KLS PROFESSIONAL ADVISORS GROUP, LLC
Complete Financial Management

Seeking Clarity

A Volatile and Disappointing Quarter for the Equity Markets

During the third quarter, the equity markets incurred substantial losses amidst great volatility. For the three months ended September 30, 2011 the Dow Jones Industrial Average declined -11.49% (-3.89% ytd); the S&P 500 and Russell 1000 Indices lost -13.87% (-8.68% ytd) and -14.68% (-9.25% ytd), respectively; while the Wilshire 5000 gave up -15.02% (-9.86 % ytd). The Russell 2000 Small Cap Index and the S&P 400 Mid Cap Index sustained losses of -21.86% (-17.02% ytd) and -19.88% (-13.02% ytd), respectively. The MSCI EAFE Index lost -19.01% (-14.98% ytd), and the MSCI All Country World Index and the MSCI EM Index lost -17.42% (-13.56% ytd) and -22.56% (-21.88% ytd), respectively.

The Issues

The European drama overshadowed the world financial stage, exacerbating fear and amplifying volatility. The inability of European leaders to accept that a decade of excess by several European sovereigns has resulted in massive public debt that has become unmanageable (a problem that will not be solved by a series of relatively small bailout funds) has captured the attention of investors. Global equity markets have reacted violently to the potential default of one or more sovereigns and its impact on the European banking system. Current Eurozone policy -- failing to provide for resolution of public debt levels and recapitalization of the banks -- can only foreshadow recession, slow, or no growth in European economies.

In the U.S. there is ample folly as well, courtesy of Washington. Unemployment remains high, demand for credit subdued, and stagnation and decline rule the housing market. All the while, our leaders behave, well, like politicians, skirting the real issues and unable to reach a “grand bargain” that will put our fiscal house in order. Reduced spending, increased revenues, and re-rationalization of entitlement programs are required to avoid “Act 2” of the European drama being played out here at home. Only when it becomes painfully clear *to them* that debt fueled fiscal problems cannot be solved with more debt, will both European and U.S. leaders act.

Only when it becomes clear *to European leaders* that European banks have a solvency problem as a result of their sovereign debt holdings which may (in some cases, must) default, will the banks be recapitalized. Bank bondholders, heretofore an insulated class by custom, will provide capital by converting a portion of their investment into equity. Then governments must prospectively rein in spending so as not to again create excessive debt. All of these steps will inevitably occur, but only when it becomes clear *to government officials*. While private investors and public pension funds would suffer losses on bonds, some recovery would result from eventual equity appreciation in then well capitalized banks. For pension funds, shortfalls in funding commitments would likely require additional contributions (in the case of public pension funds such would be funded by taxes spread over a long term period).

111 Fifth Avenue • 8th floor •New York, NY 10003 *t* 212.355.0346 *f* 212.355.0413
www.klsadvisors.com

The exposure of U.S. bank balance sheets to European sovereigns is not significant. Similarly, exposure to non-government (or Agency) mortgage-backed securities is not substantial, and bank capital positions have been rebuilt and supported by Federal Reserve sponsored programs that effectively transferred capital to the banks from the Federal Government. Nevertheless, only when it becomes clear *to U.S. leaders* that ever increasing public debt as a result of socialization of private losses and increasing entitlements will necessarily divert (to taxes servicing these obligations) funds otherwise available for future economic investment, will policymakers no longer pursue policies that exacerbate entitlement obligations and forestall resolution of mortgage debt and securities. They also must re-rationalize government involvement in the housing market and make clear to banks and their investor-bondholders that they shall not be held harmless by the government when losses result. For the foreseeable future, however, the servicing of existing debt, both public and private will slow economic activity. It will take time for debt levels to be reduced and for property values to be adjusted to a level at which residential real estate can be financed and will change hands.

Macro Issues and Investing

The issues we confront in structuring investment portfolios include:

- The impact of economic stagnation in Europe and the U.S. on corporate earnings which have thus far proven resilient;
- The slowing effect that impaired U.S. and European economies (customers) will have on emerging market economies (vendors) that presently are a driver of earnings for multinational corporations;
- The interdependence of economies with differing political and trade interests, and implications for the U.S. economy and standard of living as capital seeks lower costs.

Last quarter we wrote-

"The fundamental thesis for equity investing in the midst of all of these uncertainties is two-fold: (1) share valuations provide substantial "cushion", with the S&P 500 trading at approximately 13.5x estimated 2011 earnings and (2) the expectation that the Fed will continue strongly accommodative policies."

At September 30th the S&P 500 was valued at approximately 12x estimated 2011earnings and the Fed remains strongly accommodative, targeting lower interest rates throughout the yield curve in Operation Twist. We are cautious as to earnings outlook given the challenged worldwide economy, and do not believe that government or Federal Reserve policies can effectively create jobs. At best, policies can be designed <u>not to</u> (1) create asset bubbles (that eventually must burst and leave an impaired economy behind), and (2) discourage investment, employment, and job creation.

Given the complexity of resolving the worldwide economic problems discussed above and the profound social implications accompanying them, we are not likely to witness a swelling of the political will necessary to meaningfully engage. While it is clear to many that resolute action must be taken soon, those in a position to do so are still waiting for it to become clear *to them*.

Our task then, is to manage the risk – reward tradeoffs in client portfolios giving due consideration to these many complexities.

Portfolio Construction

We continue to stress diversification in client investment portfolios with a substantial allocation to tactical managers who consider and address macroeconomic policies and events in managing their investment portfolios. Our approach to portfolio construction is designed to mitigate, though not eliminate, the volatility experienced in the equity markets, while meaningfully participating in market gains. During the third quarter, client portfolios were impacted negatively as a result of the selloff in worldwide equity markets and currency losses attributable to fear driving investors to the U.S. dollar, but were supported by funds allocated to municipal and corporate bonds.

As you are aware, each KLS account is managed separately. Please discuss your individual account performance with your KLS account manager.

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