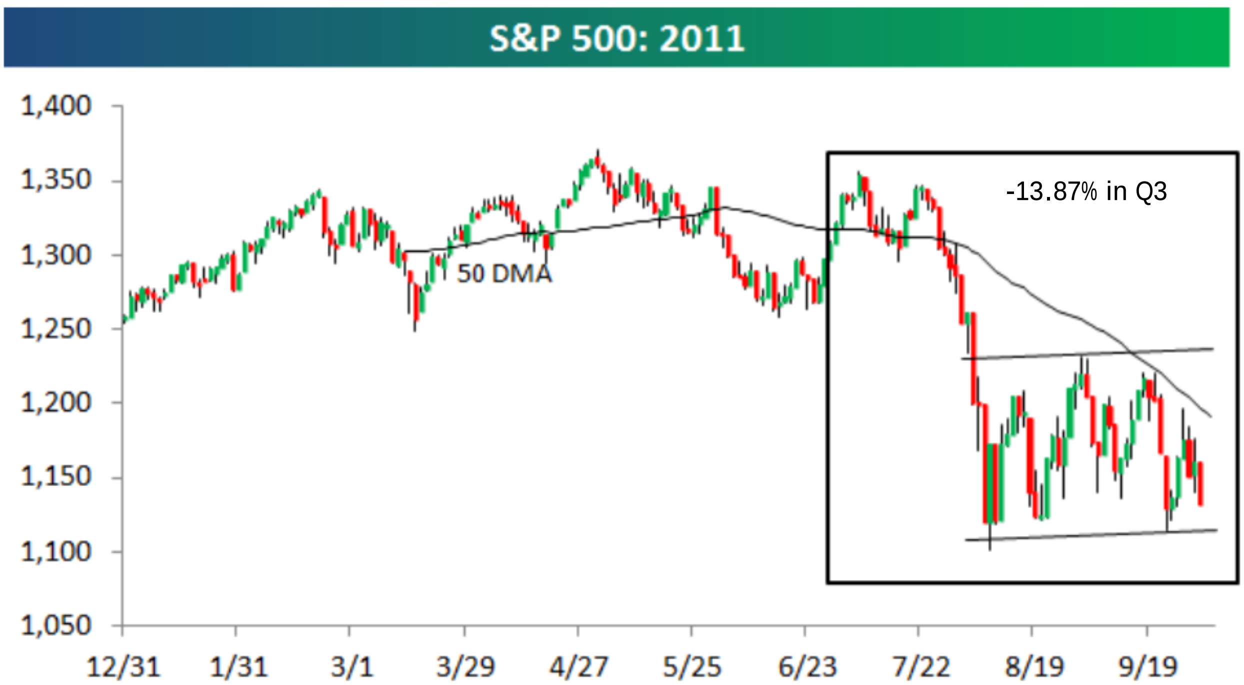
Portfolio Manager Commentary: Third Quarter 2011

What Happened?

After a very turbulent third quarter, investors hoping for a peaceful summer vacation season were left largely disappointed with the market. Concerns about the sovereign debt crisis in Europe along with softening economic data here in the US sent the market on a volatile ride that at times was similar to the ups and downs seen in 2008.

In less than a 2 week time period, the market declined 20-25% followed by one of the most extreme attacks of volatility ever seen (see chart below).



Source: Bespoke Investment Group, October 3, 2011.

Why Did It Happen?

While uncertainty and fear were the largest contributors to the steep decline and subsequent volatility, several other exogenous factors provoked the instability. All of these factors existed six months ago but it seemed investors forgot to acknowledge them until early August.

The issues at hand continue to be:

- Worries about the prospect of a double-dip recession.
- Signs that China and other emerging market economies are slowing down.
- Growing fear about Europe's capacity to deal with the fiscal irresponsibility of some of its peripheral countries (Greece, Italy, etc.) and the banks who lent to them.
- Increased knowledge about the importance of the U.S.'s debt situation and the embarrassing spectacle that played out in Washington as we approached the brink of default.
- The downgrading of US government debt by Standard and Poor's.

Taking all of these issues into account together, one can see why fear and uncertainty pervaded the market's general mood during the third quarter. Feelings of concern and insecurity were (and still are) understandable considering many of the current problems are unprecedented and extremely complex. Their resolutions aren't clear or proven. And after watching how the debt ceiling debacle was handled here in the US, confidence in political leadership arriving at a sensible solution for a complicated global financial crisis remains very low. As a result, investors and businesses alike are trying to position themselves as safely as possible in anticipation of the next policy response or negative news headline. So instead of trading on fundamentals and facts, emotion and guesswork trumps logic and the market swings violently from "everything is great" one day to "everything is really bad" the next day.

