CONVERGENT WEALTH ADVISORS

MARKET PULSE REPORT

Invest well. Manage well. Live well.™

OCTOBER 2010

Commentary

Stock markets posted strong gains in October in anticipation of a second round of quantitative easing (QE2) by the Federal Reserve. Of course, some attention has been paid to this quarter's mostly positive earnings releases and U.S. midterm elections. Questions regarding the additional stimulus, however, are now front and center. How much has already been priced into the markets and what happens next -- buy the rumor, sell the news? Will it actually make a difference? Can the U.S. escape the extended slow-growth period that many suggest will be the upshot of a non-typical, credit-crisis recession? Market reaction will be interesting.

Also on our minds are this year's dramatically increased correlations between stocks. Rather than focusing on individual company fundamentals, investors have recently been reacting en masse in a "risk-on/risk-off" fashion to macro factors such as the aforementioned Fed easing program. This macro mindset, along with the increased use of basket-like products (index derivatives and ETFs) and a short-term investment mentality, has led to a serial whipsawing of the stock markets and a continued outperformance of low quality equities. Virtually all stocks, regardless of quality or sector, have been moving in lockstep, making life difficult for active fund managers, as there have been few places to hide in downturns and little chance to add value in rallies. We believe, however, that this sometimes frustrating, high-correlation environment is only a temporary phenomenon, and at some point fundamentals will re-emerge as drivers of dispersion in performance.

CONVERGENT TACTICAL POSITIONING

While we continue to transition back to our strategic equity targets at a measured pace, we remain underweight to *developed* equity markets (though not emerging) in order to accommodate shifts to: (i) certain opportunistic credit segments (multi-sector, emerging market debt/currencies, and international bonds) to collect a current yield while addressing themes such as mitigating equity, deflation/inflation, and currency risks; and (ii) gold as a paper currency hedge and safe-haven asset. We have recently made a modest reduction to core fixed income allocations given low total return prospects in the space, shifting to a blend of cash and growth assets (equities and opportunistic credit) to approximate the risk of bonds with greater upside.

EQUITY	
U.S. Equity	underweight
Developed Non-U.S.	underweight
Emerging Markets	overweight
Private Equity	neutral
Directional Hedge	slight underweight
REAL ASSETS	
Real Estate	underweight
Commodities	overweight
ARBITRAGE/CREDIT	
Multi-Strategy Hedge	neutral
Opportunitistic Credit	overweight
CORE FIXED INCOME	
Core Fixed Income	underweight
Cash Equivalents	overweight

Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

2600 Tower Oaks Blvd.
Suite 300
Rockville, MD 20852

T 301-770-6300
F 301-770-1408

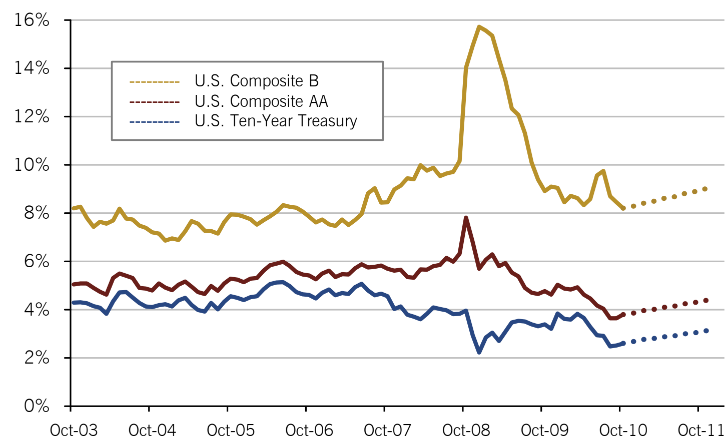
CONVERGENTWEALTH.COM

S&P 500 PRICE

Buoyed by thoughts of additional stimulus, stock market indices recorded strong gains in October, with the S&P 500 posting a monthly return of 3.8%, including dividends. Despite weak economic growth (and hence the need for further stimulus), year-to-date the U.S. large-cap stock index is squarely in the black, up nearly 8% and not too far off its high of the year (about 35 points below its 2010 high hit in April).

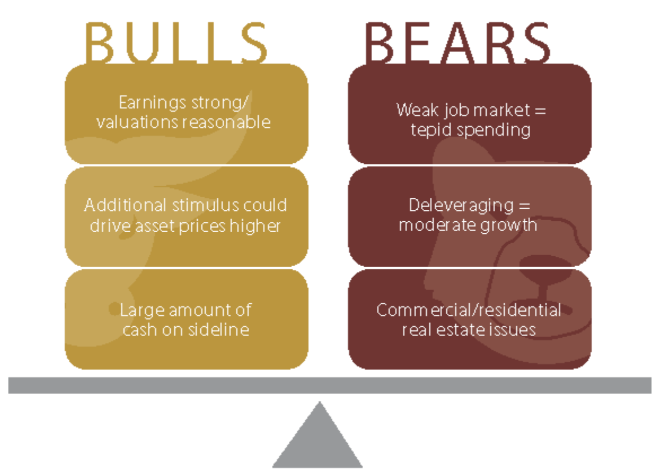
CREDIT YIELDS

Anticipation that the Fed will start buying Treasury securities kept the yield of the ten-year note in a range around the 2.6% level. It is possible that a bubble could be developing in government bonds, especially if quantitative easing is successful in spurring economic growth (and eventually inflation). Recent lackluster GDP data, however, has few worried about pricing pressures for now.



