



October 2009

# Market Insight

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# season to season



## the economy continues its transformation

With the air becoming a bit more brisk and leaves beginning to change from **green** to **yellows** and **reds**, autumn is certainly just around the corner. Autumn to me is all about the lawn and the annual tradition of fall grass planting. Throughout the summer months, the lawn takes a pounding from the family's pick-up soccer games, the dog's all-day patrol, the feet of scampering kids and the sun's brutal strength. But as the leaves start to turn colors and eventually fall, autumn is the time that the grass in our yards gets the treatment it deserves.

**In a season all about transformation**, it is hard not to think back and reflect on the journey we have been on this past year. This time a year ago we entered the fall season with a much different economic backdrop and deteriorating market conditions. Come to think of it, I don't even remember autumn last year. It may have been the first time in my adult life that my memories of fall were not about pumpkins, mums, and Halloween; but rather Lehman Brothers, sagging stock prices, layoffs and the threats of a depression.

As I walked behind my spreader filled with grass seed last weekend, I realized some parallels between our annual rite of grass growing and the market's journey over the last year. You see, the market was in tough shape last year and it required a lot of attention to make it grow again. Business cycles are like seasons and the end of the latest bull market in 2008 left the market's "yard" in the worst shape we had seen it in many decades, if not ever. Similar to the efforts of many weekend yard warriors during this time of year, the economy needed its own attention. It was this unprecedented

**BURT WHITE**  
CHIEF INVESTMENT OFFICER

global action from governments, businesses, and consumers that has transformed the economy from contraction to expansion in just a year's time.

Like the fertilizer I was spreading on my yard, the global economy needed stimulus to promote growth and transform the tattered market from recession to recovery. The unprecedented monetary and fiscal action over the last year served as the market's "fertilizer" to promote growth. The Federal Reserve (the Fed) shifted aggressively to a low interest rate environment that has begun to entice home buyers to purchase again and take the burden off of homeowners who benefitted from refinancing at lower rates. Stimulus checks, businesses unwinding inventory in once-in-a-lifetime sales and other government programs, like Cash for Clunkers, brought reluctant consumers back to stores and served as the catalyst for muted, but much needed spending. Lengthened unemployment benefits in most states helped to take the edge off the fact that there are just too many workers and not enough jobs. Any crisis, whether it is a yard ravaged by summer or a market reeling from a recession, needs the "fertilizer" to promote growth.

Another battle that amateur lawn farmers face is the dreaded dandelion and crab grass. Weeds start out as small seeds but grow to transform a carpet of grass into a yard of weeds. The same is true in the market, as problem areas start small but grow to system-wide problems that can derail an economy. Over the last few years, over-extended homeowners and ambitious loan providers contributed to a dangerous housing market that served as this economy's emerging "weed" that eventually contaminated the "yard." Banks then took these mortgages, leveraged them and scattered them throughout the market. These mortgage-backed "weeds" suddenly grew to crowd out the good grass and serve as the catalyst for the market's collapse last year. However, much improvement has been made as underwater homeowners received some mortgage relief. Swift Federal Reserve actions and government plans, such as the Troubled Asset Relief Program (TARP), have lowered mortgage rates and removed many of the toxic mortgage-related assets from bank balance sheets.

With such proactive stimulus measures by global governments and strong policies to counteract the mortgage-backed "weeds," the economy is beginning to show strong signs of budding growth; much like the seedlings in our yard that emerge several weeks after planting. However, new grass growth is fragile and needs care and water for many weeks to allow its roots to develop. The same is true about this market's recovery. While many signs of improvement are emerging—including a stabilizing labor and housing market as well as improving credit conditions—the economy is still in the early stages of recovery. Continuing stimulus programs and an accommodating monetary policy is still required to promote growth. In addition, businesses and consumers need to benefit from the early cycle opportunities to invest in growth and spending.

In the end, there are many life lessons we can learn from something as simple as a weekend of autumn lawn care. Whether we are ready for it or not, summer ends and fall begins. The same is true about the ends of business cycles. But with an end, comes a new beginning. In this seasonal analogy, I guess that it just makes sense that the market bottomed and started its recovery in mid-March of 2009—just a few days before the budding of spring. While we have come a long way already, with continued maintenance and a green thumb, this economy appears to be on track to be one good looking yard. ■



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## The U.S. Economy

### Green Shoots Blossom as Confidence Returns

Already reeling from high energy prices, a sagging real estate market, and rising concerns over the health of the U.S. banking system, the U.S. economy hit a wall after Lehman Brothers unexpectedly filed for bankruptcy on September 15, 2008. Bank lending and credit were drained from the system. The consequences for the economy were severe, turning a mild recession into the worst recession since the Great Depression of the 1930s. Importantly, the “Great Recession” of 2008-2009 was not anywhere near as bad as the Great Depression of the 1930s, and that has implications for our outlook for the economy over the remainder of 2009 and into 2010.

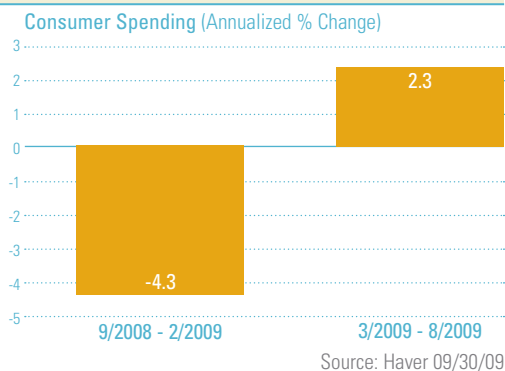
The mid-September 2008 event that precipitated the meltdown in the economy took place at a crucial time of the year for business planning. The economic data released in September, October, November, and December 2008 got progressively worse as each month passed. Businesses reacted to the collapse in economic activity, planning for 2009 as if the rapid pace of deterioration in late 2008 would persist for all of 2009. Bracing for a repeat of the Great Depression, business leaders cut production, payrolls, inventories, canceled orders, and slashed spending at every level. This initial overreaction by businesses, along with massive doses of both fiscal and monetary policy in late 2008 and early 2009 would ultimately set the stage for the rebound in the economy that took hold in mid-2009.

The feared path towards another Great Depression began to show up in the economic data shortly after the Lehman Brothers bankruptcy.

- Consumer spending (as measured by retail sales), already weakened by record high energy prices and modest job losses, fell sharply in the fall of 2008. In each of the final four months of the year, retail sales fell from the prior month and were weaker than consensus expectations. Consumer spending was in free fall.
- Initial filings for unemployment insurance benefits, often referred to as jobless claims, began September 2008 at around 400,000 new claims per week. By the end of October, claims were pushing 500,000 per week, and by the end of December were close to 600,000 per week. The labor market was in free fall.
- Industrial production entered free fall, as well, both in the U.S. and globally. Industrial production fell a stunning 17% over the final three months of 2008 and the first two months of 2009, reflecting the scramble by corporations to realign supply with expected demand.
- Even exports, which had helped the U.S. economy skirt the edge of recession in 2007 and 2008, as the housing market tumbled and energy prices soared, began a free fall by a stunning 42% over the final months of 2008 and first few months of 2009.

