We are coming up on the three year anniversary of the Financial Crisis marked by the decision to let Lehman Brothers fail and then, the very next day bail out AIG. At this point in time, the progress we've made as a country in addressing the myriad of issues that brought us to the brink of financial collapse is truly disappointing. And, as we "whistle pass the grave yard" and pretend that things are just ok, we believe the foundation of the economy and capital markets continues to erode. With the Dow Jones Industrial Average down 12% last quarter and the credit rating of the United States downgraded from AAA to AA+ by S&P, the last quarter proved to be one of the most volatile for investors since early 2009. *If the markets could talk, they are telling us to deal with our structural problems.*

On the heels of the downgrade of the credit rating of the United States, the Federal Reserve sounded warning bells in August that they were seeing significant signs of a looming economic slowdown. At the same time, the European Union continued to grapple with the bailout of Greece, the impact that a default of Greece would have on the European banking system and the potential contagion that might spread given the deterioration in the creditworthiness of Italy, Spain and Portugal. The resulting crisis in confidence threw global equity markets into turmoil and drove interest rates on U.S. Treasury debt even lower than they were before the downgrade.

So, we listen for what is *not* being said – and, the chorus is singing loud. After three years, we *still* do not have a plan to reduce the huge debt burden we took on during the financial crisis. We do not have a plan yet to address Fannie Mae and Freddie Mac which have posted a cumulative loss against capital of $247 billion since 2007. After almost three years, there are still financial institutions that have not paid back the loans the government provided through the TARP program. We have no clarity on future tax policy. Obama's healthcare law has been debated through the court system and will now be heard by the Supreme Court. And, we still do not have financial regulatory reform that has any clarity to it. In the darkness, we see an entrenched partisan Congress that is truly failing America. And, with no political courage to address the massive spending problems our country is facing, this election campaign season promises one thing - nothing will get done in Congress to fix the current problems.

So, how does this impact our investment strategy? We believe this growing populism will have important implications for monetary, fiscal and trade policies and will ultimately increase the risks for a global recession. And, if you believe like we do that the cumulative effect of the modest changes creeping through the capital markets and financial system results in a significant shift in the investment paradigm, then there are three basic tenants that need to be adhered too. First, *wealth creation starts with wealth preservation*. Second, make sure that you are *adequately compensated for the risk* you are taking with each investment. Third, *diversification* is still the best free lunch in investments – and holding 100% cash in this market is not diversification.

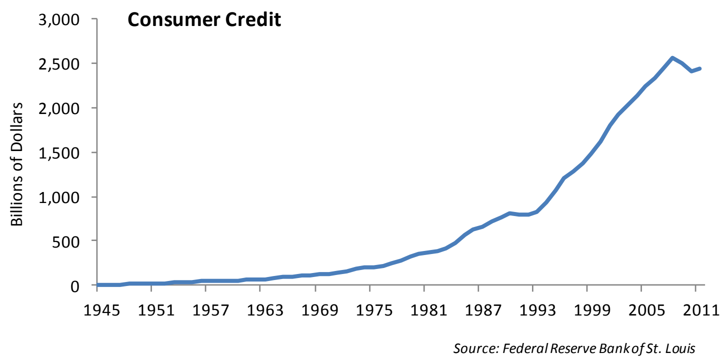
There are some wonderful investment opportunities and at the same time we see some serious traps for investors given current valuations. Our thesis remains intact: expect a slow growth economy with heightened volatility in the capital markets. Investors should recognize that we are entering a campaign season that will add to the uncertainty and likely not be great for our capital markets. Until we see financial regulatory reform that has teeth, a credible plan to reduce the deficit and a credible initiative from the Federal Reserve to withdraw its stimulus from the capital markets, we remain cautious on financial assets and risk allocation.

Assuming we can fix many of the structural problems overhanging the economy, in order to experience sustainable growth, we need both prosperity and austerity. Right now, we have neither.

The Economy

If you remember back in early 2010, the goal of the Federal Reserve was to get the economy on a track toward sustainable economic growth after the government propped up the financial system, bailed out the banks and provided stimulus initiatives, like the cash-for-clunkers program, which were designed to jump start consumption. We expected to experience a deceleration in economic growth as the effects of the stimulus wore off and the structural problems gripping the economy and capital markets impeded sustained economic growth. We believe that we are now in the midst of that slowdown.

