



Quarterly Financial Update

Third Quarter 2011

Concerns about Europe's debt woes and negative global economic news sparked recession fears and drove stock markets down steeply in the third quarter.

Even after the recent market declines, however, our analysis suggests that equities may still not be fully pricing in the effects of the global financial crisis of 2008–2009.

Despite this, as the stock market has declined, stocks have become more attractive in terms of their five-year expected returns. As a result, we incrementally reduced our underweighting to stocks this quarter.

Unfortunately, likely returns from bonds are even lower than stocks, especially after investors' recent fear-driven flight to Treasuries.

Given the ongoing macro challenges and uncertainties we face, short-term macro swings could well continue in both directions for a long time to come. This should serve as a reminder for why we need to invest with a long-term horizon in mind.

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Quarterly Investment Commentary



Investment View in Brief

Concerns about Europe's debt and negative global economic news sparked recession fears and drove stock markets down steeply in the third quarter.

Large cap domestic stocks fell 13.9% during the third quarter and have lost 8.8% year to date.

Smaller cap stocks suffered larger losses, down 21.8% for the quarter, and 17% for the year through September. International stocks also suffered double-digit losses, with developed market

equities losing 20.9% for the quarter and 18% year to date.

Emerging markets stocks were hit hardest, losing 24% for the quarter and 23.4% for the year to date.

Domestic high quality, intermediate term bonds gained 4% in the third quarter and are up 6.6% year to date, driven by investors' flight to the relative safety of Treasuries. Developed-market international bonds were up 2.4% for the quarter and have gained 6.5% year to date. Emerging markets bonds dropped significantly in September as capital flowed out of emerging market currencies; they ended the quarter down 8.5% and are now in the red by 2.2% year to date. Floating rate loans fell 3.9% in the quarter and have lost 1.4% year to date.

Since 2008, we have been in a period where macroeconomic forces weigh disproportionately on our portfolios. The most recent developments – concerns about a global economic slowdown, political gridlock, and shorter-term European and longer-term U.S. debt problems – are consistent with the risk scenarios we've been discussing for the past several years.

Spooked by macro events, investors have flocked to Treasuries, forcing their prices even higher and lowering their yields. This has resulted in short-term underperformance by our portfolios, which are underweighted to core investment grade bonds.

Yet scary headlines and market volatility, while unnerving, can also create buying opportunities for disciplined investors. In the third quarter, we took advantage of stock market declines to incrementally reduce our underweighting to equities. We made our first move to nudge our US stock holdings up in August. Then, in late September, with emerging markets equities down sharply, we began to add a small emerging markets equity position in our more risk-tolerant global balanced portfolios. Finally, we initiated a small global equity position in our most conservative portfolios.

These portfolio changes are examples of our valuation-driven approach to tactical asset allocation. Yet a word of caution is in order: even after the recent market declines, our analysis suggests that stocks are still not fully pricing in the effects of the global financial crisis of 2008–2009. As a consequence, near- to medium-term weakness in stocks is not only possible, but somewhat probable. Furthermore, this is the reason that our balanced portfolios remain slightly underweighted to equities.

Given the ongoing macro challenges and uncertainties we face, we are likely to experience shorter-term macro swings in both directions for a long time to come. This should serve as a reminder not only for why we consider several different scenarios when investing, but also for why we always want to approach investment decisions with a long-term time horizon in mind.

Politics and Policy

One of the most difficult challenges for investors today is that government policy is likely to play an outsized role in the global economy for years to come. This creates tremendous uncertainty. It is not only impossible to predict what legislative bodies will decide, it is also difficult to know what the ultimate effects – including unintended consequences – of those decisions will be.



and if you think that's weird... did you know we used to be scared of other countries' leaders more than our own?