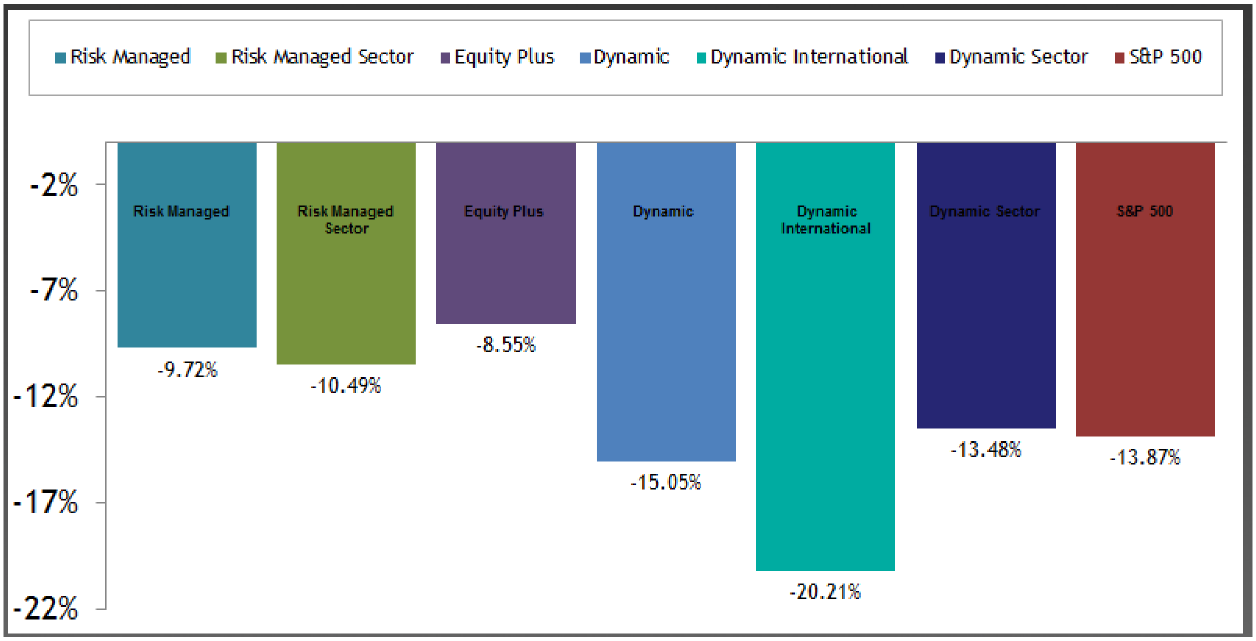
Jason Trennert of Strategas Research Partners (an esteemed private, independent research firm) pointed out in Barron's on 9/26/2011, "Frankly, we can't remember a period in which an effective market forecast was ultimately so dependent upon effective political forecasts on both sides of the Atlantic. Until greater clarity is achieved regarding almost existential questions about the global financial system, it appears that retail and institutional investors alike will be content to suffer the potential of negative real returns from bonds rather than the potential for large absolute losses in stocks." As we've noted in past commentaries, we have been observing the forces of uncertainty and trepidation surrounding policy response in our daily work for the past 2.5 years.

What did Niemann do in response?

As many of our clients and advisors know, part of our daily investment process involves an in depth analysis of market health. And like a 'good doctor,' each day we sit down with our market patient and conduct a thorough examination of vital signs, symptoms and ailments. We listen to what our market patient is telling us in order to make the best diagnosis we can. Our diagnosis helps us determine the proper prescription. If our market patient looks and feels healthy and all of the data gathered during the examination confirms it, we look for the best opportunities we can find. If the market patient is extremely sick with weak vital signs and intense symptoms, a quick and decisive response may be necessary to avoid irreversible damage. Again, **the point is to avoid irreversible damage**. Sometimes the quick and decisive action pays off and severe crisis is averted. Sometimes the patient recovers and you readjust your prescription accordingly.

In the midst of the sharp and rapid decline in late July and early August, overall market health turned decidedly sour. Our daily analysis of the "vital signs and symptoms" was pointing to a market that was extremely unhealthy and had a high probability of falling further. In other words, the patient seemed extremely sick so our prescription was to dial down the risk in all of our strategies.

