

O'BRIEN MANAGEMENT QUARTERLY REVIEW

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Economic Overview

By: Mary Jo English

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A series of economic and financial surprises in tandem with international political policy paralysis hurt confidence and harmed growth prospects in the third quarter, raising the odds of another recession. The shocks resulted in significant recent declines in the valuations of investable assets and increased financial market volatility. Many policy decisions remain unresolved, and such uncertainty should continue to beget market volatility and a flagging level of optimism in a very modest and uneven economic recovery.

ECONOMIC DATA

By far the biggest economic surprise of the quarter came with the announcement of second quarter GDP growth. Growth of 1.3% was far below expectations, but more startling were the revisions that were provided to previously released GDP growth estimates. First quarter GDP was revised down to 0.4% from an earlier estimate of 1.5%. Revisions were also provided to GDP figures marking the depth of the Great Recession showing that the economic contraction was more severe than previously thought.

Additional economic data points to sluggish recent and future growth. Hiring momentum that appeared to be building earlier in the year seems to have stalled. Jobs are being added, but not enough to absorb new labor force entrants and make a dent in the unemployment rate. As a result the unemployment rate remains stuck at a very high level. Improvements in wages and incomes have been minimal. Manufacturing data has

been weak and consumer confidence is low. Housing data is mixed and there seems to be no catalyst to forward momentum in the housing market.

SOVEREIGN DEBT CRISIS

The European debt crisis has been the primary contributor to recent market volatility. There are concerns that a Greek debt default will ultimately result in a Europe-wide banking crisis and the question has been asked whether this is Europe's "Lehman moment." This crisis is unprecedented because of the unique monetary and fiscal dynamics of the European Union. The proposed solutions are complicated and difficult. Over the past two years there have been a series of steps to delay an inevitable Greek default. As Lawrence Summers wrote in the September 19, 2011 Financial Times, "At every stage of this process, from the first signs of trouble in Greece, to the spread of problems to Portugal and Ireland, to the recognition of Greece's inability to pay its debts in full, to the rise of debt spreads in Spain and Italy, the authorities have played out the stalemate machine. They have done just enough beyond euro-orthodoxy to avoid an imminent collapse, but never enough to establish a sound foundation for resumption of confidence." The ultimate solution to Greece's insolvency and broad Euro area debt issues remains unknown. If the authorities can somehow successfully contain the crisis to Greece, then further contagion to Portugal, Ireland, Spain and Italy will be avoided. Europe simply does not have the financial means to bail out Greece, Portugal, Ireland, Spain and Italy. Thus the authorities need to be careful how they solve the problem because depending on how the specific Greek issue is solved, other highly indebted countries could

attempt to seek the same solution. The lack of a clear plan toward fiscal solvency, identifying winners and losers, has been the primary cause of international investors' concern about the global economy and global markets and has helped send European bank shares tumbling by 40% this summer. On the plus side, the "slow motion" quality of the European crisis distinguishes it from the Lehman Brothers shock and has provided time for many players, including O'Brien Management, to make adjustments that may reduce the magnitude of the negative impact.

MARKET VOLATILITY AND VALUATION

Primarily as a result of the European crisis, the markets have been volatile. Over the last 40 trading days of the third quarter, the market averaged a daily move of approximately +/- 2%. Correlations across asset classes increased so that on days that the market deteriorated, declines happened across the board with particularly sharp declines in emerging markets and commodities. Few assets appreciated on these days outside of the Japanese Yen, Swiss Franc, U.S. Dollar and U.S. Treasuries. Assets such as small capitalization stocks and emerging market stocks are officially in "bear market" territory. In other words, they have fallen by more than 20% from their recent peaks. Some investors have asked if the market is cheap. In comparing current P/E ratios to historical P/E ratios on a trailing earnings basis, both large cap and small cap stocks are fairly to modestly overvalued. Yet, P/E ratios based on forward or predicted earnings, make stocks appear undervalued. Upcoming earnings releases will help determine which measure of value is "right."

THE FED

In response to weak domestic economic data and fears that the European crisis will dampen demand and put the U.S. at a risk of another recession, the Federal Reserve took two steps to further loosen monetary policy during the quarter. First, the Fed had stated in 2009 that they would keep short-term rates at 0-.25% "for an extended period". In August, the Fed made this stance more explicit and announced that rates would be held close to zero until at least mid-2013.

The purpose of this announcement was to further reduce the cost of lending. Second, the Fed announced a program dubbed "Operation Twist" whereby the Fed would buy longer term Treasuries while selling shorter duration Treasuries. Operation Twist should, in theory, drive down the yield on longer term Treasuries. This, in turn, should drive down the rates on other bond yields tied to Treasury rates, such as mortgage rates. The Fed is undertaking this effort to reduce rates in order to further encourage lending and mortgage re-financings. It is unclear whether this will be effective. Bill Gross, a bond manager at PIMCO argues that ironically, this decline in rates will make banks less likely to lend, as the profit they earn on loans will decline. This will result in credit destruction rather than the desired credit creation. Additionally, it does not appear that many mortgage holders are taking advantage of the reduction in mortgage rates to refinance since they may have already refinanced recently, they may be put off by the procedural obstacles, or because they fear re-appraisals of their properties at current values.

POLICY STEPS

The Federal Reserve alone cannot support the economy. Fed President Ben Bernanke has stated that the Obama administration and Congress need to address plans for long-term deficit reduction while also providing additional near-term stimulus for the economy. President Obama has provided a jobs proposal that could provide support to economic growth. This proposal could increase economic growth by 2% in 2012 according to Moody's Analytics' Mark Zandi. Included in the plan are temporary tax cuts such as an extension of the employee payroll tax holiday and spending increases on infrastructure. However there is doubt that most of the President's plan will pass through Congress. Thus, it is probable that in the near future the economy will continue to muddle along in a state of low growth and high unemployment. Of course, the Congressional "super committee" now meeting to work out a budget compromise is a wild card on the upside because the current public expectations are so low that it is possible we could be surprised by a deal.