For example, there was much debate and little progress on the U.S. fiscal deficit this past quarter. The issues that need to be addressed – e.g., tax policy and entitlements – continue to be very polarizing. The debt ceiling showdown earlier in the summer was the quarter's most dramatic example of politics contributing to general uncertainty. Despite an 11th hour agreement, the contentious process and lack of meaningful action seemed to dampen consumer confidence and were specifically cited as part of the reason for Standard & Poor's subsequent decision to downgrade the U.S. sovereign debt rating from AAA to AA+. The downgrade didn't reflect any new information about the financial nature of the debt challenges we face. What it does reflect is a more pessimistic assessment of the country's political will to deal with them.

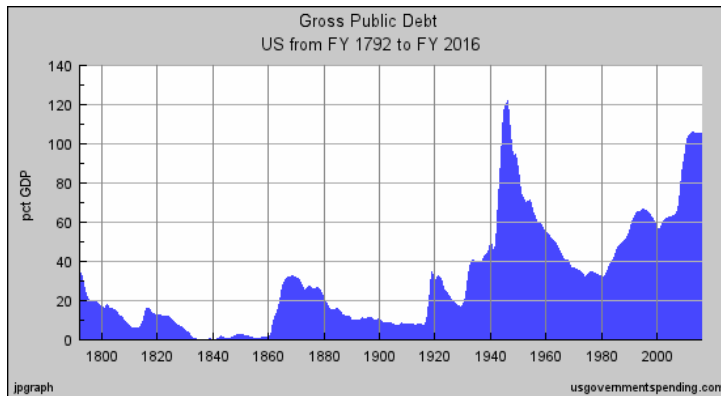
Overall, we continue to view policy mistakes, or simple inaction, as a major unknown and a significant risk factor. Failure to address the deficit and debt in a meaningful way runs the risk of markets forcing the issue: investors demanding higher returns for taking on the risk of owning U.S. debt, forcing interest rates higher and further choking off growth, not to mention raising the cost of servicing our debt.

Meanwhile, with fiscal policy stalled by politics, the Federal Reserve has taken a more aggressive approach to monetary policy, deploying a range of experimental tactics for boosting the economy. The quarter began with the end of QE2, the Fed's second bond buying campaign, and it ended with Operation Twist, with which the Fed will, in effect, exchange short-term debt on its balance sheet for long-term debt in an effort to reduce long-

term interest rates and encourage lending and investing. The Fed has also made an unusually explicit commitment to keeping rates low until at least 2013. All of these efforts represent extraordinary measures intended to further the Fed's dual mandate of ensuring price stability (which today means fending off deflation and avoiding runaway inflation down the road), and fostering full employment.

Our view is that monetary policy measures are not likely to help the economy much in the long run. We continue to believe that the problem isn't that we have overly tight monetary conditions, but that we have stalled liquidity as fiscal and regulatory uncertainty encourages banks, corporations, and consumers to hang on to their dollars rather than spending or lending them into the economy.

Debt Reduction Update



Despite the increasingly heated rhetoric of recent months, little progress has been made toward bringing down the U.S. government deficit and debt. The compromise agreement that enabled Congress to raise the debt ceiling promised some deficit reduction, mostly coming after the 2012 election. Nearer term, the budget reduction it affected is minimal and the plan puts off the inevitable decision

to raise taxes, cut entitlements (Medicare in particular), or some combination of both, without which the deficit will reach unsustainable levels.

There has been some progress in bringing down the level of consumer debt relative to income, which is necessary for the economy to again grow at a healthy rate. Yet government debt continues to grow. Ultimately, we think it could be close to a decade before overall household and government debt levels are reduced to a point where we can expect a more normal level of ongoing economic growth.

Debt and the Eurozone



European government debt problems are one of the other big picture issues with potentially huge ramifications for the economy and financial markets. Investors grew increasingly concerned about Greece in recent months but also, more worryingly, about the larger economies of Italy, Spain, and even France, as well as European banks in general, due to their exposure to European government debt. We share the view of most experts that Greece cannot repay its debt without some kind of restructuring, which is a deliberate euphemism for default. The question comes down to whether what we get is an orderly default – which can be managed in a way that avoids a damaging contagion effect that brings down other governments or banks (or both) – or a disorderly one, in which all bets are off.