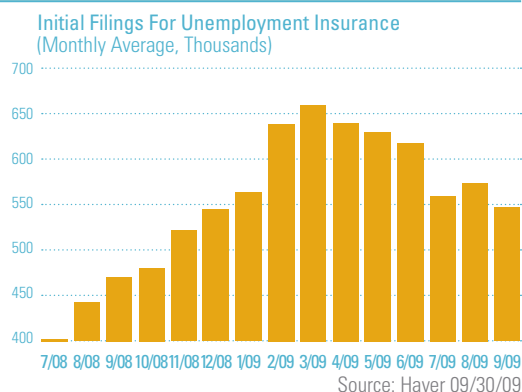
The dramatic drop in economic activity in the final months of 2008 led to the purging of inventories and a sharp contraction in economic output. In early 2009, the economy continued to worsen. The job losses, production cuts, consumer spending declines, and inventory destocking intensified. Eventually, the economy began to show signs of improvement in March, aided by the \$787 billion fiscal stimulus package that became law in February and the Federal Reserve’s “credit easing” program—which saw the Fed inject money into the financial system by purchasing close to \$1.5 trillion of U.S. Treasury,

#### Consumer Spending Reverses Course



Over the past 12 months, energy prices have receded, the real estate market has started to heal, the credit markets have thawed, and bank lending is slowly returning. The U.S. economy, which was sent to the brink of another Great Depression in late 2008 and early 2009, is now growing again.

#### Jobless Claims Continue Downward Since March Peak





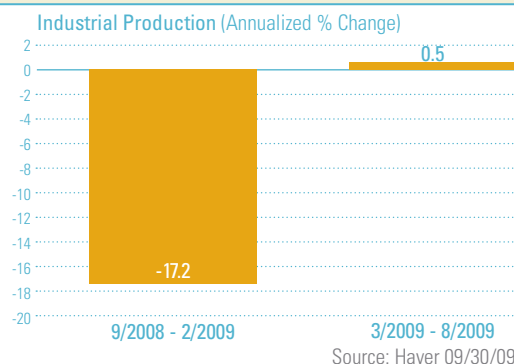
## The U.S. Economy (continued)

Agency, and Agency-Backed Mortgage-Backed Securities from banks' balance sheets. Even as the banks were undergoing government mandated "stress tests" and there was talk of "nationalization" of some banks, credit markets began healing. Retail sales were still falling, but at a slower rate than they had in late 2008 and early 2009. The same was true for employment, industrial production, and exports. These were the green shoots. The record inventory drawdown set the stage for the inventory restocking, and eventual bottoming of the economy in mid-2009.

By the end of the third quarter of 2009, the green shoots blossomed. Businesses generally reached the conclusion that they took the cutting of production, payrolls, inventories, cancelling of orders, and curtailing of spending too far. By mid-2009 demand was a lot stronger than business leaders had anticipated in late 2008. Thus, the green shoots that emerged in the spring as the economy stopped getting worse, began to grow, even as businesses cautiously adjusted their outlooks for 2009, likely resulting in positive GDP growth in the third and fourth quarters of 2009.

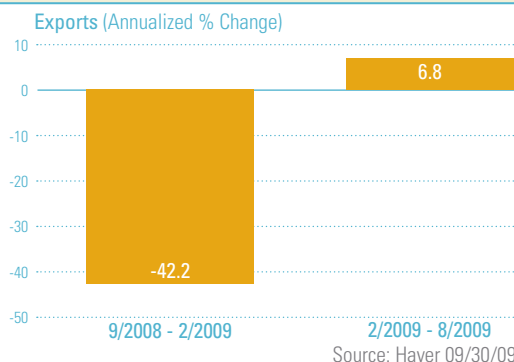
- Encouraged by falling energy prices, a few one-time boosts to income from government programs like Social Security and a payroll tax cut courtesy of the \$787 billion fiscal stimulus plan, consumer spending stabilized and then turned positive in the spring, although spending remained well below levels seen in September. The nearly 60% gain in the stock market and the modest gain in home prices have helped to make consumers feel more wealthy in the past six months. Looking ahead, the consumer still faces many challenges that will likely keep spending growth muted.
- Jobless claims peaked in early 2009 as businesses cut payrolls to the bone in late 2008 and early 2009. As we enter the third quarter, and look ahead to the fourth quarter of 2009 and beyond, initial jobless claims are still not back to where they were before Lehman filed for bankruptcy. Still, the 100,000 drop in claims from the peak in late March suggests that the layoffs are subsiding. Looking ahead, if the diminishing severity of the monthly job losses that has been evident over most of 2009 can continue, the economy is on track to post modest job gains by early 2010. While employment is a lagging indicator, a return to job growth would help to reinforce the durability of the recovery.
- Industrial production finally stopped falling in July 2009, after a record 14.8% decline from its peak in December 2007. The production cuts in the U.S. were matched overseas, setting up what could be the first synchronized global recovery since 1982-83. Industrial production posted month-over-month gains in both July and August, as businesses restocked depleted inventories. New orders—a good leading indicator of future production—suggest that the recent gains in industrial production will be sustained over the medium term, and that the rebound in production has broadened out beyond the auto sector.
- Exports, which helped to lead the U.S. out of the last two recessions (1991 and 2001), have rebounded as well, as the global economy roars back to life. In fact, at this point in the cycle (about two months beyond the trough in the economy) export orders are stronger than they were in either the 1991 or 2001 recoveries.

### Industrial Production Looks to be Sustainable



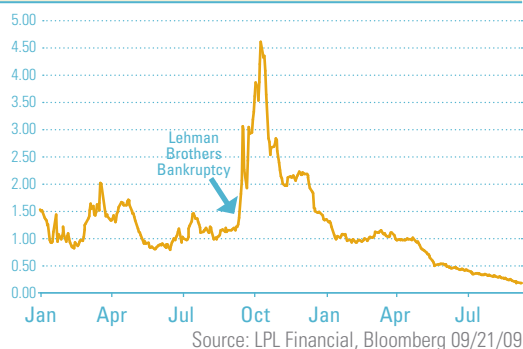
On balance, companies cut too far too fast in late 2008 and early 2009, resulting in the largest inventory drawdown on record in the first half of 2009. Thus far the story of the economy in the second half of 2009 has been the efforts of businesses worldwide to restock those inventories in the face of much stronger demand than they anticipated during the dark days of September and October 2008.

### Exports Help Economy Roar Back to Life



## The Markets

### Key Financial Risk Gauge Clearly Shows the Impact of Lehman Brothers' Bankruptcy TED Spread\*



### The Leverage Impact

Tight credit spreads prompted the investment banks to use high amounts of leverage in order to increase the profit on investments. To illustrate the problem, consider that a homeowner would be leveraged 5-to-1 with a purchase of a home with 20% down payment and an 80% mortgage. With a 5-to-1 ratio, when the price of the home declines 10%, the value of the homeowners' equity would be cut by 50%. Some investment banks, like Lehman Brothers were leveraged more than 30-to-1 on their housing-related investments.

\*The TED Spread measures the difference between 3-month LIBOR rate and the yield on 3-month Treasury bills. This is an effective measure of the liquidity available to banks. With bank capital adequacy near the center of the financial crisis this is an important gauge of the stress in the banking system. A rise in the TED Spread is a sign of rising stress.

### One Year Later

The powerful rally during the third quarter of 2009 (around 15%) brought the S&P 500 to about 10% below where it was on September 15, 2008, when Lehman Brothers filed for bankruptcy—the event that precipitated the financial crisis. It has been a long trip for the stock market and investors over the past year. After falling 43% from September 15, 2008 to the low point on March 9, 2009, stocks have rebounded by about 60%. Investors' optimism is also slowly working its way back.

### Looking Back

After the bailouts of Bear Stearns, Fannie Mae, and Freddie Mac earlier in the year, it was widely assumed that Lehman Brothers was the next troubled company on the list to get bailed out. The general expectation was that Barclays would absorb Lehman Brothers with the Fed guaranteeing them against some of the losses—essentially the same deal that the Fed provided to J.P. Morgan earlier in 2008 to facilitate the purchase of Bear Stearns as it was collapsing. In fact, this was so much of a foregone conclusion that the stock market rose during the several days that led up to the weekend the deal was to take place.

