

Invest well. Manage well. Live well.™

OCTOBER 2011

## Commentary

With recession fears receding for the moment, the imminent risk to stock markets and the economy appears to be a European banking crisis brought on by a disorderly Greek default. While the news and possible outcomes seem to change on a daily basis, policymakers in the region appear to recognize the issue's importance and have made some tangible progress to stem the concerns about other countries' abilities to pay their debts.

Europe's debt problem is not the only thing on our minds. Overshadowed as of late are the issues in our own backyard. The congressional "super committee" has until later this month to come up with \$1.2 trillion in deficit cuts. Politicians cannot seem to agree on whether deficit reduction should come in the form of taxes or cuts in spending. And their track record of reaching compromise is not too promising. (Who can forget the debt ceiling debacle just a few months ago?) If a resolution is not produced, it is possible Moody's might follow Standard & Poor's lead and downgrade the country's credit rating.

Either way, investors may react in knee-jerk fashion in the short term. While these events are not irrelevant to us, as long-term investors we focus more on relative valuations and the prospects for assets once the "noise" has been eliminated. In particular, we feel confident that equities have a positive long-term view relative to bonds, which are producing little yield. If corporate earnings do not falter materially (and as of now we see little evidence they will), then the earnings yield on stocks (about 7% for the S&P 500) will continue to offer significantly better value than the yield on bonds (about 2% for ten-year U.S. Treasuries). For those investors who can tolerate interim volatility, the allocation decision of having more risk assets and less core bonds appears to be an easy one.

## CONVERGENT TACTICAL POSITIONING

- We are underweight our strategic core fixed income target because of the intermediate-term risk of bonds' ability to preserve purchasing power.
- This underweight accommodates a shift to opportunistic credit segments (e.g., multi-sector, emerging market currencies/debt, and mortgages) where we can collect a current yield while addressing inflation, currency, and U.S. interest rate risks.
- We are overweight real assets, primarily as a result of our allocation to gold, which serves as a paper currency hedge and safe-haven asset. We remain underweight to REITs.
- Our overall equity allocation is neutral.

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

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

## OVERVIEW OF THE EQUITY AND FIXED INCOME MARKETS

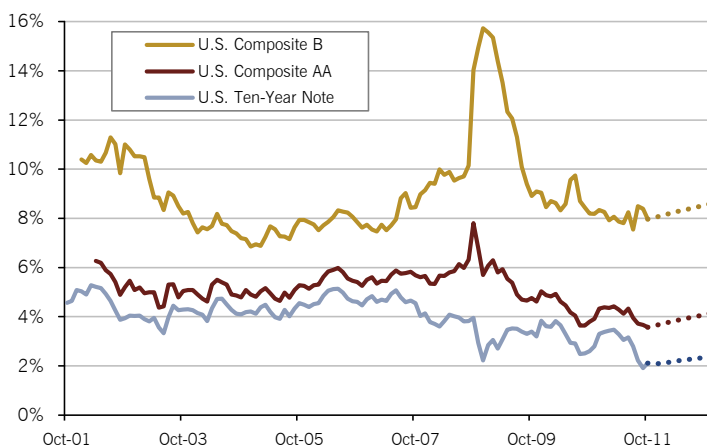
### S&P 500 PRICE

In a dramatic turnaround, stocks generated their best month in almost 20 years (for the S&P 500 index), rallying off the lows of the year. Investors were buoyed by a sense that the economy stepped away from the brink of recession, news that European leaders might get a debt plan in place, and continued strong corporate earnings.



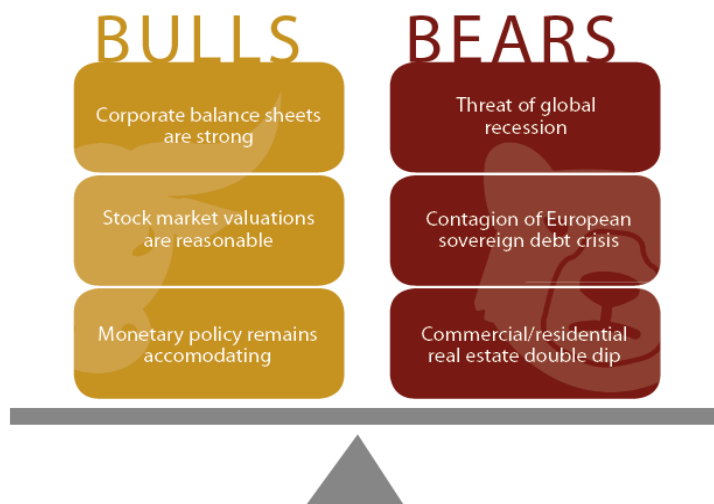
### CREDIT YIELDS

U.S. Treasury yields backed up a bit (from 1.9% to 2.2% for the ten-year note) during the month, but remained near historic lows. High yield debt rallied, though spreads between the yields of Treasuries and lower quality corporate bonds remained quite wide.



### SUMMARY OF CURRENT EQUITY MARKET LEANINGS

- Our overall equity allocation is neutral.
- While economic growth is sluggish and a recession is a possibility, several factors (monetary policy, valuations, and corporate balance sheets) remain supportive of stocks.
- Within the equity category, we are overweight U.S. and emerging market equity and underweight developed international and long/short equity.