SUMMARY OF CURRENT EQUITY MARKET LEANINGS

While we are modestly below our target equity allocations, it is not due to an overly pessimistic outlook regarding stocks. Rather, our equity underweight accommodates our desired shifts to gold, emerging market currencies/debt, and other opportunistic credit segments that play into global themes we want to address. In fact, we are not below target with regard to what we categorize as "growth assets" within the portfolio.

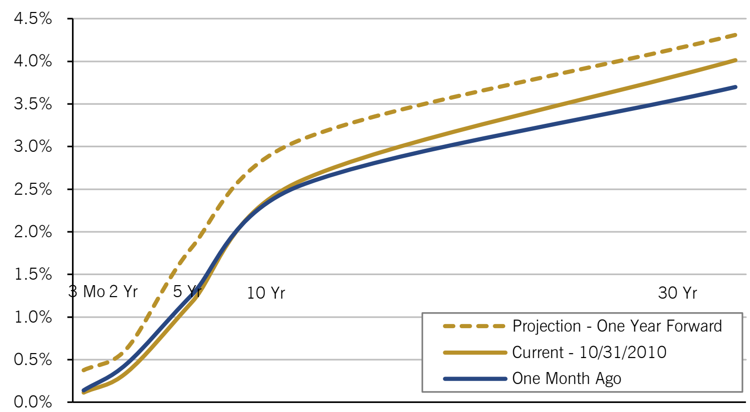


Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

U.S. TREASURY YIELD CURVE

As U.S. monetary authorities prepared for another round of Treasury purchases, the two-year note yield hit a new low in October. Longer-term rates lifted a bit, however, as inflation expectations rose and the market weighed possible long-term consequences (on inflation and the U.S. dollar) of the Fed's actions.

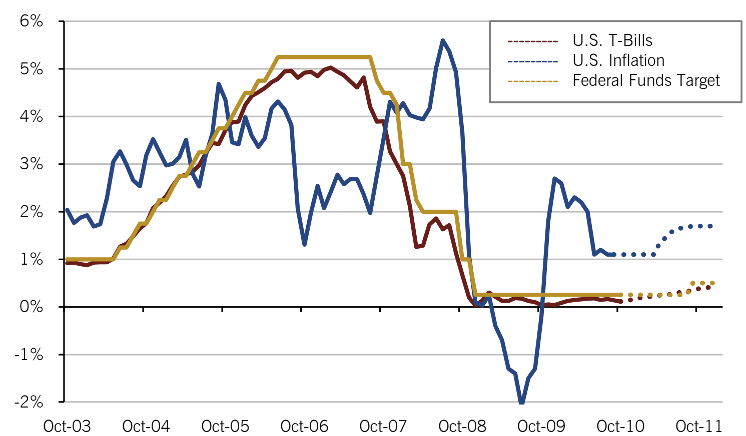
Advantage: Neutral



T-BILLS, FEDERAL FUNDS, AND INFLATION

"Unacceptable" levels of unemployment and low inflation, as the New York Fed put it, have short-term interest rates at record lows. Because rates are already near zero, most expect the Fed to buy Treasuries to pump more money into the system and try to spur the recovery. Longer-term, many fear aggressive moves by the Fed may lead to some form of inflation (perhaps caused by currency devaluation).

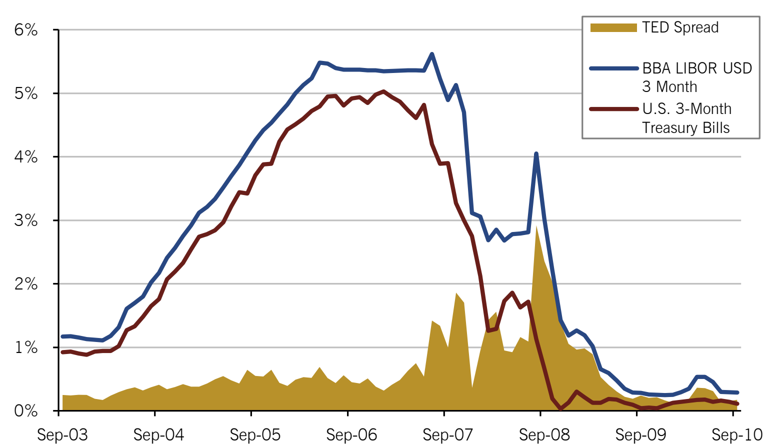
Advantage: Neutral



LIBOR/T-BILL RATES AND TED SPREAD

The TED spread is a measure of how tight the credit markets are, as illustrated by the difference between T-Bill yields (a risk-free loan) and LIBOR yields (the rate at which banks lend to one another). Currently low spreads illustrate credit markets are operating with little anxiety.

Advantage: Bullish

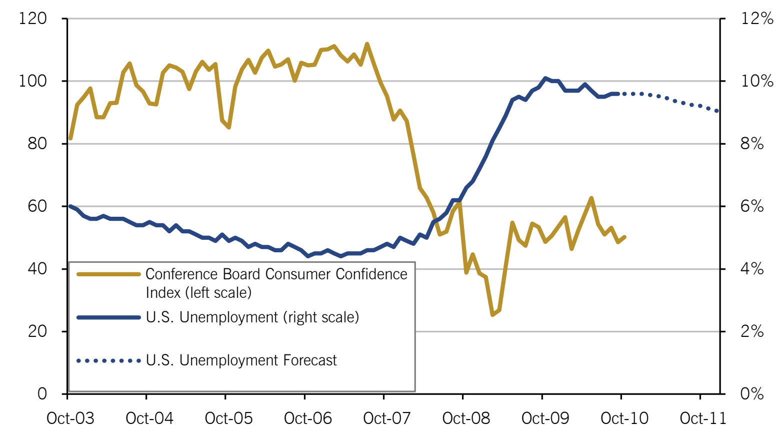


Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

CONSUMER CONFIDENCE AND UNEMPLOYMENT

U.S. real GDP expanded at a sluggish 2% annual rate in the third quarter -- a slight improvement from the previous quarter, but still much too slow to generate solid job growth. As such, consumer confidence remains nowhere near levels that signal a healthy economy.