However, it was not to be. The backlash against bailouts and a desire to contain the toxic debt rather than spread it to more solvent institutions was too great and over the weekend of September 13-14, Barclays was denied the support it wanted and approvals it needed resulting in the bankruptcy of Lehman on Monday, September 15. The shock of a major player in the credit markets that was leveraged more than 30-to-1 resulted in a spike in the TED spread\*. Banks would not lend to each other for fear that their counterparty may go bankrupt.

For the two weeks that followed the bankruptcy the stock market remained flat, but as the aftermath of the Lehman failure became clear and the whole financial system began to seize, the stock market began to plunge. Within a few days of Lehman's bankruptcy, a money market fund broke the buck and money markets stopped buying the commercial paper of financial institutions. General Electric, one of the few companies in the U.S. that had the highest possible credit rating, tried to borrow some money on a short-term basis. Despite very low short-term interest rates, on October 2, GE had to pay 10% plus equity to Warren Buffett's Berkshire Hathaway to get the \$3 billion it needed. If credit was unavailable to a company like GE, it was certainly inaccessible to smaller businesses and consumers and the economy began to fall deep into recession. As October began, stocks around the world began to plunge. No region was spared the effects, even in China—often thought to be immune from the weakening pace of growth in the rest of the world—stocks fell over 20% in October.

The Federal Reserve and Treasury responded to the credit crisis with enormous and unprecedented policy actions to liquefy the seized financial markets and restore funding to financial institutions. However, investors were skeptical and after Treasury Secretary Geithner disappointed the markets with a Financial Stability Plan that fell short of expectations, the stock market fell another 25%, finally bottoming on March 6, 2009.

### Starting to Heal

Eventually, the credit markets began to heal and the economic engine restarted. The Financials sector, a key barometer of the health of the financial



## The Markets (continued)

system has rebounded well over 100% since the low. In fact, it is worth noting that during the third quarter of 2009 many financial companies re-attained their year-ago price level and others are worth more than they were a year ago even though their stock price is lower. For example, Citigroup's stock price is down over 70% from a year ago, yet the market capitalization of the company (the combined value of all outstanding shares) is higher than it was just before the Lehman Brothers bankruptcy. This is because Citigroup was forced to issue many new shares, diluting the value of existing shares. This is also true for General Electric which has a much larger market capitalization than a year ago despite the stock trading more than 30% below where it was a year ago. As a result, the stock market recovery masks the full extent of the healing that has taken place.

The return of growth has occurred outside the U.S. as well. During the third quarter, virtually every country has seen an uptrend in key measures of growth, including: manufacturing output, exports, housing activity, business confidence, and the stock market. We are witnessing a globally synchronized recovery.

### Investment Opportunities

Over the past two quarters as the market has rebounded, we have favored Mid and Small Cap stocks. These companies have outperformed their Large Cap peers since the market bottom, which has historically been the case during economic recoveries. In fact, Small Cap stocks have outperformed during the first third of every economic cycle over the past 80 years. These companies are more reliant on borrowing to fund their growth than their Large Cap peers and therefore are key beneficiaries of the improving credit markets.

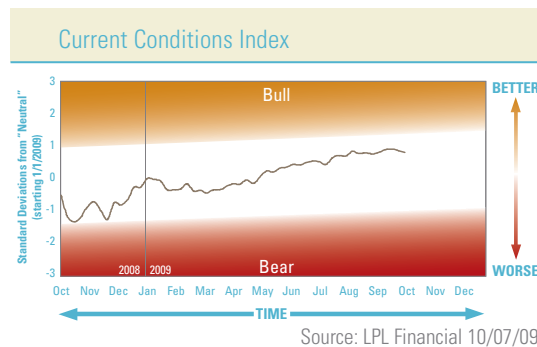
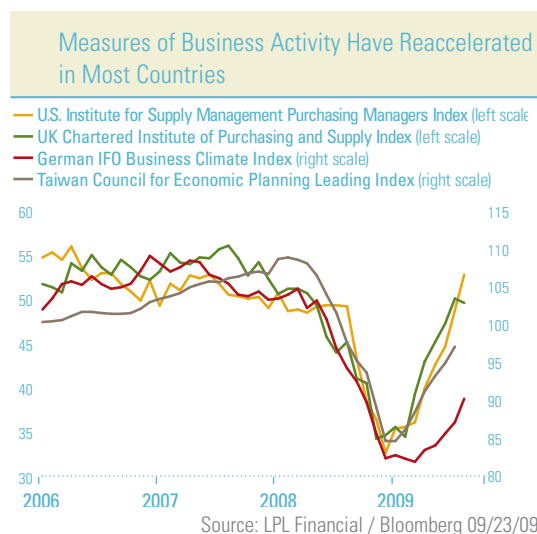
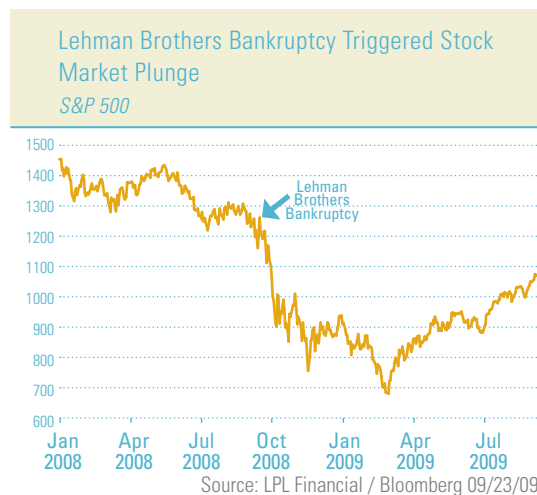
In general, we prefer Growth over Value stocks. Our favorite sectors include the traditional growth sectors, such as Information Technology, Consumer Discretionary, Industrials, and Materials. Growth sectors tend to have more exposure to strong Emerging Market demand, rising merger and acquisition activity, better balance sheets, and better earnings growth prospects.

We have also favored Emerging Market stocks to developed foreign markets as the global economy rebounds. These markets are highly leveraged to economic activity and have an abundance of capital to finance growth. China remains a powerful end-market for the products of Asian emerging market companies. Our outlook for a steady decline in the value of the dollar also benefits this asset class.

### Looking Out to Year-End

While the rise in valuations has powered the rally thus far, earnings growth—the most important driver of stock market performance—is now on the rise. While still down from the third quarter of 2008, the rebound in earnings from the low earlier this year is powerful. The impact of aggressive cost cutting will be magnified by the return of revenue growth in the third quarter from the second. Third quarter earnings results, to be reported during the weeks surrounding the end of October, are likely to reflect a record-breaking number of companies beating estimates which should help to sustain the rising trend in the U.S. stock market.

The LPL Financial Current Conditions Index currently reflects the high end of our 2009 base case outlook, with mid-teen gains in the stock market and mid-single digits gains in the bond market. However, the CCI implies the economy and markets are on track for an outcome somewhat better than our base case. We believe additional stock market gains are likely by year-end.