As has been the case all along, we worry that markets may essentially force a resolution of Europe's debt issues by driving up bond yields (and therefore funding costs) to a level that would push the weaker eurozone nations (Greece, Portugal, Ireland) toward default and could also force Spain and Italy

into a liquidity crisis and potential insolvency. We expect central banks to step in to provide liquidity but, even with support, this scenario (or a less severe version of it) would be a significant economic shock at a time when the global economy can ill afford it.

At the overall portfolio level, possible shocks from the European debt situation are another of the reasons for our decision to remain underweighted to equities. Within our equity allocation specifically, however, we have maintained close-to-neutral exposure to developed international markets. While we are not tactically tilting the portfolios toward these markets, we recognize that active managers can use the declines of European stock and bond markets to take advantage of new opportunities (and a few have sought to do so). For us, the risks and unknowns are too high to warrant a tactical allocation at this time. Even after recent market declines that were greater in Europe than here at home, we don't currently find the valuations to be highly compelling.

Successful Investing Requires a Long-Term Perspective

As one investor we respect put it, "You need to be a marathon runner when investing. Investors should never judge their decisions based on a moment in time." Earlier this year when markets were shooting higher, some of our decisions and portfolio positions may have looked overly pessimistic or defensive. More recently, as markets tumbled and

headlines blared about the possible collapse of the Eurozone, our positioning may have appeared overly optimistic or risky. But, in our opinion, overly short-term thinking of all types is what leads most investors to get whipsawed, chasing the market (or asset classes or fund managers) on the way up and then riding them down before jumping into

the next hot asset class or manager. In contrast, we believe in sticking with a process that has been successful over time, if not all the time, and in using an appropriate time horizon to assess the success or failure of our investment decisions. As in long-distance running, first out of the gate doesn't necessarily win races; it's staying power over the course of the whole race that counts.

For example, in our commentary last quarter we wrote, "In a recessionary, deflationary or 'flight-to-safety' scenario we assume that these [absolute-return-oriented/unconstrained bond] funds will lag investment grade bonds by several percentage points." Sure enough, that is what has played out over the past couple of months.

Over the past three months, Vanguard Total Bond Index is up 4%, while our absolute-return-oriented bond funds are roughly flat to negative 2%. That is significant underperformance, but it is within our range of expectations for these funds in this type of flight to quality or risk-off scenario. It is also very short-term performance.

In spite of this third quarter experience, we believe our actively managed bond funds can generate at least low- to mid-single-digit returns *over the next five years*, while managing interest rate, credit, and currency

risk. This contrasts with the investment grade bond index, which has very poor return potential and significant future interest rate risk. In other words, if rates rise meaningfully, the investment grade bond index will lose money, the inverse of what has happened as a result of the recent drop in interest rates.

Moreover, if we look back further than just the past few months we can see the value added from our fixed income positioning.

Over the trailing three years, our bond funds have either significantly outperformed the investment grade bond benchmark or trailed modestly. And, as recently as the end of August, all of these funds had beaten the investment grade bond benchmark over the trailing three years.

"You need to be a marathon runner when investing. Investors should never judge their decisions based on a moment in time."

A final note on risk and expectations. We try very hard to do a good job of analyzing and weighting possible outcomes. It's worth a reminder, however, that no one knows for sure how things will play out. Intellectually honest advisors know what can and cannot be analyzed with confidence and tell their clients as much. We are currently in a global economic environment that continues to be subject to unpredictable forces and events. That said, we strive to make long-term investment decisions based on thorough and careful analysis of what we *do* know, taking both risk and return into account.