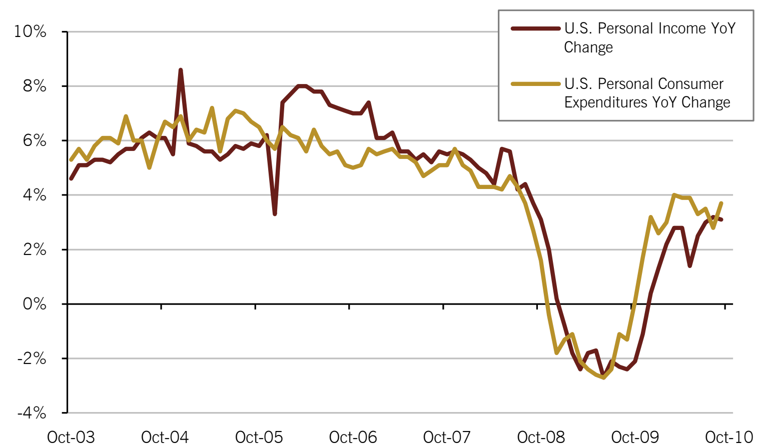
Advantage: Bears



U.S. CONSUMER INCOME AND SPENDING

The primary concern with high, lingering unemployment and low confidence is that consumers will increase savings and not spend enough to rejuvenate the economy. The upcoming expiration of unemployment benefits for many (barring extension) could be a further detriment.

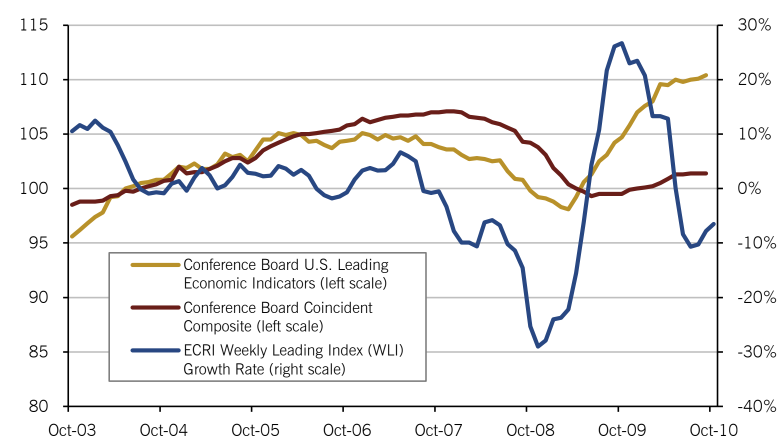
Advantage: Neutral to Bearish



LEI AND ECRI

The U.S. leading economic index (LEI) remains high, though the steady rise over the past year appears to be peaking. The Economic Cycle Research Institute (ECRI) weekly leading index, meanwhile, is rebounding off levels that historically have signified a slowdown in economic growth. This bounce may simply mean we experienced a mid-year slowdown, not the start of a double-dip recession.

Advantage: Neutral

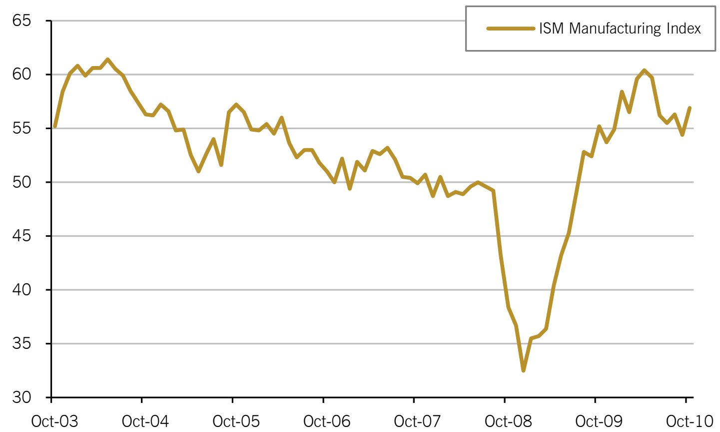


Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

ISM MANUFACTURING INDEX

The ISM report is a national survey of purchasing managers covering such indicators as new orders, production, employment, inventories, prices, export orders, and import orders. A reading over 50% indicates expansion relative to the prior month, while a reading under 50% indicates contraction. The latest reading was the 15th consecutive month of expansion.

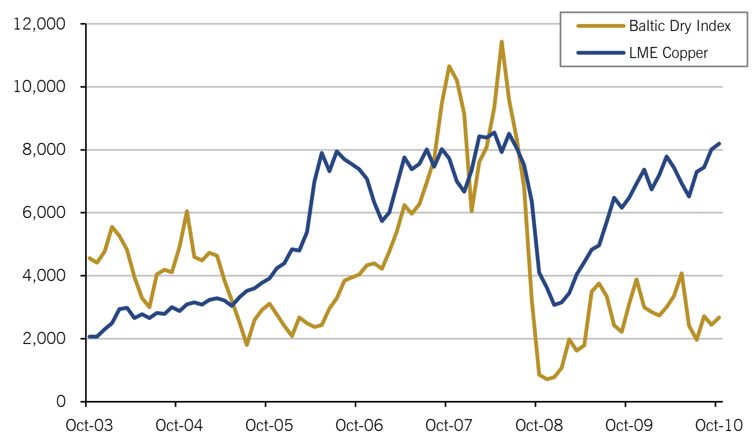
Advantage: Bulls



BALTIC DRY INDEX

The Baltic Dry Index (BDI), a measure of world trade, provides a barometer of the shipping costs for commodities. The BDI has seen choppy trading for several months. Meanwhile, the increasing demand for copper as a plentiful and heavily-relied upon metal in construction and manufacturing activities reflects a healthy trend in global economic growth.