## Fixed Income

### The Credit Markets Continue to Heal

The fall of Lehman Brothers marked the start of rapid deterioration in all non-government sectors of the bond market. The demise of one of the largest players in the bond market sent shock waves in a market that is almost entirely over-the-counter and highly dependent on financial institutions' willingness to buy and hold bonds. That willingness swung to reluctance as liquidity, the ability to easily buy and sell bonds of any kind, all but disappeared. Despite strong reactions by the Federal Reserve and Treasury Department, yield spreads would continue to widen and eventually peak in late November. Even yield spreads on Fannie Mae and Freddie Mac bonds and Mortgage-Backed Securities (MBS) reached new record wide levels despite having operated under the umbrella of the Treasury for two months.

Eventually, measures by the Federal Reserve and Treasury helped the bond market function normally again. The Fed's decision to repurchase Agency Bonds and Agency MBS was perhaps the key event that ended the process of yield spreads widening on Agency, MBS, and Corporate Bonds. The Fed's repurchase program, along with stabilizing the major banks were key factors in restoring liquidity to bond markets.

One year after the fall of Lehman, higher quality segments of the bond market have improved to pre-crisis levels as evidenced by narrower yield spreads to Treasuries [chart 1]. Both Agency Mortgage-Backed Security (MBS) spreads and Investment-Grade Corporate Bond spreads are now narrower than at the time of Lehman's failure. Investment-Grade Corporate Bond spreads are actually narrower than the 2002 peak.

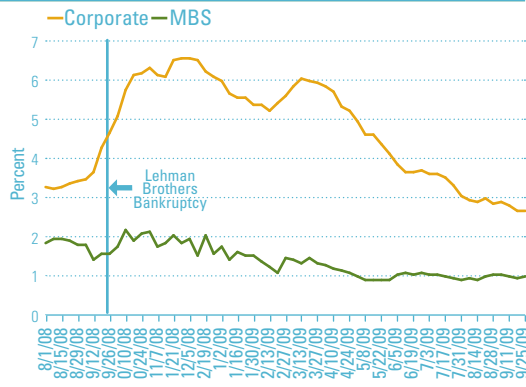
Emerging Market Debt (EMD) and High-Yield Bonds have also witnessed impressive improvements and recuperated to yield spreads prevalent just prior to Lehman's fall [chart 2]. Although volatility persisted initially, Investment-Grade Corporate Bonds, High-Yield Bonds, and EMD have witnessed almost uninterrupted improvement since early March.

Low Treasury yields, better than expected earnings, and, most importantly, cheap valuations fueled demand for corporate bonds. EMD benefited from IMF stimulus and liquidity programs with some nations showing a quicker economic rebound from the global recession. The Fed's \$1.25 trillion purchase program, representing roughly one quarter of the MBS market, has been a tremendous support to the MBS market.

Short- and Intermediate-Term municipals, as evidenced by Municipal-Treasury ratios, a valuation measure [chart 3], are much improved and have returned to pre-Lehman levels, while longer-term municipals still have room for improvement. The higher municipal yields are as a percentage of Treasury yields, the more attractively valued they are relative to Treasuries. Municipals benefited not only from attractive valuations but also a significant shift in the supply/demand balance. The Build America Bond (BAB) program shifted significant new issuance from the traditional tax-exempt market to the taxable market. Long-Term Municipals have also improved nicely and if not for the recent decline in long Treasury yields may have also exhibited pre-Lehman valuations.

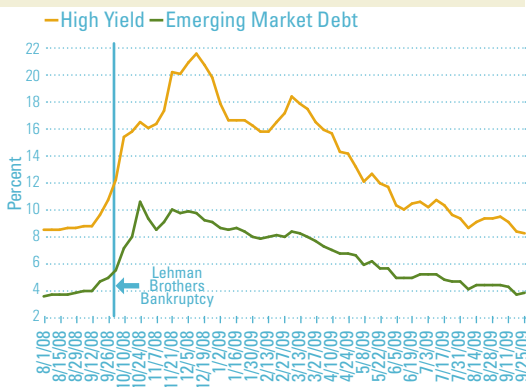
The side effect of improvement has been lower overall yields complicating future performance for bond investors. The impact is more evident among higher quality bonds where yields are notably below year ago levels [charts 4&5]. Yields on EMD and High-Yield Bonds are only slightly below Lehman levels.

#### 1 Corporate and MBS Yield Spreads Have Narrowed to Pre-Lehman Levels *Yield Spreads Above Treasuries*



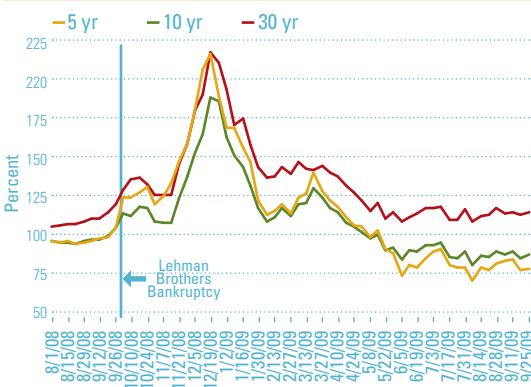
Source: Barclays Capital, LPL Financial 09/25/09

#### 2 Similarly, EMD and High-Yield Bond Spreads are Just Now Back to Pre-Lehman Levels *Yield Spreads Above Treasuries*



Source: Barclays Capital, LPL Financial 09/25/09

#### 3 Short- and Intermediate-Term Municipal Valuations Have Shown Notable Improvements *AAA-Muni Yields as Percent of Treasuries*



Source: MMA, Bloomberg, LPL Financial 09/25/09



## Fixed Income (continued)

Higher quality bonds have witnessed a greater degree of improvement to pre-Lehman levels, as evidenced by greater yield spread contraction and greater yield declines. This is not to say that the amelioration in EMD and High-Yield Bonds has not been impressive. It certainly has. But it has not matched the magnitude of improvement of higher quality bonds over the past year. This small disparity merely reflects investors migrating first to higher quality assets, but the move to lower quality bonds has picked up momentum recently.

### Moving Up the Risks Spectrum

The Obama administration has postponed hearings on the future of the two largest Government Sponsored Enterprises (GSEs) until February 2010. Both GSEs continue to sustain notable losses and potential solutions have grown more complex. New complexities, poor financial results, and delayed hearings indicate the GSEs will likely remain backed by the Treasury for longer than initially expected. Treasury backing is a strong positive for credit quality but will likely keep valuations high.

Looking forward, we believe investors are likely to continue their move up the risk spectrum and into sectors with more room for improvement, such as EMD and High-Yield Bonds. We also believe Investment-Grade Corporate Bonds will improve with yield spreads contracting slightly further. However, we expect this contraction to come more slowly as Investment-Grade Corporate Bond spreads approach their long-term average of 1.5%.

We believe additional yield spread contraction among EMD, High-Yield Bonds, and to a lesser degree, Investment-Grade Corporate Bonds, can lead to modest price appreciation. This price appreciation can offset the impact of lower yields on higher quality bonds. For MBS, we believe spread contraction has run its course and investors are left with a relatively low yield as the main driver of return. We find the opportunity set among both Investment-Grade and High-Yield Corporate Bonds, along with EMD, as more compelling. EMD offers diversification benefits and along with High-Yield Bonds plays a key role in a diversified bond portfolio. The higher yields from both sectors can be a key offset to the possibility of higher interest rates.

We continue to prefer sector exposure over making a bet on interest rates and therefore remain focused on intermediate bonds. Intermediate maturity bonds will benefit more than short maturity bonds from additional spread contraction. The yield curve remains steep (i.e., significant incremental yield achievable by lengthening maturity) by historical comparisons and intermediate bonds provide much more yield. Furthermore, the message from the Fed is lower for longer, implying interest rate hikes are a long way off. A Fed on hold is a positive for bondholders.