Postcards From Foreign Places



Sometimes the current economic environment – both personal and global – feels like a foreign place. In spite of the fact that I’ve been talking some time now about the fact that we crossed a financial Rubicon during the financial crisis of 2008-2009, the new financial terrain sometimes still seems, well, *new*. It simply takes a long time for us to experience the full scope and complexity of a new environment

In fact, most of us are still trying to figure out the brave new world that we’ve entered. I believe, however, that we can discern some of its features. So I’m going to take a stab at highlighting what some of those features are, based not on a thorough analysis but rather on experience and anecdote. The full story will have to wait for economic historians. Until then, here are a few postcards that may give you an idea of what traveling in this foreign place is like.

Debt: The 800 Pound Gorilla In The Room

Do you remember anyone obsessing about national debt-to-GDP ratios or personal debt ratios before 2008? Nope. Except for a few financial geeks (and oldtimers who remembered the Great Depression), our collective mind had lost an appreciation for the costs associated with debt, both personal and domestic. Debt was somehow ‘free’.

Events since 2008 have changed that – from the bailout of Bear Stearns and the bankruptcy of Lehman Brothers, to TARP, to a million mortgage foreclosures (and counting), to the Greek (and Spanish and Irish and Italian) sovereign debt crises. Anybody today who isn’t at least aware that debt of all kinds is causing massive economic problems has been in a coma for the past three years.

The good news is that, on a national level, we are beginning to agree on the *fact* of the problem. The bad news is that there is widespread – and violent – disagreement about its causes, its fundamental nature, and its likely remedies.

Politically speaking, “spenders” have (reluctantly) acknowledged that there needs to be a theoretical limit to their use of the national credit card. Yet they still conceive of the problem largely as a short-term mismatch between sources and uses of cash. Like Saint Augustine, their most fervent prayer is that fiscal abstinence come later rather than sooner. If we get over this current rough funding patch, they assert, we can go back to providing them with the benefits of federal borrowing – a subsidized interest rate on their mortgage, a pension that is not (and probably never was) financially viable, and general government benefits that exceed current fiscal resources. The problem, of course, is that there is no longer universal buy-in to the notion that debt required to do this is “free”.

If the debt isn't free, say the "savers" on the other side of the political debate, one needs to weigh the costs against the benefits of such decisions. Are the costs worth it absolutely? Do the benefits to society as a whole outweigh the costs to its individual members as well as to its collective financial security? And who should bear those costs? Is it fair if one group of citizens bears all of the costs and receives little-to-none of the benefits? Is it fair for some citizens to achieve more, to have more absolutely, than others? What should government's role in all this deciding-about-fairness actually be? Finally, what does the Constitution say about all this – and do we still care about trying to live within the framework that it established more than two centuries ago?

Yes, this is a contentious debate – because it needs to be. There is a lot at stake, not only in terms of immediate financial outcomes but also in terms of the fundamental reach of our political system into its citizens' lives. Until now, this is a conversation with ourselves that we have avoided lest we wake the gorilla.

Whichever side of the debate you happen to be on, however, what has undeniably changed is the fact that the 800-pound gorilla is now roaming around the house and can no longer be ignored.

Occupy – Where?



As a number of commentators on the recent "Occupy Wall Street" goings-on have noted, the demonstrators seem to have missed the memo about who's doing what here. Though there can still be legitimate inquiry into what their point is, there does seem to be agreement that the "occupyers" don't like banks in general and, further, harbor a particular dislike for those "fat cats" that our politicians love to vilify. The general idea is that these folks are responsible for all our economic pain by virtue of not sharing it.

I sympathize with the frustrations of many with regard to our current economic condition – with those who are trying to find that first (or new) job, with owners stuck in an underwater property, and with depositors who are being paid nothing to hold their wealth in cash. From my humble perch, however, it looks to me like the banks are *not* in the driver's seat here. Indeed, my recent experience has been that the banks (and financial institutions in general) are doing exactly what – no more and no less – than the federal government wants (or allows) them to do.