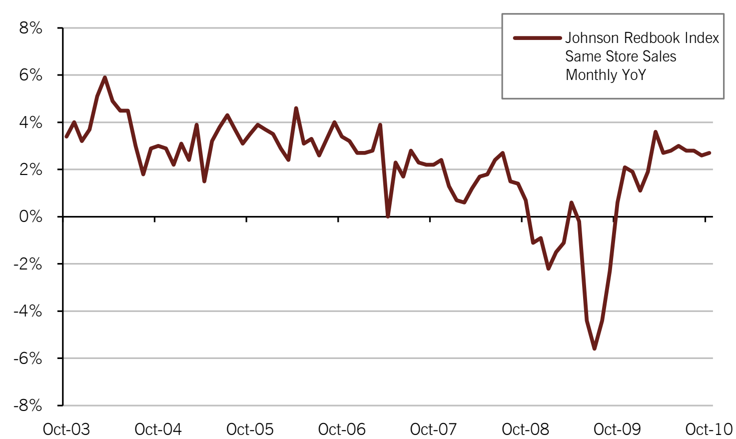
Advantage: Neutral



RETAIL SALES

Retail sales figures, which track the dollar value of merchandise sold to consumers, could be an indicator of economic recovery. Recent data have been modestly positive as Halloween business was on target. Holiday merchandise, meanwhile, is already being displayed in earlier-than-normal promotions.

Advantage: Neutral

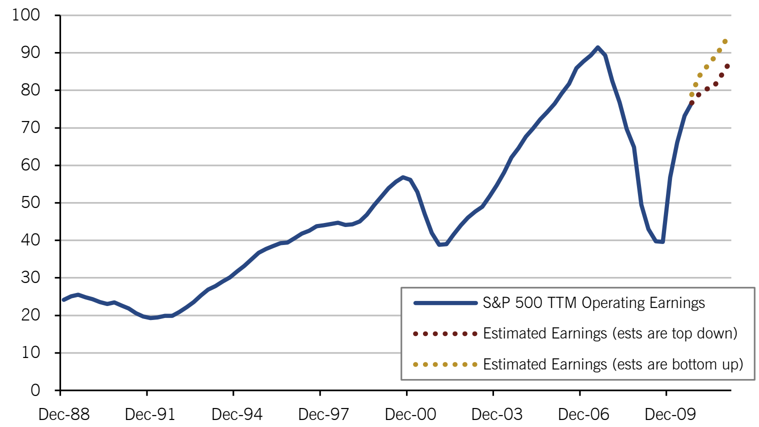


Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

CORPORATE EARNINGS

Another strong quarterly earnings season is underway, as more than 70% of companies reporting thus far have beat estimates. Expectations are that the pace of growth will slow going forward, however, especially with GDP projected to be below trend next year. Next year, attention may turn towards getting companies to put their large cash hoards to work in a domestic fashion.

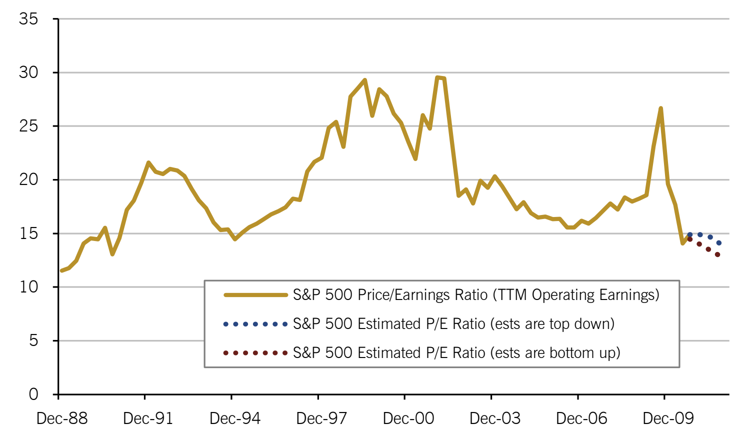
Advantage: Neutral to Bullish



STOCK MARKET VALUATIONS

Sustained earnings growth over the past year has helped trailing 12-month P/E valuations look reasonable (slightly below historical norms). Longer-term methods of measuring valuations, however, such as the ten-year real P/E pioneered by Yale economist Robert Shiller, remain a bit elevated (slightly above 20).