CONCLUSION

The U.S. economy could be on the cusp of another downturn. The European debt crisis has undermined confidence and is in part responsible for a surge in volatility and a sharp third-quarter decline in the value of assets. European and U.S. policy makers need to act promptly and decisively to prevent another

recession. Unfortunately, it will likely require an “acute crisis” to motivate them. At O’Brien Management we believe we have weathered the recent volatility effectively and are well positioned in the event of continued volatility. We will continue to track economic, financial and policy developments and will be looking for pricing dislocations and opportunities in all areas of the market.

Market Update

By: Mary Jo English

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In the third quarter of 2011, world stock markets declined steeply in light of weakening economic data, the European sovereign debt crisis and a rating agency’s downgrade in the rating of the U.S. government’s debt. During the quarter, the S&P 500 stocks fell by approximately 14% and the MSCI EAFE, representing international developed market stocks, fell by over 20%. One of the themes of the quarter was that “risky” assets fell more than their less volatile counterparts. Emerging market stocks illustrated this theme as they were down over 26% for the quarter. Small capitalization stocks, which are also considered “risky”, fell close to 22% during the quarter.

Fed actions, weak economic growth and the rating downgrade coincided with a sharp rally in the U.S. Treasury market. During the quarter, the U.S. rating agency, Standard and Poors, downgraded long term U.S. debt to AA+. There were initial fears that this downgrade would result in a sharp deterioration in U.S. Treasury prices, yet, the opposite happened. Fears that the U.S. might face a future debt crisis caused investors to flock to the “least risky” financial asset, the U.S. Treasury bond!

The downgrade, in combination with weaker economic growth and a flight to quality due to the sovereign debt crisis, caused U.S. 10 year Treasury rates to plummet from over 3% to under 2% during the quarter. These are historically low rates. Long Treasury bonds were the stellar performer of all asset classes for the quarter, returning nearly 28%. In contrast, and in keeping with

the third quarter’s “risky assets” underperformance theme, high yield bond yields increased adding to their spread over Treasury yields, causing the high yield bond market to fall by over 6%. At some point, high yield bonds may become an attractively-priced asset class that may be of interest to us. Emerging market bond spreads and floating rate loan spreads widened during the quarter as well, and this hurt our overall fixed income performance during the quarter.

Index Performance as of 09/30/2011				
Equities	Q3	1-Year	3-Year	5-Year
U.S. Large Cap				
S&P 500 (Total Return)	-13.9%	1.0%	1.2%	-1.2%
Russell 1000 Value (iShares)	-16.2%	-2.0%	-1.6%	-3.6%
Russell 1000 Growth (iShares)	-13.1%	3.7%	4.2%	1.5%
U.S. Mid Cap Stocks				
Russell MidCap Value (iShares)	-18.4%	-2.5%	1.9%	-1.0%
Russell MidCap Growth (iShares)	-19.4%	0.6%	5.7%	1.4%
U.S. Small Cap Stocks				
Russell 2000 Value (iShares)	-21.5%	-6.2%	-3.4%	-3.1%
Russell 2000 Growth (iShares)	-22.3%	-1.0%	2.1%	1.0%
International				
MSCI EAFE (Developed) (iShares)	-20.6%	-10.5%	-2.5%	-3.9%
MSCI EM (Emerging Markets) (iShares)	-26.3%	-20.2%	2.8%	3.6%
Bonds				
US Bond Market (BarCap Aggregate Index) (iShares)	4.0%	5.0%	7.6%	6.2%

In May of 2010 we took some of the “risk” out of your portfolios by reducing your small capitalization stock exposure. At the time, we felt that small caps were overvalued on a fundamental basis and on a relative basis when compared to large capitalization stocks. During the third quarter, after small capitalization stocks had declined considerably more than large capitalization stocks, we reversed this May, 2010 trade by purchasing a Russell 2000 Value exchange traded fund (ticker IWN) which represents small capitalization stocks and selling our S&P 500 exchange traded fund. Over the time horizon of this

trade, while we were overweight large cap stocks and underweight small cap stocks, large cap stocks outperformed small cap stocks by approximately 8%. After reversing this trade, we are now back to our “baseline” exposure to small capitalization stocks.

At the end of last year, we increased the income component of your portfolios through the purchase of the SPDR Dividend ETF (ticker “SDY”), an investment designed to track the S&P High Yield Dividend Aristocrats Index. According to State Street Global Advisors, this index “is comprised of the 60 highest dividend-yielding stock constituents of the S&P Composite 1500 Index that have increased dividends for at least 25 consecutive years. These stocks have both capital growth and dividend income characteristics, as opposed to stocks that are mostly dividend, or mostly capital growth oriented”. This fund outperformed the S&P 500 by over 4% during the

quarter. Given a continuing level of uncertainty throughout global financial markets and the global economy in the short-to-medium term, we think SDY will provide portfolios with good income and capital appreciation potential while mitigating the effects of unforeseen negative shocks.

At O’Brien Management we will continue to look for prudent tactical opportunities to add value to your portfolio. Last quarter we outlined the many steps we had taken to reduce your portfolio risk in anticipation of market volatility. This quarter, we were able to take advantage of the market’s volatility and small capitalization stocks’ underperformance to rebuild our position in that asset class. We will continue to act to preserve your capital while we also take steps to add value by identifying mis-pricing related to volatility and engaging in occasional tactical trades to take advantage of these unsettling movements.

The O’Brien Management Investment Committee

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