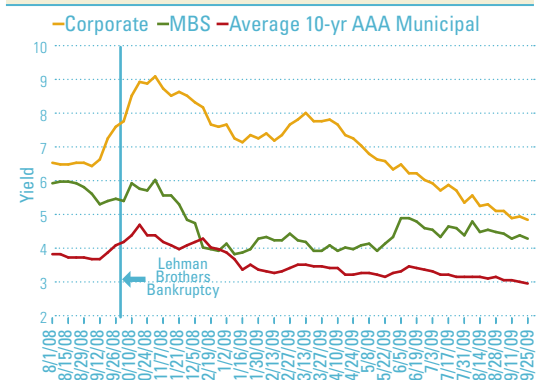
The healing in credit markets still has a ways to go but the past year has seen significant improvement. We believe Investment-Grade Corporate Bonds, High-Yield Bonds, and EMD have additional room for improvement. Our favorable view is based upon the backdrop of an improving economy and existing monetary and fiscal stimulus which will continue to promote liquidity for bond investors.

### Yield Spreads

A yield spread is the yield advantage of a particular bond, or sector, relative to a comparable Treasury. The greater the yield advantage the cheaper the valuation relative to comparable Treasuries and vice versa.

#### 4 Higher Quality Bond Yields Are Now Notably Below Lehman Levels...

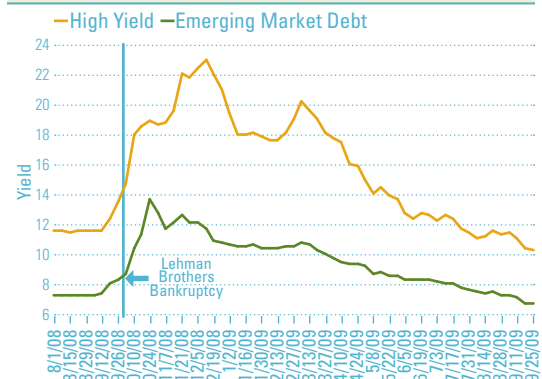
Select Bond Index Yields (%)



Source: Barclays Capital, MMA, Bloomberg, LPL Financial 09/25/09

#### 5 While Lower Rated Bond Yields Are Just Below Year Ago Levels.

Select Capital Bond Index Yields (%)



Source: Barclays Capital, LPL Financial 09/25/09

International and emerging markets investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

High Yield/Junk Bonds are not investment grade securities, involve substantial risks and generally should be part of the diversified portfolio of sophisticated investors.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

## Alternative Investments

### Real Estate Outlook

In the wake of the widespread global recession and the challenges in the credit markets, real estate fundamentals have deteriorated to levels not seen since the early 1990s. Real estate fundamentals tend to lag the broader economy by several quarters- as it takes time for businesses to assess the need for space, and rents mature every few years or longer depending on the sector. With this in mind, we would expect direct real estate fundamentals to remain weak for the next few quarters and improve in mid to late 2010. After falling more than 60% off of their highs set in 2007, as investors questioned their viability altogether, publicly traded REITs bounced 37% off of their lows in March of 2009. The publicly traded REITs demonstrated their ability to raise capital through tapping the equity markets, Furthermore the number of bankruptcies was fewer than expected.

Long positions may decline as short positions rise, thereby accelerating potential losses to the investor.

Alternative investments mutual fund strategies are subject to increased risks due to the use of derivatives and/or futures.

Alternative investments may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

The fast price swings in commodities will result in significant volatility in an investor's holdings.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

Options are not suitable for all investors and certain options strategies may expose investors to significant potential losses such as losing entire amount paid for the option.

We view the environment for Opportunistic Alternative Strategies (Real Estate, Commodities, and Distressed Debt) to be positive as the group benefits from an improving global economy. Attractive credit spreads and valuations provide a constructive environment for other categories, such as convertible and merger arbitrage, which should benefit from a pick-up in merger activity. However, we believe that these strategies will have difficulty competing with stocks and bonds on a relative basis as those asset classes rebound. Managed Futures and Global Macro strategies are likely to have the most difficulty on a relative basis until sustainable trends beyond stocks and corporate bonds reemerge.

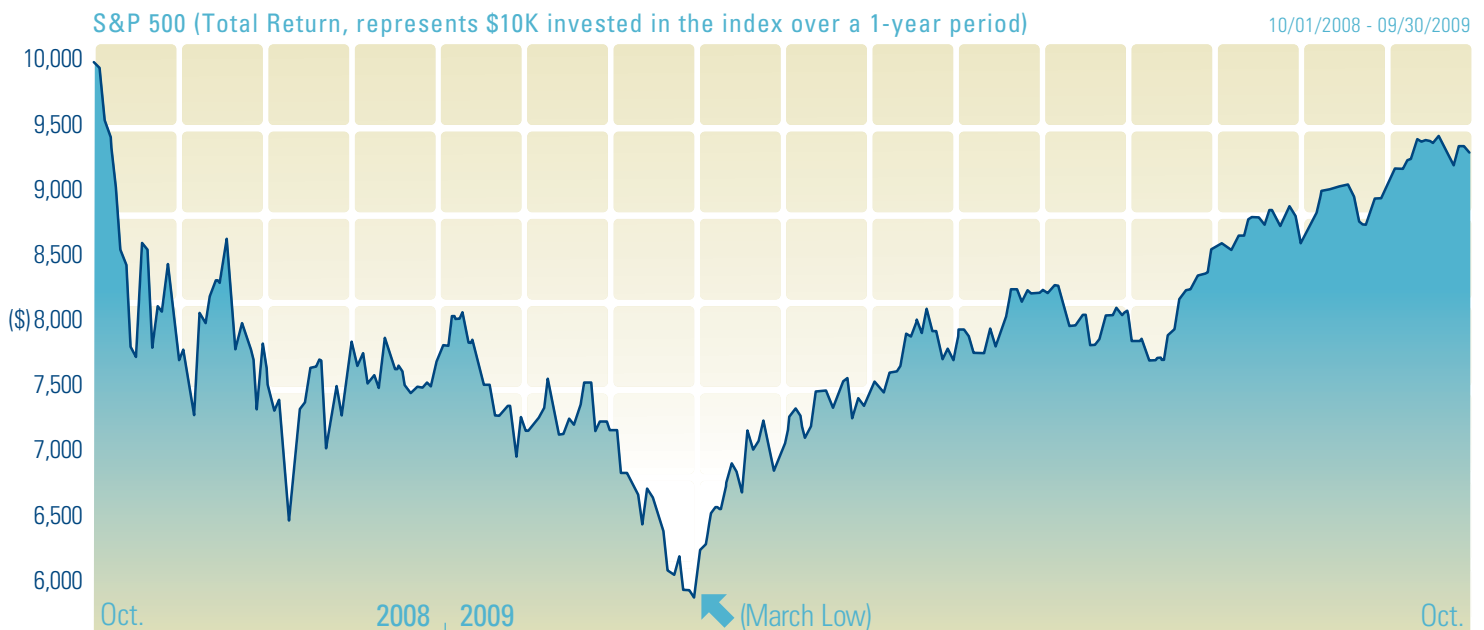
### HOW TO USE ALTERNATIVE STRATEGY MUTUAL FUNDS IN DIFFERENT MARKET ENVIRONMENTS

Bull Market	Sideways Markets	Bear Market
<i>More of</i>	<i>More of</i>	<i>More of</i>
Opportunistic	Volatility Strategies Risk Management REITs Commodities	Volatility Strategies Risk Management Distressed Debt
<i>Less of</i>	<i>Less of</i>	<i>Less of</i>
Volatility Strategies Risk Management Distressed Debt	Managed Futures Distressed Debt	Opportunistic