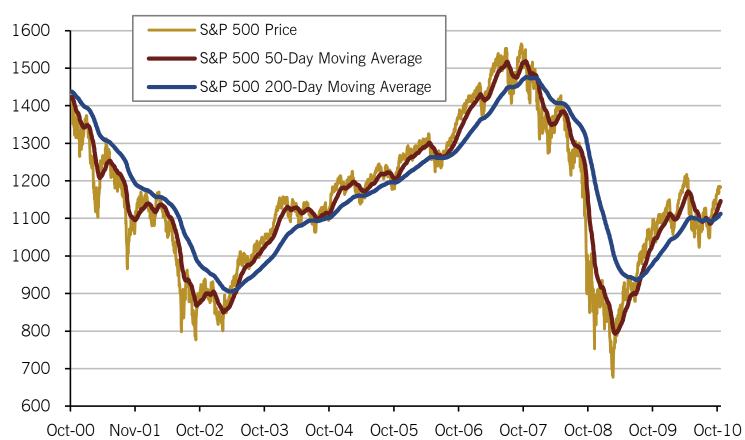
Advantage: Neutral to Bullish



STOCK MARKET TECHNICALS

The S&P 500 50-day moving average, after falling below the 200-day moving average for a brief period of time this summer, has crossed into higher territory (the so-called "Golden Cross"), interpreted by many as a bullish signal.

Advantage: Bullish

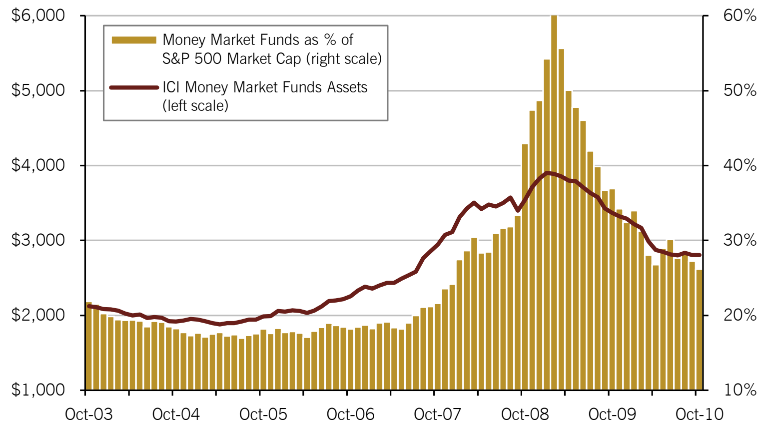


Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

MONEY MARKET FUNDS ASSETS ($ BILLIONS)

While much of the cash balance built up over the past few years has been put to work, there still remains a large amount on the sidelines in money market funds (approximately $2.8 trillion) despite extremely low interest rates. Barring a secular shift towards increased cash and bond allocations, there remains plenty of dry powder available for stocks.

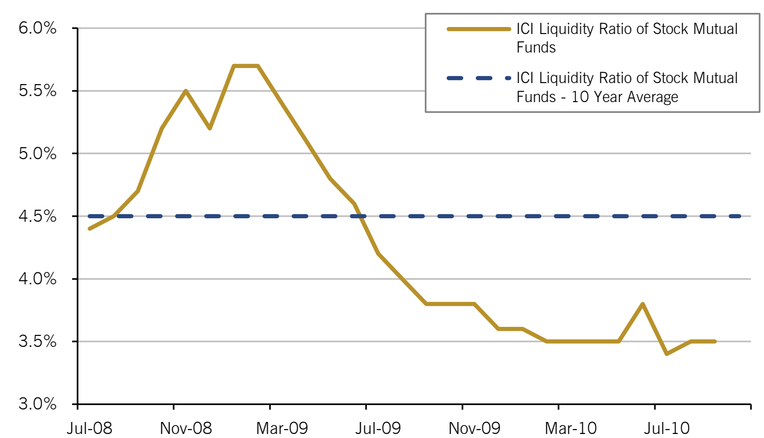
Advantage: Bulls



MUTUAL FUND LIQUIDITY RATIO

The liquidity ratio compares the amount of cash relative to total assets held by stock mutual funds. As stocks tumbled in 2009, mutual fund managers were bearish and sitting on a large amount of cash. Since then, managers have put most of that cash to work and are now holding unusually low levels of cash.

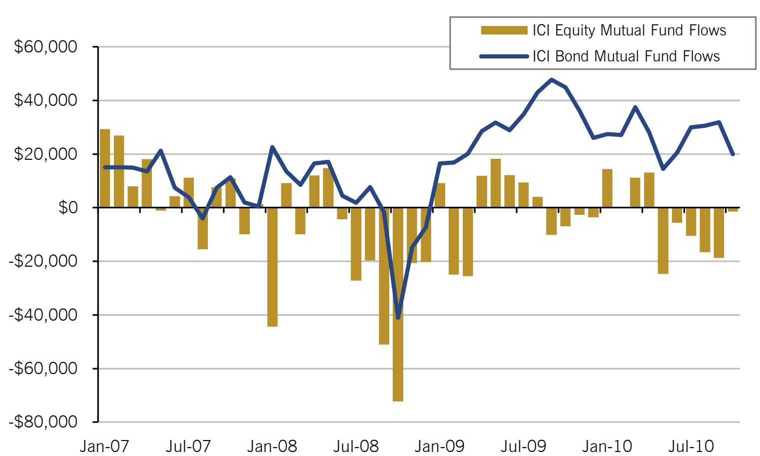
Advantage: Bears



MUTUAL FUND CASH FLOWS ($ MILLIONS)

Based on preliminary data, investors took money out of stock funds for the sixth month in a row and gave it to bond managers. Shifting demographics and attitudes may be resulting in a secular shift towards income generating investments. Until this trend reverses, one leg of support for the stock market is wobbly at best.

