ROOF ADVISORY GROUP, INC.®
INVESTMENT ADVISORY & FINANCIAL PLANNING SERVICES

INVESTMENT UPDATE

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Economic Conditions & Market Outlook

Over the years, prior *Investment Updates* have frequently noted that market moves are periodically driven much more by psychological factors than by economic or investment fundamentals. This was taken to extremes during the third quarter of 2011 when the equity market's behavior bordered on being schizophrenic.

Lest one think this is an exaggeration, consider these facts. During the sixty-four trading days that comprised the third quarter, on *thirty-five* of those the Dow Jones Industrial Average (DJIA) equity index closed more than 100 points higher or lower than where it opened. That's a 100-plus point change from opening price to closing price over 55% of the time. The largest single day decline in the DJIA during the period was on August 8th when it closed down 624 points; a drop that was immediately followed by the quarter's largest single day gain on August 9th when the DJIA closed up 428 points. This wild day-to-day volatility continued when the index fell 507 points on August 10th, only to be followed by a 413 point bounce up on August 11th.

Even more astonishing was the degree of *intraday* volatility that was regularly experienced between market open and close. On all but two of the sixty-four trading days during the quarter, the DJIA had at least a 150 point swing between intraday highs and lows, often times with multiple 150 point moves up and down during the same session. In thirty-seven of the days, the difference between intraday highs and lows was more than 250 points; with the spread between intraday high-low being in excess of 350 points over 25% of the time.

Despite these frenetic moves, there was a surprising balance in the actual number of positive/negative market closes for the DJIA during the period, with thirty-two days closing up and thirty-two days closing down. However, any balance was of little consolation because the net return of each equity index for the quarter was rather ugly. The percentage price change for the DJIA from June 30 to September 30 was -12.09%, with the Standard & Poor's 500 and NASDAQ logging price drops for the period of -14.33% and -12.91% respectively.

As referenced earlier, the economic fundamentals for the period were not as dire as the accompanying market decline might suggest. While modest by any measure, the U.S. recovery continues to muddle along. The much-followed Institute of Supply Management (ISM) figures for September showed that U.S. manufacturing again expanded and beat most economists' predictions, with the ISM manufacturing purchasing manager index increasing to 51.6 from 50.6 in August. Any measure above 50 indicates growth in manufacturing activity.

The U.S. consumer was also not as moribund as the gloomy stock market performance might suggest. For example, September saw U.S. auto sales climb significantly from levels one year prior, with General Motors, Chrysler and Nissan all posting U.S. sales gains of at least 20% above twelve months prior. Ford also logged an 8.9% sales gain for the period; with Honda and Toyota being the exceptions in seeing sales figures drop, driven mostly by lingering low dealer inventory due to the supply chain disruptions from March's earthquake in Japan. With dealer incentives spurring buyers on, demand for some larger purchases has clearly returned.

Employers added 103,000 jobs in September, with the August jobs growth number being revised upward to 57,000 from the government's previous estimate of zero. A growth rate of this level will not notably improve the current overall unemployment rate of 9.1% but it does dampen the din of those warning that the U.S. economy is again on the precipice of falling back into a recession. Despite the painfully slow progress on the jobs creation front, as noted previously, we continue to see evidence that the modest recovery is still intact.

Federal Reserve Chairman Ben Bernanke acknowledged as much at his recent appearance before the Joint Economic Committee but was more pointed than usual when he warned committee members that the U.S. economic recovery could be ‘close to faltering’ unless policymakers recognized a ‘shared responsibility’ with the central bank to take appropriate actions in nurturing the ongoing economic recovery. Mr. Bernanke called for broader actions from Congress and the White House in several key areas. These ranged from developing better fiscal policies focused on shrinking the bloated federal deficit, to creating taxation and spending policies that encourage long term economic growth, to ‘improving the process for making long-term budget decisions, to create better predictability and clarity, while avoiding disruptions to the financial markets and the economy.’

This last comment was clearly referencing the bumbling U.S. budget debates that so roiled the markets in late July/early August, exacerbating investor unease worldwide and helping propel the markets to their dismal quarterly decline. That process flamed an existing crisis in confidence among skittish investors who wondered if governments across the globe truly understood the problems at hand, much less having the political will to successfully address them.

In reality, politicians of all stripes, both here and abroad, have been anything but a friend to the markets and economy of late. Their recent blunders, missteps and apparent inability to grasp some of the most basic economic principles have sent investors and businesses ducking for cover and the markets reeling. U.S. policymakers have continued to demonstrate their inability or unwillingness to put personal politics aside and instead place the public good as top priority. While the extremes of each major political party clearly disagree as to what that ‘good’ may be, the tiresome game of endless posturing and faulting the other has created the crippling polarization in politics that exists today. In reality, there is plenty of blame to go around.

Over the years, we have tried to remain as apolitical as possible when commenting on current conditions in the markets and economy. Candidly, elected officials have much less influence over the health of these two areas than they like to take credit for when times are good and rarely can they so severely muck things up in such a short period of time. This was the exception. Congress’ prolonged fumbling through the process of raising the U.S. debt ceiling, along with their inability to take any meaningful steps to correct the government’s addiction to overspending, earned the U.S. a downgrade to its credit rating and raised suspicion that any future attempts by the U.S. government to get its financial house in order would be just as chaotic and impotent.