Volatility	Outlook for Strategy
Covered Call	The combination of a brighter outlook for equities and a decline in volatility reduces the overall utility of covered calls as equity replacements. That said, the asset class remains a solid option for limiting downside risk.
Managed Futures	Managed Futures strategies have struggled in 2009 following a strong showing in 2008. Relative performance is likely to continue to struggle as the equity markets continue their recovery.
Global Macro	Global Macro strategies profit from global mispricings and trends across various markets. Relative performance for this asset class is also likely to remain weak as prices across asset classes have become more rational.
Risk Management	Outlook for Strategy
Long/Short	Long/Short strategies should perform well in the rising market environment, but are unlikely to outperform equities in a beta driven market.
Absolute Return	Attractive spreads in fixed income and valuations in equities create an attractive environment for Absolute Return funds. However, these strategies should only be used by investors looking to lower risk due to the superior relative attractiveness of both stocks and corporate bonds.
Market Neutral	The lack of earnings visibility has been a challenge for many quantitatively driven market neutral strategies. While this is likely to improve going forward, we expect these strategies to trail stocks and corporate bonds as the recovery in those asset classes continues.
Opportunistic	Outlook for Strategy
Distressed Debt	We believe that Distressed Debt continues to offer opportunities as the credit markets and broader economy continue to heal. The lack of financing available from traditional sources creates a need for financing from private investors.
REITs	While real estate fundamentals are expected to remain weak for several quarters, publicly traded REITs stand to benefit from economic growth and from their ability to tap the equity markets to raise capital. Relative performance for this asset class is likely to be strong.
Commodities	Commodity prices are dependent on economic growth and tend to serve as a hedge against inflation. Relative performance is expected to be moderate in the shorter-term, but stronger as inflation increases.

Source: LPL Financial

# what a difference a year makes



The S&P 500 Index is an unmanaged index which cannot be invested into directly. Past performance is no guarantee of future results.

Source: FactSet

## LPL Financial Research Investing Strategies

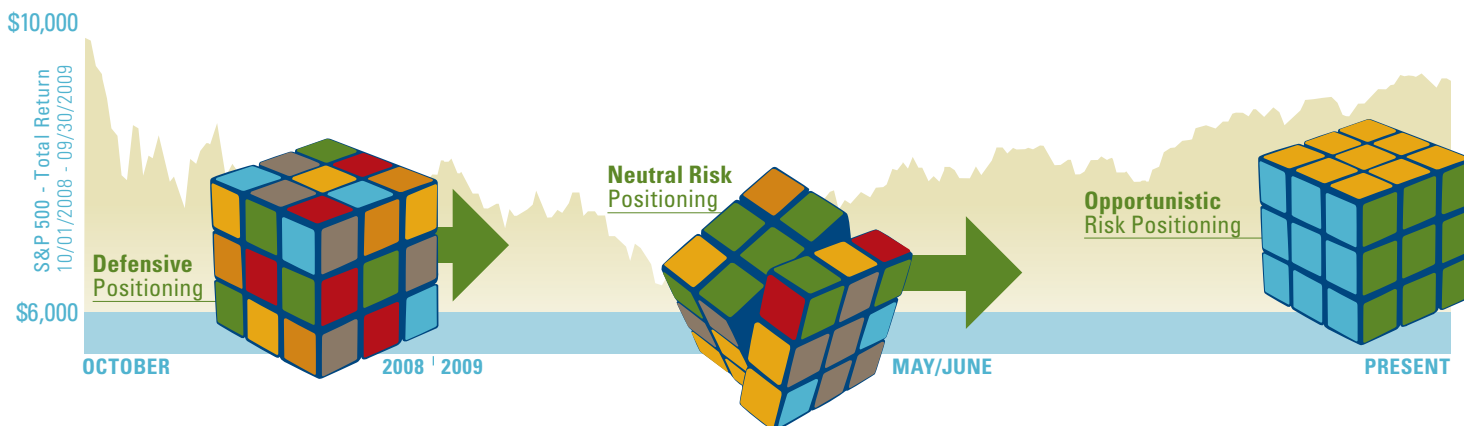
The market extremes over the past 12 months have shown that tactical investing and proactive portfolio positioning can help enhance performance.

In our models, we took this to heart and sought to protect from the risks and profit from the opportunities. Late last year, as the financial crisis intensified we became defensive and added investments that tend to do better in volatile markets to our recommended positioning. Earlier this year, as we uncovered signs of economic improvement and “green shoots” began to emerge, we transitioned to a more balanced risk-return position. Eventually, on true confirmation of economic progress, we further transitioned our models to where they are today.

The process of repositioning models over the past year entailed proactively investing to benefit from broad themes. Currently, our portfolios reflect broad investment themes that center on an economy exiting a recession and transitioning to a more modest growth environment.



# what a difference a year makes (continued)



## Dominant Investing Themes Over the Past Year

### Defensive Positioning

At this time last year, market participants were plagued with terrible bond liquidity, a plunging stock market, and an economy that had fallen into a deep recession. Given the tremendous risk in the markets, LPL Financial Research chose a broad defensive posture for our models. On the equity side, we maintained a beta modestly lower than the benchmark and utilized investments that might benefit from volatility—Covered Calls, Global Macro Strategies, and the arbitrage characteristics of opportunistic balanced strategies. On the fixed income side, based on our belief that the extraordinary fiscal and monetary policies would improve bond market liquidity and facilitate healing in the credit market, we positioned our models with a significantly higher beta. To increase beta, we allocated to those fixed income asset classes we believed would benefit from improving liquidity—Municipals, Investment-Grade Corporate and High-Yield Bonds, Mortgage-Backed Securities, Bank Loans, and Preferred Stock.

### Neutral Risk Positioning

Moving past that bleak period, fiscal and monetary policy intervention raised the prospects for economic recovery in the second half of 2009. The improved backdrop, signaled by increasingly good economic news, and a seemingly increased investor appetite for risk led us to begin to move toward a neutral risk stance near the end of the first quarter of 2009. We embarked on this repositioning through the reduction of those investments that work well in volatile environments and began a measured approach toward increasing exposure to more aggressive investment opportunities such as Commodities strategies, Small Caps, and Emerging Markets; investments that are historically strong performers as the economy recovers from a recession.

### Opportunistic Risk Positioning

As the transition to recovery from recession unfolded, we furthered our move towards an aggressive risk stance within each model. We did this by gradually increasing the equity exposure in our recommended models based on specific themes, or investment opportunities that we identified as the year progressed.

Mortgage-Backed Securities are subject to credit risk, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, and interest rate risk.

Alternative investments may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

Options are not suitable for all investors and certain options strategies may expose investors to significant potential losses such as losing entire amount paid for the option

Beta measures a portfolio's volatility relative to its benchmark. A Beta greater than 1 suggests the portfolio has historically been more volatile than its benchmark. A Beta less than 1 suggests the portfolio has historically been less volatile than its benchmark.



## what a difference a year makes (continued)

Many of the investment themes that we initiated earlier this year or during the past quarter continue to be reflected in our current positioning. Each theme consists of one or more investment opportunities that possess a favorable combination of fundamental, valuation, or technical (momentum) characteristics. We have embedded the following broad opportunistic investment themes in our models:

**It's the Economy** - Historically, when confidence returns to the financial markets, investors tend to target economically sensitive asset classes. As investors increasingly adopt the belief that the recession is over they are likely to seek the traditional beneficiaries of recovery, fueling the sectors and asset classes highly correlated to the economy. With this in mind we believe cyclical sectors, like Information Technology, Consumer Discretionary, Materials and Industrials will continue their strong performance. Likewise, outside the U.S., we believe Emerging Market companies will continue their strong performance.