Advantage: Neutral to Bearish



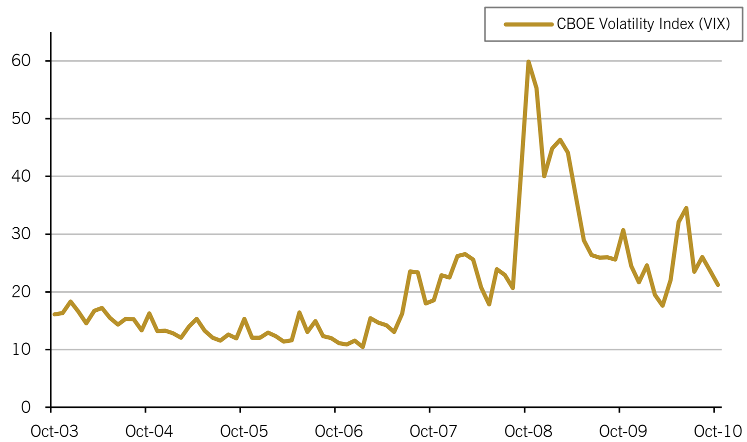
Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

FEAR MEASURES

STOCK MARKET VOLATILITY

Volatility, as measured by the Chicago Board Options Exchange Volatility Index, fell slightly to end October at 21.2. Readings in excess of 30 generally correspond with times of investor fear or uncertainty, while values below 20 are typically associated with less stressful (or even complacent) times in the markets.

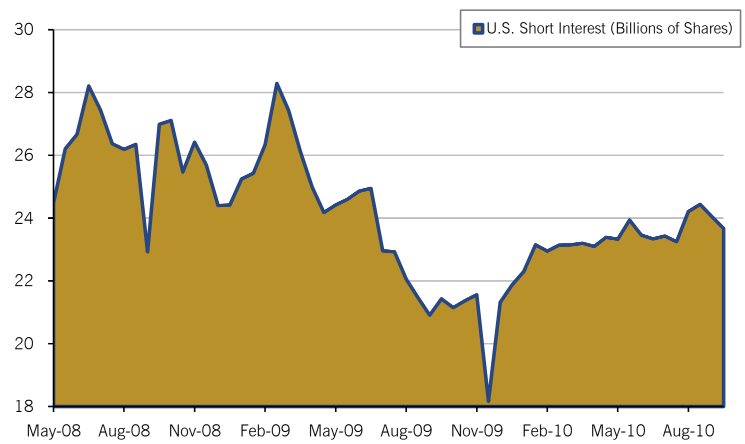
Advantage: Neutral



U.S. SHORT INTEREST

Short interest can be a measure of investor sentiment, though it is often viewed as a contrary indicator since high levels of short positions are eventually covered, providing upward pressure on stock prices.

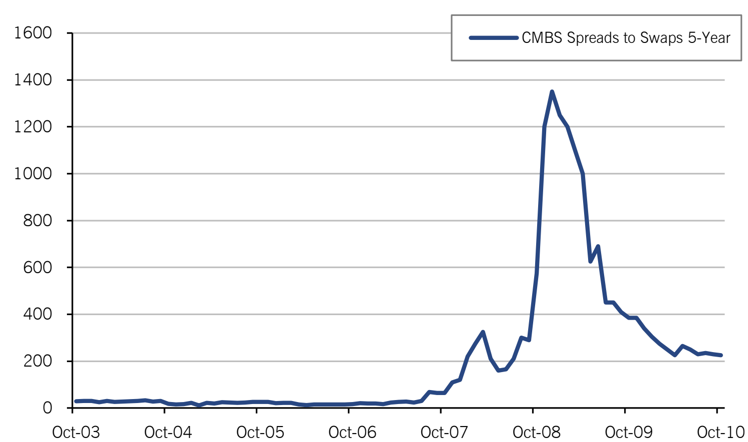
Advantage: Neutral



CMBS SPREADS

Problems in the commercial real estate market are slowly working themselves out, as banks are systematically moving troubled loan assets through their books (or perhaps simply pushing distress into the future). Commercial mortgage-backed securities (CMBS) spreads have been in a narrow, though historically elevated, range for months.

Advantage: Neutral

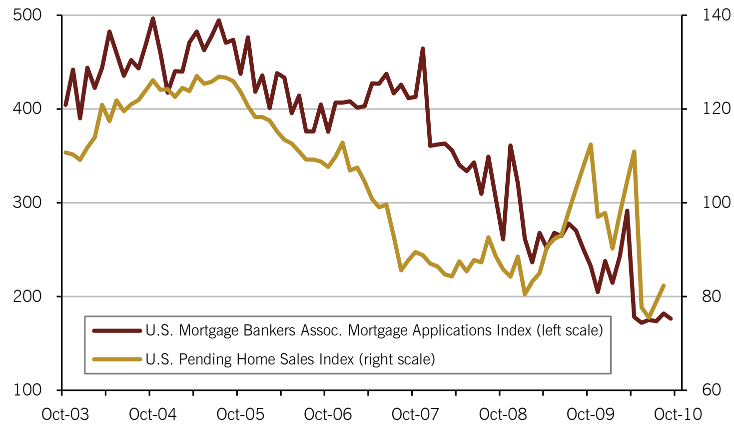


Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

MORTGAGE APPLICATIONS AND PENDING HOME SALES

As if the housing market needed any more problems, some fear flawed foreclosure documents and potential lawsuits might keep buyers away, even though mortgage rates are near all-time lows and housing affordability near record highs.

