

Outlook

Amid great volatility the S&P 500 gained approximately 11% during the third quarter of 2010 resulting in a gain of approximately 4% year to date. A gain of 9% in September was preceded by a 4.5% loss in August, and a 7% gain in July. These were preceded by a 5% loss in June and an 8% loss in May. In the best light, equity investors were searching for clarity in the midst of uncertainty surrounding economic growth, outlook for corporate profits, fiscal stimulus, and signals broadcast and actions taken by the Fed and other central banks.

In the third quarter of 2010, the Dow Jones Industrial Average gained approximately 11.12 % (5.57% ytd). The Russell 1000 and Wilshire 5000 Indices gained approximately 11.55 % (4.41% ytd) and 11.5 % (5 % ytd), respectively. The Russell 2000 Small Cap Index and the S&P 400 Mid Cap Index gained approximately 11.29% (9.13% ytd) and 13.12% (11.57% ytd), respectively.

As policymakers continue the debate on how best to address a lackluster economy, high unemployment and mounting deficits, businesses, lacking confidence in the economic outlook and stymied by the uncertainties of an evolving economic and social policy, are reluctant to make investments and increase their payrolls. Investors who have focused on economic fundamentals and financial analysis in allocating capital accepted that domestic and foreign governmental policy changes and ongoing and unprecedented central bank market intervention is an important fundamental factor impacting investment decisions.

As worldwide economies have become more interconnected through trade and finance, the economic consequences and events in a specific country have reach far beyond its borders. Interest rates, credit, prices of natural resources, and currency relationships require continuous reassessment of the risk/reward balance in each asset class and investment as individual country events occur and policies evolve.

Domestic Outlook

The Federal Reserve recently announced that it intends to continue and accelerate its policy of quantitative easing. With short-term rates near zero, the Federal Reserve has been purchasing longer-term mortgage backed securities and treasury bonds in an effort to further drive down longer-term interest rates. With the 10 year treasury bond at approximately 2.5%, the Fed is seeking to exert more pressure on these yields in hopes of spurring investment and spending activity. It is thought that lower rates will increase demand for refinancings, freeing up funds for additional consumer spending. Individuals do, however, have an alternative in de-leveraging their personal balance sheets by paying down consumer debt. Finally, by driving borrowing costs down the Fed seeks to stimulate business activity.

Corporations with substantial stores of cash have thus far been disinclined to invest in growth. By driving down rates of return further the Fed is seeking to change this behavior. As the Fed has driven down longer-term interest rates, the yield on the 10-year bond has declined from 4% levels to 2.5% levels. During the past two years banks and other financial institutions have been borrowing at low short-term rates and purchasing longer-term bonds at higher yields thus boosting their profits. The net interest margin from this activity will be reduced and corresponding earnings for financial institutions will be lower as a result of a continuing decline in longer-term interest rates.

Additional implications of the Fed's policy are that both private and governmental pension funds will realize lower rates of return on fixed income investments going forward. This increases funding demands on the employer, and will impact corporate earnings as well as increase budgetary pressures at the state and local levels. Another by-product of these policies is also to incentivize investors to deploy capital in risk assets. Nevertheless, with risk continuing to be elevated for many of the reasons discussed above, caution is required.

The policy direction outlined above arises out of a conviction that the economy continues to be slowing and that a self-sustaining recovery has not been attained.

International Outlook

While the Euro has recently made significant gains as compared to the US dollar, recent developments in Ireland highlight that the banking crisis and its impact on individual country debt and deficits has not been resolved. Underreported by the financial press is the interconnectivity of European banks as a result of cross border debt ownership of banks in other countries. Finally, developing countries have benefited from the needs of developed country enterprises to maintain a low-cost structure. Outsourcing from the United States and Europe and exports to these economic zones have been a driver of the economies of developing nations.

As interest rates decline and US currency softens these developing countries may be less competitive on cost. Hence, the recent high profile rhetoric between China and the United States regarding currency and trade policies.

Portfolio Construction

Portfolio construction has never been more important. Important for the purpose of risk mitigation and important for the purpose of rate of return optimization.

Recently a research paper was issued that again raised serious questions regarding the financial health of many state and local governments. We have, for most of our clients, aggressively diversified issuer risk in our municipal bond portfolios as municipalities and states have come under increased financial pressure. For most clients portfolio duration has been shortened and the percentage of the portfolio allocated to municipal credits has been reduced. The issues that remain ahead are substantial and have not yet been addressed adequately. The credit quality in our portfolios remains high and bond selection and diversification are extremely important.

The tactical managers represented in our client portfolios have performed as expected, varying their exposures to risk assets and the yield curve taking into account fundamentals and global macroeconomic and policy considerations. We continue to believe that the ability to quickly modify asset allocation in the current environment is essential.

Finally, the equity managers represented in our clients' portfolios have performed well by comparison to their benchmarks. In aggregate most clients' equity portfolios are overweight mid-cap and small-cap stocks. These have outperformed the large-cap sector.

With price earnings ratios for corporations at 13 to 14 times earnings, we believe that equities are reasonably priced despite economic pressures that may impact earnings growth. Notwithstanding these economic pressures, Standard & Poor's estimates earnings increases in 2011 for the S&P 500 of approximately 10% attributable to reduced costs, operating efficiencies and cyclical demand requirements.

Longer-Term Outlook

Many observers have begun to raise concerns regarding future consequences of a protracted and expansive accommodative Fed policy. Some have questioned whether the Fed will be able to control the inflation engine once it starts. While we don't view this as a near-term concern, it may have implications in the future that affect not only bond and stock prices but also currencies and commodity prices as well. The time horizon over which these concerns may impact an investment portfolio is uncertain. It is clear, however, that the immediate consequences of policy shifts are ever-present for participants in both fixed income and equity markets and have been for some time.

We will continue to monitor developments and adjust our clients' investment portfolios as appropriate. Client portfolios are managed individually taking into account individual circumstance as well as broader financial market implications. Please discuss your individual account performance with your KLS account manager.

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