**A More Aggressive 007** - We believe the fixed income markets continue to provide the best opportunities investors have had in several years. Though some investors view bonds as the safety net that limits the potential downside of a portfolio that also contains stock market exposure, at times aggressive fixed income strategies can offer tremendous capital appreciation opportunities. Continuing the strategy that we embarked on throughout the year to further increase our exposure to more aggressive fixed income strategies, in the third quarter we increased our High-Yield Bond allocation and added exposure to Emerging Markets Bonds. We expect both to benefit from contracting yield spreads, declining default rates, and improved financial conditions of companies in both asset classes.

**Pedal to the Metal** - We remain committed to our bullish outlook toward Commodities strategies, especially those integral to the manufacturing process. The key driver remains demand-driven growth from China. This past quarter, we expanded upon our optimism toward Commodities strategies by adding precious metals like Gold and Silver. We believe these metals should benefit from increased demand, serve as a partial hedge for inflation and a declining U.S. dollar, and benefit from the wealth effect of consumers.

**Growth at This Price** - Earlier this year, with the U.S. economy firmly entrenched in a recession, we maintained a neutral stance between the Growth and Value styles of investing in our allocations. Historically, Value tends to outperform Growth from the trough to the end of a recession. As the U.S. economy exited the recession, we introduced a relative overweight to Growth. Our favorite sectors include the traditional growth sectors, such as: Information Technology, Consumer Discretionary, Materials, and Industrials. Growth sectors tend to have more exposure to strong emerging market demand, rising merger and acquisition activity, better balance sheets, and better earnings growth prospects.

**Sometimes Smaller is Better** - Historically, Small Cap companies tend to perform well coming out of a recession and, because they are more dependent on credit markets to fund growth, are beneficiaries of improving credit markets. During the third quarter, we increased our exposure to Small Cap companies, a theme we have had embedded in our models since early in the second quarter.

### Tactically Investing

The past year has captured nearly an entire market cycle in just 12 short months. It is clear that the current market environment is very dynamic and requires a more active than usual approach to asset allocation. Our recommended allocations were defensive a year ago and changes that we made throughout 2009 moved us towards a neutral and then to the current opportunistic stance within each Investment Objective. Today, our portfolios reflect multiple themes based on one common thread—the economy is on track to recover. As we evaluate the data and events that drive the economy and markets toward our base, bear, or bull cases for 2009, as described in the *2009 Outlook* publication, we will make additional recommendations, as needed to enhance performance.

High Yield/Junk Bonds are not investment grade securities, involve substantial risks and generally should be part of the diversified portfolio of sophisticated investors.

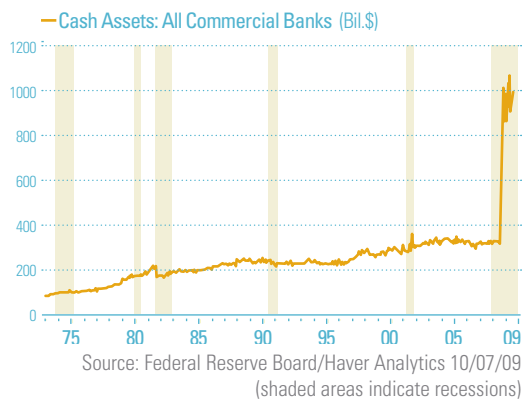
International and emerging markets investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

The fast price swings in commodities will result in significant volatility in an investor's holdings.

Small Cap stocks may be subject to higher degree of risk than more established companies' securities. The illiquidity of the Small Cap market may adversely affect the value of these investments.

## The Cost of the Recovery

### The Fed Still Has Its Foot Firmly on the Gas Pedal



Fundamentally speaking, the economy has clearly benefited from both the fiscal and monetary stimulus. Maybe not the most efficient use of taxpayer dollars, a little scattershot, definitely some pork, but it is working.

For example, the loosening of credit markets and reduction in mortgage interest rates, as a result of the Fed's aggressive easing, has allowed the housing market to stabilize. The fiscal stimulus plan helped to pay for the Cash for Clunkers program, which led to an uptick in auto sales and production in the second half of 2009. Additionally, the infrastructure spending portion of the bill should begin to lift the battered non-residential construction market (office buildings, shopping malls, industrial buildings) by later this year and early 2010.

The Federal Reserve's massive dose of monetary policy and the \$787 billion fiscal stimulus package passed by Congress in early 2009 have played an important role in pulling the U.S. economy back from the brink of another Great Depression. Our view remains that there is still plenty of monetary and fiscal stimulus left in the pipeline that will help support the recovery over the rest of 2009 and into 2010. However, even as the fiscal and monetary policy stimulus continues to buttress the economy, policy makers and, more importantly, financial market participants, have already begun to worry about how the stimulus will be removed, what will happen to the economy when the stimulus is removed, and how the economy will absorb the cost of the stimulus in the years ahead.

On the fiscal stimulus side, only about 20% of the amount that was allocated to infrastructure spending within the \$787 billion fiscal stimulus plan has actually been spent through the end of September 2009. Over on the monetary policy side, it is important to remember that monetary policy usually works with a long lag, typically, 9 to 12 months. The Fed's last rate cut was in late 2008 and the Fed embarked on its quantitative easing regime in March 2009. Thus, the lagged effects of the Fed's rate cuts since late 2007 and the Fed's quantitative easing program are only now being felt, and the Fed clearly still has its foot firmly on the gas pedal.

### Today on Wall Street, in Washington and on Main Street they are questioning:

- How will the stimulus be removed?,
- Can the economy continue to grow when the stimulus is removed?, and
- How will the U.S. pay the bill for the stimulus when it comes due?

Since at least January 2009, the Fed has been publicly discussing how it intends to remove the monetary stimulus, but of course, it has not disclosed "when" the stimulus will begin to be removed. It's important to note that many of the programs the Fed has in place will fade away as the need for the programs wane. A mistake by the Fed in leaving the stimulus on too long (and risking an unwanted surge in inflation) or in removing the stimulus too early (and risking a relapse in the economy in 2010) is one of our biggest concerns for 2010.

Similar plans for removing the fiscal policy stimulus are less transparent, although thus far, Congress and the Obama Administration have wisely resisted the temptation to enact a second round of stimulus. In addition, a portion of the fiscal stimulus in place today will fade as the economy recovers. For example, the non-partisan Congressional Budget Office estimates that as the economy recovers—and if current laws and policies remained in place—the deficit would shrink (from the \$1.6 trillion deficit in the fiscal year that ended on September 30, 2009), but remain above \$500 billion per year, or more than 3% of GDP, throughout the 2010–2019 period.

On the question of how can the economy grow when the stimulus is removed, it's important to remember that the stimulus put in place was designed to be temporary, as most, if not all economic stimulus plans have been in the past. The idea is that the government stimulus acts to support the economy until the private sector is able to stand on its own.