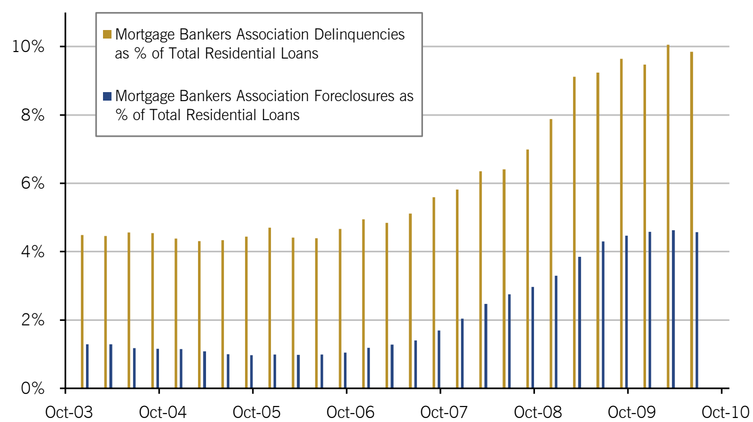
Advantage: Bears



RESIDENTIAL DELINQUENCIES AND DEFAULTS

Mortgage delinquencies and foreclosures have surged to record levels. With unemployment and unsold inventories remaining high, foreclosure rates are expected to remain elevated and a headwind to the housing market and economy for some time.

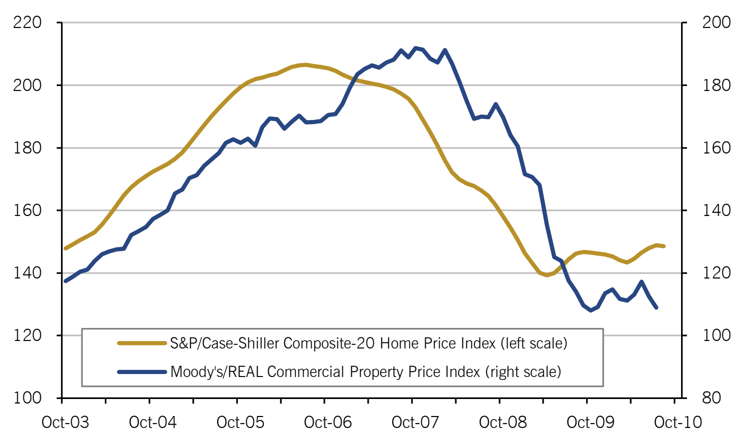
Advantage: Bears



RESIDENTIAL/COMMERCIAL PROPERTY PRICE INDICES

Real estate prices slipped a bit in August, and many are curious to see where residential values go as the effects of the tax credit expiration and "Foreclosure-Gate" hit the market. Any renewed downturn in prices could put further pressure on financial institutions and the economic recovery.

Advantage: Neutral to Bearish

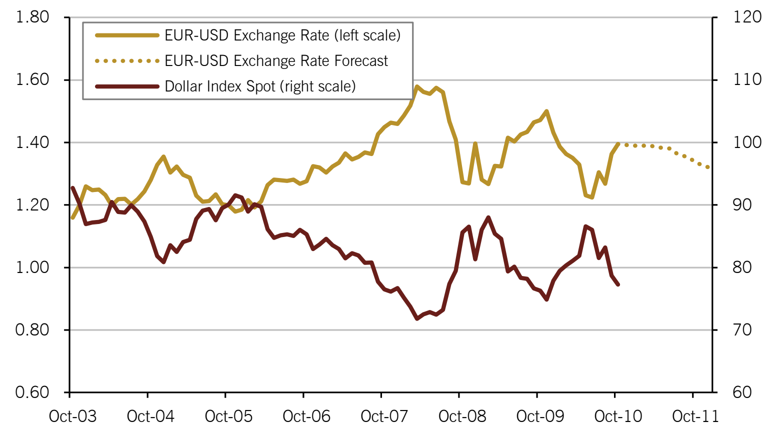


Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

U.S. DOLLAR

The dollar has been weakening against major currencies in anticipation of another round of quantitative easing by the Federal Reserve. Given longer-term issues, such as the size of the U.S. budget deficit, most expect the dollar to struggle against many currencies for some time. Many continue to see gold as a reasonable currency hedge.

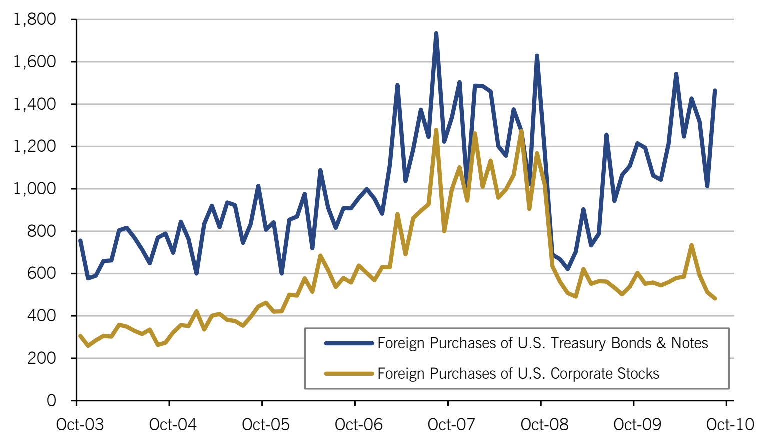
Advantage: Neutral



FOREIGN PURCHASES OF U.S. SECURITIES ($ BILLIONS)

Demand for U.S. Treasuries from foreign investors surged in August. China and Japan, the largest holders, both increased their holdings, but there was also surprising interest from the U.K. Any significant drop in foreign demand could lead to higher U.S. interest rates.

