attractive than Treasuries and expect municipals to perform relatively well, particularly if tax increases are part of the ultimate deficit solution. We remain underweight international developed markets as we wait for Europe to produce a credible plan to contain potential contagion risk and resolve the status of the peripheral economies. We favor emerging-markets sovereign debt as an interesting avenue to diversify fixed-income exposure with potentially attractive returns and lower default risk.

We remain overweight alternative investments, with a skew towards tactical and non-directional strategies. With regard to commodities, we generally maintain a neutral view, but we continue to prefer oil as a hedge to geopolitical risk. We also remain neutral on the dollar, with gold as a hedge to more accommodative monetary policy.

Sources: *Stratfor, FactSet, Eaton Vance.*

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