Take mortgage lending, for example. Most financial institutions forgot how to make independent mortgage lending decisions beginning in the 1980s and 1990s. After all, if Fannie or Freddie was going to buy the paper, what sense did it make for a bank to make its own credit determination? By setting the standard for loan guarantees, the federal government usurped the traditional role of local banks in determining who should receive credit based on a detailed knowledge of their economic viability as borrowers. And we've all seen where that eventually led us.

But has that changed now? Are the banks all of a sudden making (customer unfriendly) decisions on their own? Not according to my experience. Sure, the feds are pressuring financial institutions to forgive loans that were made to certain constituencies because it is politically expedient to do so, but that entails destroying investors' capital or putting their own capital structures at risk, *which other federal rules forbid*, by the way. So the banks are getting very mixed – not to mention economically toxic – signals about this. What the feds *haven't* done is allow local banks to go back to the business they should be in, i.e., of making mortgage credit decisions. They must still rely on Fannie/Freddie rules whose primary goal seems to be PR, i.e., convincing someone that “something was done about the problem,” even if that something doesn't make a lot of sense.



Take an example that a mortgage broker friend of mine recently brought to my attention. Let's say there's a borrower who isn't even underwater on his loan. He has a decent job and a perfect record of paying his mortgage. But – and here's the rub – his income-to-debt ratio is below the amount required by Fannie/Freddie for a new loan. As a result, this borrower is prevented from refinancing to take advantage of current, ultra-low rates. So despite the fact that the

bank would be helping the borrower (and presumably the economy) as well as benefiting the credit-worthiness of their overall loan portfolio by making this loan, federal rules put into place in the wake of the credit crisis prevent it. Go figure.

Call it economics-by-rule, and it doesn't work very well. But get used to the idea, because unless things in Washington change dramatically we're going to continue to see more and more of it. It's just too tempting for our elected officials – almost none of whom have experience working in or running businesses – to label specific business practices as the cause of their problem du jour and then claim triumph over the latest evil by passing a law (or creating a rule) against them. The example above is one of hundreds of thousands of such rules that the government has recently imposed on businesses large and small and that the business community is still trying to digest and adapt to. The problem is, of course, that most of this rule-making is done by individuals whose heads are in the weeds. They aren't looking at the big picture. In particular, they aren't considering what the rules cost, whether or not they're even effective, and – heaven forbid – whether or not they have other (and bad) unintended consequences.

So why are businesses stuck in low gear and not hiring? There are many reasons, of course, but at least one of them is the added cost and decreased flexibility to independently pursue economic goals that our government continues to impose on them. One wonders how long it may take for the young demonstrators hoping for an improving economy to realize that they should be taking up their beef with the folks a bit further south, say, on the Potomac.

To A Man With A Hammer, Everything Looks Like A Nail.

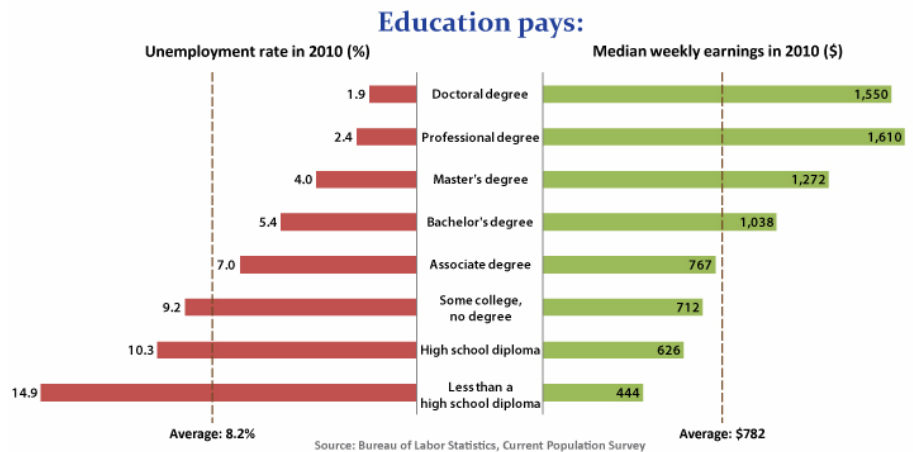
As any doctor will tell you, the correct diagnosis is critical to a successful cure. To the current Federal Reserve, however, every economic ill looks like a monetary problem – you guessed it, because they have the tools to deal with monetary problems. Yet the longer the Fed leaves interest rates at zero and continues to flood the U.S. (and the world) with dollars, the more evident it becomes that the real problem isn't monetary at all.