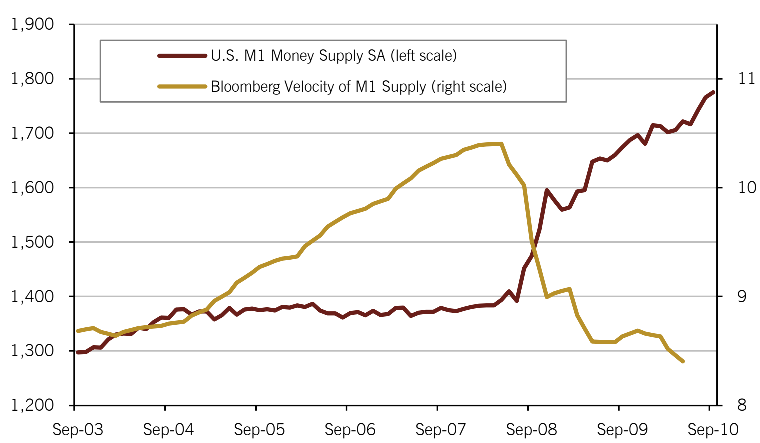
Advantage: Neutral to Bearish



U.S. M1 MONEY SUPPLY AND VELOCITY

M1 consists of the most liquid forms of money, namely currency and checkable deposits. With the recent stimulus, M1 has spiked to unprecedented levels, causing fears of eventual inflation and dollar weakness. Currently, however, velocity of money (the rate at which money changes hands) has actually been dropping as consumers and businesses are not spending or borrowing.

Advantage: Neutral to Bearish

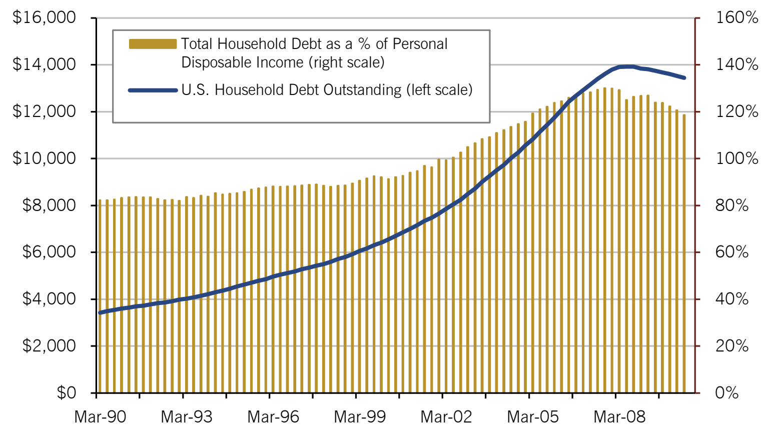


Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

U.S. HOUSEHOLD DEBT AS A % OF DISPOSABLE INCOME

U.S. household debt (including mortgages and consumer credit debt), and its percentage of disposable personal income, have increased dramatically since the early 1990's, fueled in part by declining interest rates. Despite talk of a deleveraging cycle, consumers so far have been decreasing debt slowly.

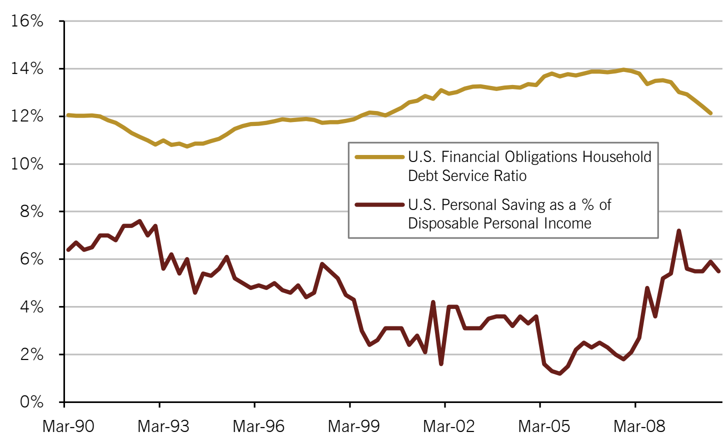
Advantage: Neutral to Bearish



U.S. SAVINGS AND HOUSEHOLD DEBT SERVICE RATIO

The debt service ratio measures how much of their earnings households spend on debt payments. Despite the remarkable increase in total debt over the past few decades, the rise in service ratios has been more muted due to the decline in interest rates. If rates spike, however, so too could debt payments.

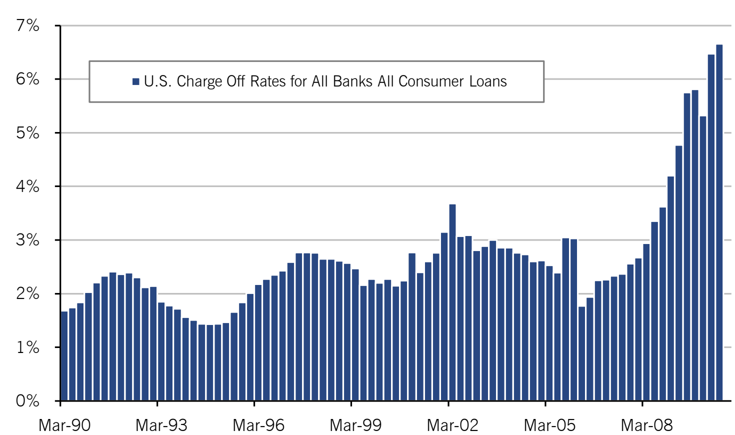
Advantage: Neutral



U.S. CONSUMER LOAN CHARGE-OFF RATES

Even though interest rates remain low, U.S. consumer bank loans (including credit cards, but excluding real estate) written off as unrecoverable remain near the highest levels on record.

Advantage: Neutral to Bearish



Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

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