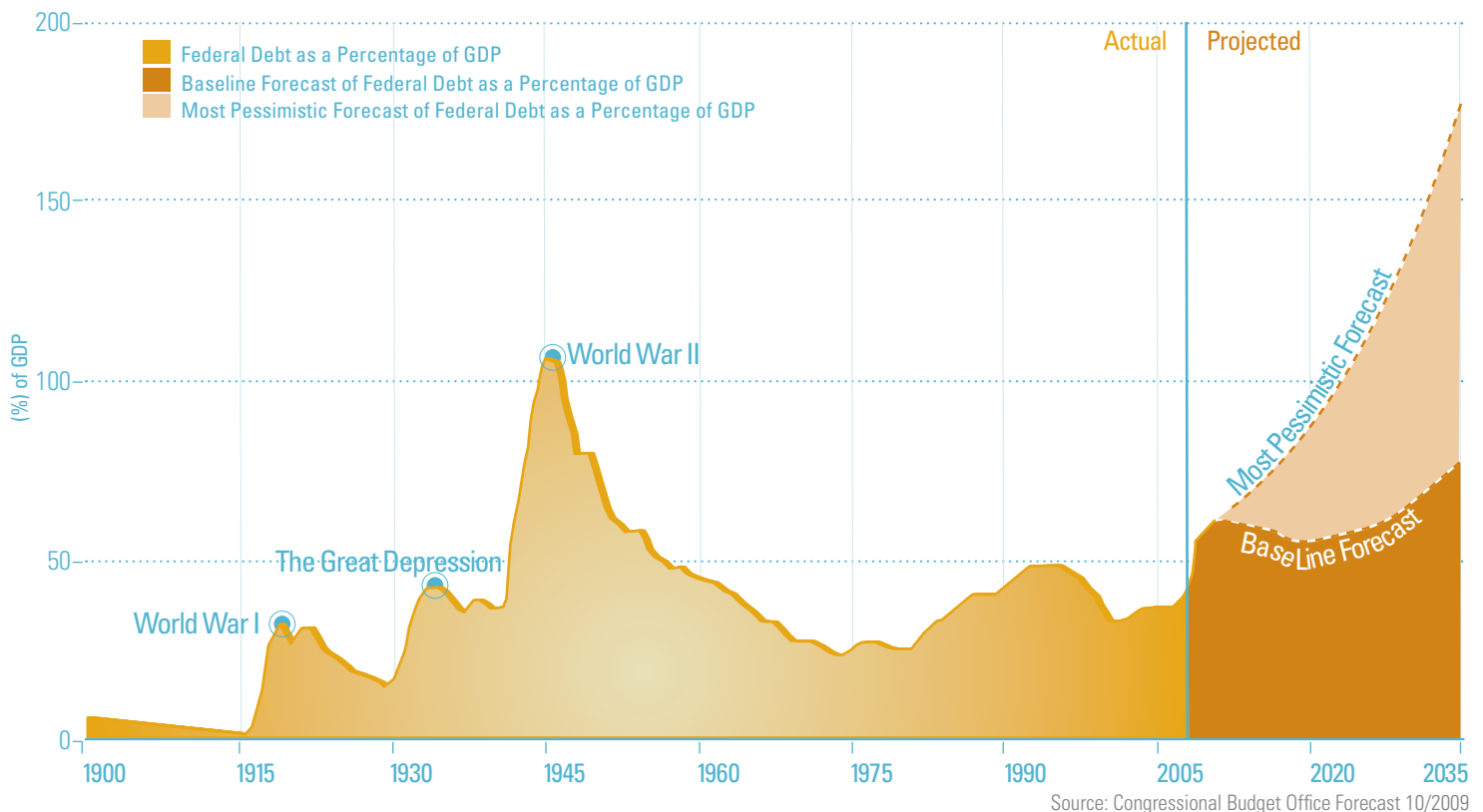
## The Cost of the Recovery (continued)

The evidence in hand suggests that although some segments of the private sector still may need more government support in the period ahead, the private sector is well positioned to thrive on its own as the stimulus is lifted.

Turning to the question of “how will we pay?” The good news is that in the near term, and even in the medium term, government deficits and debt have only limited impact on financial markets and the economy. In the long term, however, rising government debt and deficits will certainly impact markets by raising long-term interest rates and reducing GDP growth. In addition, continued large deficits and the resulting increases in federal debt over time would reduce long-term economic growth by lowering national saving and investment relative to what would otherwise occur, causing productivity and wage growth to gradually slow.

According to the non-partisan Congressional Budget Office, assuming current policies remain in place, the federal debt will continue to grow much faster than the economy over the long run. To keep deficits and debt from reaching levels that could cause substantial harm to the economy, policy makers over the next few years will need to increase revenues significantly as a percentage of GDP (i.e., higher taxes), decrease projected spending sharply, or implement some combination of the two.

Doing Nothing is Not an Option: The Long-Term Budget Outlook is Scary  
Forecast of Federal Debt Held by the Public Under the Congressional Budget Office's Two Budget Scenarios



This report has been prepared by LPL Financial

Please keep in mind that past performance is no guarantee of future results and that investment return and principal value fluctuate with changing market conditions.

**IMPORTANT DISCLOSURES**

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested in directly.

There are risks involved with investing, including possible loss of principal. In addition to the normal risks associated with equity investing, narrowly focused investments, investments in smaller companies and investments in single countries typically exhibit higher volatility. International investments may involve risk of capital loss from unfavorable fluctuations in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations.

GNMA's are guaranteed by the U.S. government as to the timely payment of principal and interest, however this guarantee does not apply to the yield, nor does it protect against loss of principal if the bonds are sold prior to the payment of all underlying mortgages.

High yield/junk bonds are not investment grade securities, involve substantial risks and generally should be part of the diversified portfolio of sophisticated investors.

Selling bonds prior to maturity may make the actual yield differ from their advertised yield and may involve a loss or gain. Bond values will decline as interest rates rise and are subject to availability and change in price.

Small-cap stocks maybe subject to higher degree of risk than more established companies' securities. The illiquidity of the small-cap market may adversely affect the value of these investments.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

Municipal Bonds are subject to availability and change in price; subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federal tax-free but other state and local taxes may apply.

Investing in alternative investments may not be suitable for all investors and involve special risks such as risk associated with leveraging the investment, potential adverse market forces, regulatory changes, and potential illiquidity. There is no assurance that the investment objective will be attained.

International and emerging markets investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

**INDEX DESCRIPTIONS**

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Russell 1000 Index measures performance of 1000 large cap, US companies. The Russell 2000 Index measures performance of 2000 small cap, US companies. Russell 2000® Growth Index measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values. Russell 2000® Value Index measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.

MSCI EAFE is an index of approximately 1,045 equity securities issued by companies located in 21 countries and listed on the stock exchanges of Europe, Australasia, and the Far East. All values are expressed in U.S. dollars.

The Barclays Municipal Bond Index includes investment-grade, tax-exempt, and fixed-rate bonds with long-term maturities (greater than two years) selected from issues larger than \$50 million.

The Barclays Aggregate Bond Index is made up of the Barclays Government/Credit Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, including securities that are of investment-grade quality or better, have at least one year to maturity, and have an outstanding par value of at least \$100 million.

The S&P GSCI™ is a composite index of commodity sector returns representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. The returns are calculated on a fully collateralized basis with full reinvestment. The combination of these attributes provides investors with a representative and realistic picture of realizable returns attainable in the commodities markets.

Individual components qualify for inclusion in the S&P GSCI™ on the basis of liquidity and are weighted by their respective world production quantities. The principles behind the construction of the index are public and designed to allow easy and cost-efficient investment implementation. Possible means of implementation include the purchase of S&P GSCI™ related instruments, such as the S&P GSCI™ futures contract traded on the Chicago Mercantile Exchange (CME) or over-the-counter derivatives, or the direct purchase of the underlying futures contracts.

Investing in mutual funds involve risk, including possible loss of principal. Investments in specialized industry sectors have additional risks, which are outlined in the prospectus.

This research material has been prepared by LPL Financial.

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