Ongoing investor concern over the possible domino effect from Greece’s potential sovereign debt default was already weighing heavy on the world’s markets and seeing leaders of the globe’s most powerful free economy not being able to make any significant headway in controlling their own deficit problem made the likely success of their spendy European counterparts doing so seem rather remote.

Daily unresolved speculation as to the severity of the financial fallout when Greece’s sizeable debt finally is restructured also contributed to the markets’ frenzied moves during the last quarter. Greece’s problems have been addressed with various band-aid fixes during the past several years but only recently, at the admonition of the International Monetary Fund, did the major euro-zone heavyweights of Germany and France recognize the depth and breadth of the financial bailout and backstopping needed to prevent a potential meltdown of the European banking system. Full agreement has yet to be reached as to how the balance sheets of Europe’s banks would best be bolstered to protect them from the consequences of any debt restructuring but, at least for now; the markets appear to view recent discussions among Europe’s key players as a positive step.

Given these treacherous market conditions, why are investors even venturing forth in equities? First, other asset classes currently offer less-than-attractive alternatives. Short-term fixed income rates are at historic lows, providing little to no return. Mid-maturity bond rates have likewise dropped and the present modest yields of long-term bonds are insufficiently enticing for most investors to lock up their cash for twenty to thirty years.

Second, equity investments look fundamentally attractive on several fronts. The traditional ‘value’ measure of price to earnings (P/E ratio) shows stocks looking notably underpriced versus historic norms. For instance, the S&P 500 index had a forward looking P/E ratio of 10.6x as of third quarter end, compared to a P/E ratio of 12.4x one year ago and three, five and ten year P/E averages of 12.9x, 13.4x and 15.0x respectively. Likewise, current dividend yields on stocks are also compelling when compared to both historic standards and fixed income alternatives. The yield of the S&P 500 index also approximated 2.5% at month end, nearly 25% above its ten year average, with many individual stocks currently offering yields well in excess 3.5%.

However, as noted in the opening paragraph, rational investment fundamentals are currently taking the back seat to manic market moves, with the first week of October picking up right where September left off. Whether the present discussions in Europe will finally be enough to convince these Jekyll and Hyde markets that any debt default contagion there can be contained is yet to be seen. Hopefully so, but we have our doubts that any quick fix for that complex problem will be forthcoming.

Ongoing improvement in the U.S. economy and market fundamentals will also eventually help buoy nervous market sentiment, as well as greater confidence that domestic U.S. policymakers understand and appreciate that cultivating a climate conducive to business and jobs growth is essential to forward economic progress. In the meantime, investors will likely continue to cast a wary eye on frantic upward market movement, fearing that any gains today very well may be gone tomorrow.

Our Tactical Investment Stance

Roof Advisory Group's disciplined investment approach emphasizes adding upside value to client portfolios while also controlling downside risk. Strategies include clearly defining investment policy ranges based on each client's specific investment objectives/risk tolerance, monitoring portfolio adherence to established benchmark parameters, and ongoing evaluation of portfolio return relative to various risk measures.

Within this strategic investment management context, the firm makes tactical shifts to address changing market conditions and optimize client portfolio performance. Each client situation is unique but a few of the tactics presently being used across most portfolios managed are outlined below:

• The overall ***target level*** for managed portfolio allocations is currently at approximately ***one step below mid-point*** equity exposure based on each client's investment policy. This target allocation has ***shifted up and down*** one range step throughout the summer in response to ***volatile market conditions*** after being at ***mid-point*** in late June. As noted, ***fundamental risk/return*** potential in equities remains ***more attractive*** than either bonds or cash but we ***remain cautious*** in overall allocation until daily stock market volatility subsides.

• ***Portfolio composition*** in all investment policies has been consistently and significantly ***restructured to reduce risk*** in this volatile market. An overall ***increase in equity yield*** has again resulted in each target portfolio, as well as a ***notable reduction in portfolio beta*** to help curb volatility. ***Profits were taken*** and several equity/fund holdings were eliminated when risk/return potential deteriorated.

While overall sector diversification based on benchmark standards remains a priority, ***higher than normal*** concentrations currently exist in certain more ***defensive sectors*** such as ***Utilities, Telecom & Healthcare.*** The prior overconcentration in the ***Industrial & Materials*** sectors was ***reduced to benchmark*** level for ***more growth-oriented*** policies and to ***below benchmark*** level for ***more conservative*** portfolios. Most other sectors remain near benchmark for all but income oriented investment policies, with the exception of the ***Financials*** sector which remains ***underweighted*** across all target portfolios.

Per usual, we maintain a ***large-cap equity bias*** but ***mid-cap equity*** exposure across most policies also remains ***close to standard levels***. Some of this is due to mid-cap utility stocks being held, as opposed to the more volatile positions normally associated with mid-cap equities. Dedicated ***foreign equities*** remain ***underweighted***, with international exposure coming primarily via select ***multi-national companies*** offering superior comparative returns relative to purely foreign alternatives.

• Ultra-short-term fixed income exposure continues to be ***significantly below target levels*** due to very low yields, except for periodic cash concentrations that may occur during tactical portfolio repositioning or rebalancing. The ***average duration*** of bond portfolios continues to be ***short to intermediate,*** with select ***longer maturities*** being used where deemed advantageous. Selective ***preferred stock holdings***, which are more akin to fixed income investments, have been ***used in moderation*** to help ***enhance portfolio yield.*** The ***diversification*** and ***credit quality*** of each portfolio's fixed income holdings remains a critical consideration.

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