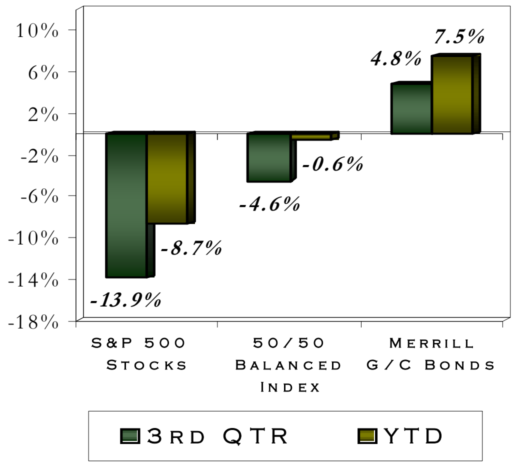
THIRD QUARTER 2011

CCM
Investment Advisers

OCTOBER 13, 2011

MARKET COMMENTARY

MARKET PERFORMANCE



MARKET SUMMARY

The third quarter news cycle was exceedingly bleak, from the embarrassing debt limit debate to the endless sovereign debt crisis in Europe. In addition, U.S. economic indicators were weak, amplifying talk of a double-dip recession. Investor psychology, still scarred by the financial crisis of 2008, turned decidedly negative. The benchmark S&P 500 Index dropped 13.9%, leaving a decline of 8.7% for the year.

Bonds were the primary beneficiary of the pervasive "fear trade" during the third quarter. As measured by the Merrill Lynch Gov't/Credit Index, bonds delivered a quarterly return of 4.8%, bringing the year-to-date gain to 7.5%. However, despite the recent credit downgrade and high interest rate risk, returns have been heavily skewed towards longer dated Treasuries. Intermediate corporates have only returned 3.0%. This performance dichotomy has been difficult for bond investors, most notably "Bond King" Bill Gross, whose his flagship PIMCO Total Return fund has returned only 1.9% for the year.

ECONOMIC FORECAST

Despite the media chatter, the U.S. is <u>not</u> in a recession, nor does it appear to be headed in that direction. Both the ISM manufacturing and non-manufacturing surveys remain in growth mode, capital expenditures are skyrocketing, auto sales have recovered to 13 million units and unemployment claims have stabilized near 400k. All signs point to 2% real economic growth in the third quarter and a similar trend for the fourth.

The longer view is hazy, as the forecast is highly reliant on the fluid situation in Europe. With eight bilateral summits in just the past twenty months it is easy to lose track of the iterations, but the latest plan for Greece and the banks is scheduled for unveiling November 3. Our instinct is that the powers in Europe will never allow their grand Euro project to fail. However, the risk of at least a moderate recession in Europe is still very real. Only 22% of U.S. exports go to Europe, though, and each 1-2% drop in Eurozone GDP should only encumber U.S. growth by .25%.

FIXED INCOME STRATEGY

We have long shunned Treasury issues, particularly at the longer end of the maturity spectrum. Accordingly, our fixed income performance has lagged the benchmark for the year. Going forward, an example is helpful in explaining our continued disdain for longer Treasuries. Consider the following outcomes from the purchase of a ten-year Treasury bond. With the ten-year yielding just above 2%, it is only feasible for rates to fall modestly. For the best case bond scenario, assume the worst case for Europe, and rates quickly fall to an almost inconceivable 1%. The bond would then deliver a 9% capital gain. On the other hand, should the situation stabilize and rates rise to a likely 3%, the bondholder would be left with a loss of 9%. Should the global economy return to form and rates approach their historic norm of 5%, the bond would **lose over 25% of its value**. Unquestionably there is very little upside versus extreme downside risk. We will remain defensive in our maturity structure and concentrate our efforts on non-Treasury credits.

EQUITY STRATEGY

We are employing a barbell strategy in our equity portfolios, where both defensive <u>and</u> cyclical characteristics are displayed. In terms of defense, we are overweight in the health care and utility sectors (yet avoiding pricey consumer staples). More importantly, we continue to stress dividend yield. In the end, our portfolio's yield approaches that of the thirty-year Treasury bond - an opportunity never seen by our seasoned investment staff.

Regarding growth stocks, while there is a tail risk for economic stagnation, the "muddle through" scenario is much more likely. Should economic growth remain, the industrial and technology sectors are best poised to benefit - particularly at historically low valuation levels. We are maintaining overweight positions in both sectors.

ASSET ALLOCATION

If it were not for Europe our appetite for stocks would be much higher, though it is <u>because</u> of Europe that valuations are so anomalous. For stocks, valuations are **25% lower** than during the past nine recessions since 1957. For bonds, in spite of the recent spike in yields, the ten- and thirty-year Treasuries are still yielding just over 2% and 3% respectively. The resulting equity risk premium easily stands at a record high. From a statistical view, the spread stands at over three standard deviations - perhaps a once-in-a-lifetime occurrence.

Valuation is undeniably attractive, but we are also keenly aware of the concept of a "value trap". Stocks and bonds are currently priced for Armageddon, but should the situation in Europe worsen, psychology is so damaged that further losses would still be unavoidable. Accordingly, we remain true to our conservative roots. Though there is significant "return-free risk" in bonds, we still can not allow equity exposure to become too heady. We will maintain just a modest overweight position in a high yielding yet growth-friendly equity portfolio.

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