What the Fed is trying to fix with loose monetary policy is unemployment. But unemployment among bachelor's degree holders is only 5.4%. It is only the least educated workers who find themselves in double-digit unemployment categories. It is intellectually dishonest to maintain that we have a general unemployment problem. The problem we

have is concentrated in unskilled and semi-skilled segments of the working population. This is primarily the result of the collapse of the construction industry, which employed many of those less-than-college-educated workers and which overexpanded to meet the demand of the housing boom. But homebuilding is set to underperform the economy as a whole for years to come, and no amount of government stimulus will make those jobs economically viable any time soon.

Unfortunately, it will take time and economic flexibility to fundamentally address this imbalance. There are no quick fixes. Individual workers need to seek new training. Some will need to relocate. Many need to enter new industries. One would be tempted to call for government training programs if it weren't for the fact that the historical effectiveness of such programs has been virtually nil. What would clearly help, eventually, would be a general improvement in the quality and availability of public education – especially at the post-secondary level – but that will take even longer and is itself embroiled in political controversy.

In the meantime, however, the Fed is distorting the economy by not letting interest rates float back up to a more normal level. The latest figures from Washington indicate that the inflation rate this year so far is running around 3.9%. Compare that to the return you're getting for the money you hold in the bank and you'll realize that you are paying a monetary "tax" of around 4% to underwrite the Fed's loose money policy. In the meantime, our politicians are being lulled into a false sense of security by the fact that the Eurozone's monetary house is in even greater disarray than ours, which continues to support the dollar's status as the go-to currency in a crisis. But how long can we rely on the misfortune of others for our own prosperity? Sooner or later we'll need to effectively treat the problem we actually have if we want our economy to improve.



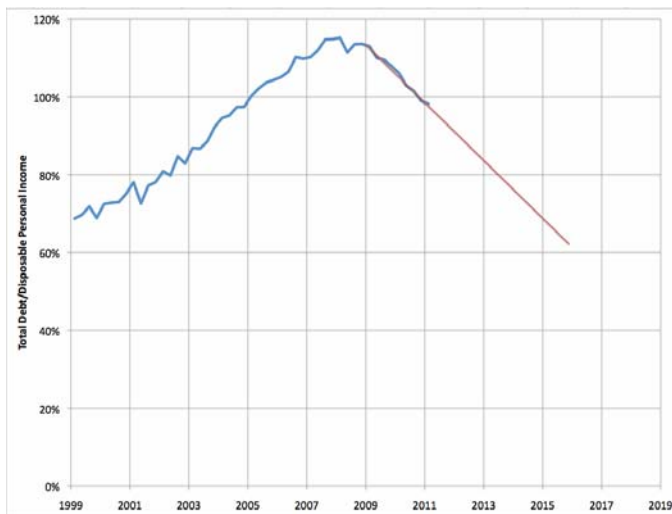
The Glass Is Half...



I'm actually an optimist. For all the doom and gloom being reported in the media – and in spite of my comments above – I actually think the economy is in better shape than we generally believe it to be.

Take the unemployment issue. True, it's a big problem if you are in one of the most seriously affected groups. But looking at it the other way, very large segments of the population still have decent jobs. This is not a replay of the Great Depression. Among college graduates we have 95% employment. And because these workers generally earn higher wages (see above), the disposable income of the economy as a whole has not been as significantly curtailed as might otherwise have been the case.