Typically, coming out of a recession, growth is much stronger than the 1.3% that we are currently experiencing. We have discussed at length our belief that there are structural problems which are impeding sustained economic growth. These structural problems include the huge debt burden, uncertainty with respect to healthcare and financial regulatory reform, high unemployment, uncertain tax policy, political gridlock and the impaired growth in private credit. Because of these structural problems, we expect economic growth will be below historic norms and economic cycles will be shorter in length until the problems are fixed. In addition, tighter credit in Europe as a result of its austerity measures will further restrict global capital further slowing domestic economic growth.



At the same time that we are working through a cyclical recovery, we are still working through a deleveraging after two decades of easy money, overconsumption, and massive growth in consumer credit. Today, household debt is down roughly 10% from its peak. And, corporate balance sheets are flush with over $2.5 trillion in cash on the balance sheets. Yet, the process of deleveraging curtails consumption and business investment which results in slower economic growth. When you layer on top of this normal deleveraging the added uncertainty of the bipartisan gridlock in Congress, business and consumers are less likely to invest and spend, which further restricts credit flows.

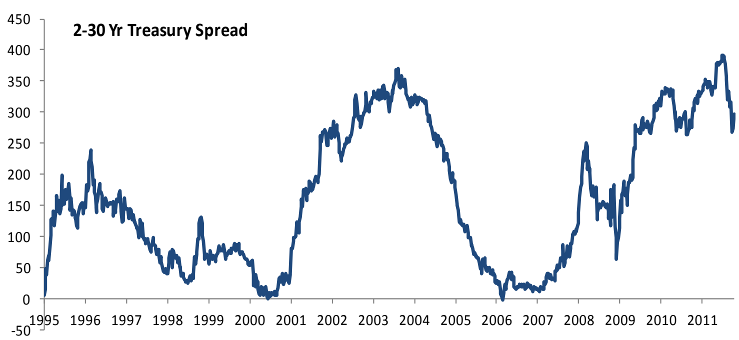
Sadly, we do not expect to see corporations in America make any meaningful investment in their businesses over the next 18 months beyond maintenance capital expenditures. While flush with cash, the uncertainty in tax policies and the economy are enough of an excuse for management to sit back and let cash continue to pile up. Thanks to the interest rate policies of the Federal Reserve, the after tax cost of capital for most companies is the lowest it's ever been in history. *Corporate management is effectively saying that they do not believe they can earn an after tax rate of return that is above their cost of capital.* It appears to be acceptable corporate stewardship today for companies to buy back their stock in the open market; however, they are not willing to put their compensation at risk to reinvest in their business. Unfortunately, stock buyback programs do not create jobs.

While the economy added 103,000 jobs in September, hours worked per employee rose for the month. In addition, hourly earnings growth has been stable in recent months. However, we remain concerned that job growth is too slow to sustain economic expansion. We estimate that the economy should produce 200,000 jobs per month over the next three years in order to make a meaningful dent in the unemployment rate. While the unemployment rate has declined through the year, it is more a result of people leaving the labor force than the unemployed finding jobs. With the announced layoffs already for the fourth quarter, muted business investment, slow consumer spending and the lack of direction from Congress, we expect further sluggishness going into 2012.

The Federal Reserve Continues its Experiment

In the absence of meaningful policy initiatives from Washington that would address the structural problems in the economy and stimulate job growth, the Federal Reserve continues its efforts to manipulate the markets and pull interest rates lower. We maintain that traditional monetary policy tools have proven ineffective given the damaged state of the banking system and the economy. Excess reserves on deposit at the Federal Reserve total almost $1.5 trillion. Loan demand is down, as a result business formation and the expansion of credit is curtailed. We see evidence of this in the money multiplier which theoretically is the number of times that a dollar moves through the economy - the higher that number, the more vibrant the economic activity.