Our conservative and moderate portfolios raised cash significantly and in Equity Plus, inverse funds were employed to help dampen risk and volatility further. Our aggressive portfolios (Dynamic, Dynamic International and Dynamic Sector) all rotated to the lowest risk areas we could find – Utilities, Consumer Staples and blue chip dividend paying ETFs. While there's no telling where the market will go from here, it seems as if our move to manage risk finally paid off in the third quarter after several false alarms throughout the recovery rally.



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What Now?

When everyone thinks one way and leans in one direction, the chances of the market thinking and leaning in the other direction are usually pretty high. Consider March of 2009 – while the market was putting in a very important bottom, was investor emotion ever as negative? One of the most optimistic things one can say about where we are now is that people are really pessimistic about the future. Investors are disenchanted with the market and think the game is rigged. The retail investor has been largely on the sidelines (as indicated by low volume), too disillusioned with the environment to put money to work. Confidence in political leadership is low. An overwhelming majority agrees the state of the world is bleak. But from the ashes of our many current issues comes tremendous opportunity for those who persevere.

Consider the following:

- Quality stocks are getting cheaper even as companies themselves (balance sheets) are very strong. The S&P 500 alone is trading at less than 12 times future earnings, the lowest multiple since the last secular bull market began 30 years ago!
- Emerging market valuations are also compressing. When Europe comes out with a sensible bailout package (please note the optimism), there may be a glimmer of light at the end of the tunnel that may unleash the growth in emerging markets again.
- Many investors are overweighted bonds. After taxes and inflation, the potential for negative real returns on fixed income is quite high. Big asset allocation changes out of bonds into stocks will eventually help fuel equities higher.
- In addition, the final months of a pre-presidential-election year are typically very strong. Seasonality factors usually come into play in the 4th quarter as well – October is historically the month that ends stock market weakness as the market begins to reverse declines.

Toward the end of a bear market, everyone comes to understand and believe the mess they're in. The media fuels a vicious cycle of negativity, which flushes out the market and creates new buying opportunities. The more pessimistic the mood becomes, in reality, the closer we are to the start of the next bull phase. We've learned through hard experience that the market really does move in cycles - the tides flow in and out and the market moves up and down. As it does, the world will be full of opportunity. It always is. We never know exactly when opportunity will reveal itself but it will. But to benefit from opportunity, you have to be there to seize it when it emerges. The flexible nature of our investment methodology is perfectly suited to do just that. Limit losses early on by getting out of harm's way, but be nimble enough to recognize when the environment has improved and important investment trends are developing. We hear it a lot. "I know when to get out, but I have a hard time knowing when to get back in." Our investment process handles moving in and out of the market for you.

In Conclusion

Since the financial crisis, our advisors and clients have repeatedly asked us for more frequent and timely communication. After listening to your feedback and suggestions, we are proud to announce a more enhanced communication effort going forward. We will continue to communicate with you as we always have but with a few additions and improvements. Building on the Niemann community of interest and knowledge over the past 20 years, you can now follow our research, get to know our firm and our employees more personally and ultimately gain added transparency about our investment process on a more frequent basis. On our recently launched blog (blog.ncm.net), you will find market updates, white papers on key industry topics, articles of interest, etc. You can also follow us on Twitter (http://twitter.com/niemanncapital) and LinkedIn (Niemann's LinkdedIn Company Page). However you choose to access us, we now have several different channels available to you. Information is power so we hope you will take full advantage of the resources available to you.

We also continue our progress toward implementing a new and advanced equity trading platform that will allow us to refine and improve our execution, timing and other important factors associated with your account. As we mentioned in our last letter to you, the platform will also lead to a broader array of products all designed to enhance your returns. As an example within one managed account, we plan to offer alternatives like Emerging Market sectors, Dividend Growth, Fixed Income, Global Value and Commodities, with additional options and opportunities offered further down the road. Again, these additions are enhancements - you can rest assured we remain true to our core philosophy and investment methodology. Keep your eyes and ears open for exciting new developments on this front!

We hope you find this information helpful. Should you have any questions or wish to discuss this commentary in more detail, please feel free to contact your financial advisor.

Don Niemann
Chief Investment Officer

S&P 500 Index- Assumes reinvested dividends: The S&P 500 Index is a capitalization weighted, unmanaged group of 500 stocks as selected by the Standard & Poor's Publishing Company. They are usually the 500 largest companies in terms of market capitalization and are chosen to represent the entire market's value. The S&P 500 is used by many institutional investors as a performance benchmark representing the "stock market" return.

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