As a result, and despite all the headwinds, businesses and households in general are holding their own. It seems to me that the economy isn't growing as quickly as economists would like because we are, in fact, in the process of making a long-term structural realignment.



Source: The New York Federal Reserve

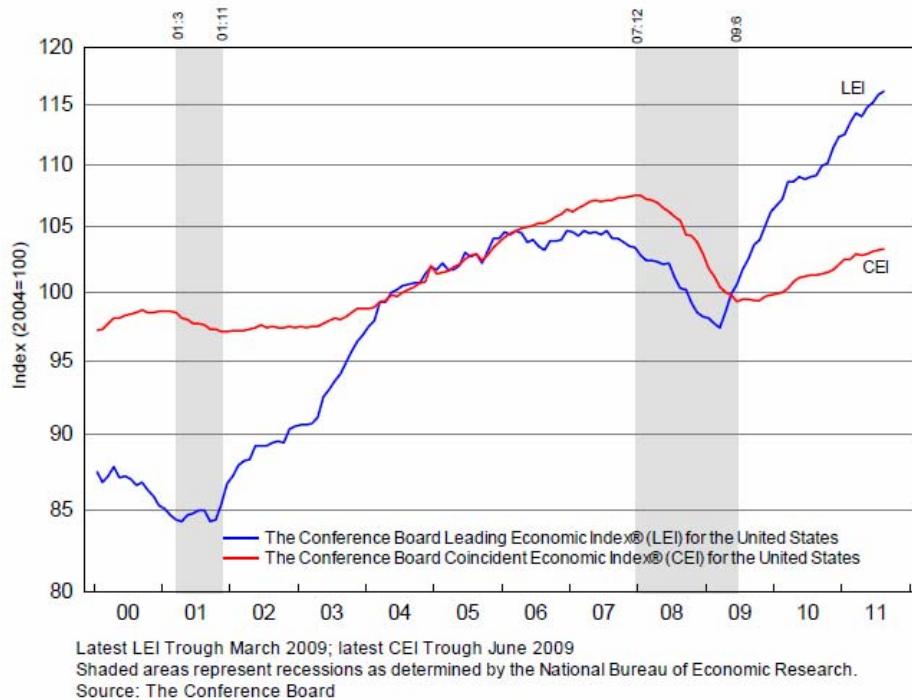
The graph above shows the amount of debt held by U.S. households relative to their disposable income, both historical and projected. It's easy to see that, rather than using credit to expand coming out of this recession (and as was the norm for

most other post-war downturns), households are tightening their belts and paying down accumulated debt. Over the long run, this is necessary if the economy is going to resume its long-term growth trajectory. In the short term, however, it makes for an anemic recovery.

Double Dip? Here is some more decent news that suggests we're going to continue to grow, albeit slowly, rather than drop into another recession.

- Consumer spending and business investment continue to rise. Chain store sales, hotel occupancy, and rail traffic are up 3.5%, 4.1% and 3.8% respectively from last year.
- Layoffs are decreasing and hiring is expanding, though the pace is obviously slower than would be required to make a big dent in the unemployment rate.
- Both industrial production (up 3.3%) and other measures of manufacturing and service output continue to expand.

The Conference Board Leading Economic Index® (LEI) for the U.S. Increases in August



- The Conference Board's Leading Economic Index, which has a reasonable track record of predicting recessions, continues to rise.

The bottom line for investors seems to be a likelihood that we will continue to muddle through for some time to come – barring a major disaster in Europe (on the downside) or a major change in monetary, fiscal & regulatory policy in Washington (on the upside).

So although we need to be ready for trading-driven shocks, I am personally betting that slow and steady will eventually win the race. As we've previously written, portfolio returns are not likely to be a substitute for a solid savings strategy, though they can augment it. And market returns are likely to be low across all asset classes for some time, so attention to limiting risk is more important than ever.

Happy Halloween!