Last month, the Fed initiated “Operation Twist”, its third significant quantitative easing program. Through the first two programs, the Fed accumulated a portfolio of US Treasury and Mortgage-Backed Securities totaling in excess of $2.4 trillion that was designed to force short term interest rates lower. However, unlike the first two programs, this third initiative does not require any additional borrowing. The Fed is now selling $400 billion of its short term holdings and reinvesting in US Treasury and Mortgage-Backed Securities with longer maturities in an effort to lower long term interest rates and flatten the yield curve. During the third quarter, the yield curve, measured by the difference in the yield of the 30 year US Treasury bond and the 2 year US Treasury note, declined from 393 basis points to 268 basis points. We believe this program will be effective in generating capital market activity that will allow for additional risk taking as portfolios search for higher yielding alternatives to replace Treasuries.



However, Federal Reserve policies can only do so much to stimulate economic activity and create jobs. Given the structural problems in the economy, we do not believe this initiative will help stimulate job creation. We do think it will encourage profitable capital market transactions.

We believe that we have entered a *new monetary policy regime* which will have a pervasive impact on investment strategies and risk management. Jim Grant, the author of *Grant’s Interest Rate Observer*, has postulated that the lifespan of any monetary system since 1880 has not been longer than 30 or 40 years in length. After we moved entirely off the gold standard in 1971, the Fed targeted growth in the money supply to manipulate short-term interest rates and economic activity as a result. We expect that this new form of monetary policy, while currently viewed as temporary, will become a more permanent tool for central bank policies.

Without any question in our minds, the Fed has been extremely effective at manipulating interest rates lower in the absence of an efficient and open free market. And, through these programs, the Fed has effectively transferred debt from the private sector over to the government sector. However, we expect the unintended consequences of these initiatives will have a negative impact on retirement savings, risk taking, and the financial services industry for many years. We are free market capitalists and are uncomfortable with the extended role of the Federal Reserve in the capital markets. However, we recognize the continued shift to a new form of government sponsored capitalism.

Investment Strategy

The stock market, measured by the DJIA, ended the quarter down 12% as volatility increased sharply, its worst decline since the first quarter of 2009. The selloff has allowed investors to capture a pretty good entry point to invest in high quality high dividend stocks. Companies with solid balance sheets, strong cash flow and healthy dividends that we believe are cheap include Proctor & Gamble, Johnson and Johnson and Bristol Meyers Squibb. Given the lack of credit expansion, slow loan demand and uncertainty in financial regulatory reform, we are not rushing to buy banks stocks in here, even on weakness. We expect revenues at the banks will continue to adjust lower as regulations further restrict their activities and we believe there is better relative value in securities further up the capital structure.

We are totally out of China and prefer to watch from the sidelines as the Chinese government steps in to prop up several of the banks. Last quarter, several U.S. listed Chinese companies were accused of accounting fraud at the same time economic growth in China slowed. We are also concerned that the infrastructure and real estate investments made in the country can only be supported through an export driven economy which appears at risk in the face of a global slowdown.

The concern in the capital levels of European banks combined with the increase in volatility forced credit spreads wider in the bank sector. We see wonderful value in investment grade banks given the wider spreads and overall weakness. However, we caveat that we would expect further downgrades from the rating agencies which may put additional pressure on the sector. Short Morgan Stanley debt in particular is cheap at +400 to comparable US Treasury yields.

The turmoil in the financial sector resulted in weakness in the hybrid securities market. The preferred stocks and trust preferred securities of many of the banks including Morgan Staley, Citi, HSBC and PNC cheapened up during the quarter and now offer yields between 7.5% and 8.5%. The stock of Bank of America has been under pressure as the bank struggles through selling off noncore businesses and cleaning up its mortgage portfolio. As a result, the convertible preferred offers investors a cheap valuation with a dividend yield near 7.8%.

With the dramatic decline in the level of interest rates, we are convicted about staying short on the yield curve and not extending maturities to pick up yield. We believe that Operation Twist will lead to higher rates after the Federal Reserve completes the program and prefer to stay conservative. We see a lot of value in short high yield debt in credits where the issuer clearly has cash on the books to retire its near term maturities but still retains a noninvestment grade rating. One of the anomalies that exist in the credit markets is that the rating agencies place the same rating on the debt of an issuer that matures in six months as it does the same class of bond that matures in 30 years. Yet, the risks are vastly different given the timing of the near term maturity. We believe there is very good relative value in certain high yield credits including Ford Motor Credit, Ally Financial, HCA, and International Lease Finance.