## APPENDIX

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## SUMMARY

Below is a summary of the key statistics contained in this Appendix.

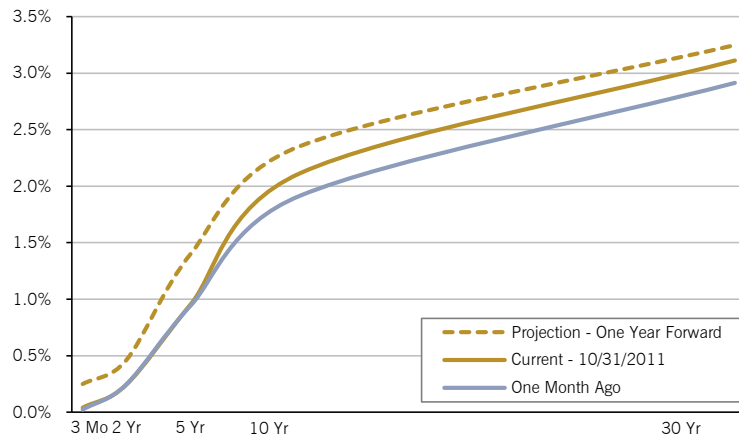
<p><b>CREDIT MARKETS</b>            U.S. Treasury Yield Curve            T-Bills, Federal Funds, and Inflation            LIBOR/T-Bill Rates and TED Spread            Corporate Yield Spreads (page 2)</p>	<p><b>Mixed</b>            Neutral to Bullish            Neutral to Bullish            Bullish            Bearish</p>	<p><b>Notes</b>            yields rise some in October but curve remains steep            Fed keeping short-term rates low; less worried with inflation            low TED spread = little liquidity anxiety            spreads of high yield debt to Treasuries are wide</p>
<p><b>THE ECONOMY AND THE CONSUMER</b>            Consumer Confidence and Unemployment            U.S. Consumer Income and Spending            LEI and ECRI</p>	<p><b>Neutral to Bearish</b>            Bearish            Neutral            ↓ Neutral to Bearish</p>	<p>confidence at recession-type levels on worries about jobs            incomes falling, but spending remains strong            leading indicators on a slow pace; ECRI at recession levels</p>
<p><b>THE ECONOMY AND SUPPLIERS</b>            ISM Manufacturing Index            Baltic Dry Index and Commodities            Retail Sales</p>	<p><b>Neutral</b>            Neutral            Neutral            Neutral</p>	<p>expansionary, but near lowest level in two years            BDI remains stagnant but copper gained in October            fall sales holding up well so far</p>
<p><b>U.S. CORPORATIONS</b>            Corporate Earnings            Stock Market Valuations            Stock Market Technicals</p>	<p><b>Mixed</b>            Neutral to Bullish            Neutral to Bullish            Bearish</p>	<p>earnings season showing healthy corporations            valuations reasonable - trailing 12-month P/E below average            S&amp;P 500 50-day average &lt; 200-day average</p>
<p><b>INVESTOR FLOWS AND LIQUIDITY</b>            Money Market Funds Assets            Mutual Fund Liquidity Ratio            Mutual Fund Cash Flows</p>	<p><b>Neutral to Bearish</b>            Neutral            Neutral to Bearish            Neutral</p>	<p>slowly declining as 0% yield forces investors into bond funds            mutual fund cash to be invested still at low levels            investors still retreating from stocks - secular shift to income?</p>
<p><b>FEAR MEASURES</b>            Stock Market Volatility            Correlations            U.S. Short Interest</p>	<p>↑ <b>Neutral</b>            ↑ Neutral            Neutral            Neutral</p>	<p>VIX falls as investor stress alleviates            spiked higher with risk-on/risk-off mentality            short covering might have contributed to the market rally</p>
<p><b>REAL ESTATE</b>            Mortgage Applications and Pending Sales            Residential Delinquencies and Defaults            Residential/Commercial Property Price Indices</p>	<p><b>Bearish</b>            Bearish            Bearish            ↑ Neutral to Bearish</p>	<p>pending sales and mortgage applications still weak            likely to remain high until there are more jobs            not exactly a rally, but could be forming a bottom</p>
<p><b>CURRENCY</b>            U.S. Dollar            Foreign Purchases of U.S. Securities            U.S. M1 Money Supply and Velocity</p>	<p><b>Neutral</b>            Neutral            Neutral            Neutral</p>	<p>falling again after flight to safety            foreign purchases of U.S. bonds spiked in global turmoil            M1 at unprecedented levels, but velocity is low</p>
<p><b>BORROWING</b>            U.S. Household Debt            U.S. Savings and Debt Service Ratio            U.S. Consumer Loan Charge-Off Rates</p>	<p><b>Neutral to Bearish</b>            Neutral to Bearish            Neutral to Bearish            Neutral to Bearish</p>	<p>deleveraging cycle likely a headwind for several years            any increase in rates could raise debt servicing costs            below peak but remain at relatively high historical levels</p>

Note: The arrows indicate the directional change from the prior month's reading (i.e., a shift from "Bullish" to "Neutral to Bullish" is viewed as a negative change).

**U.S. TREASURY YIELD CURVE**

Better-than-expected economic data and some progress on the European sovereign debt front helped alleviate investor fears of recession and contributed to a shift out of bonds in October. The Treasury yield curve shifted higher and remains steep.

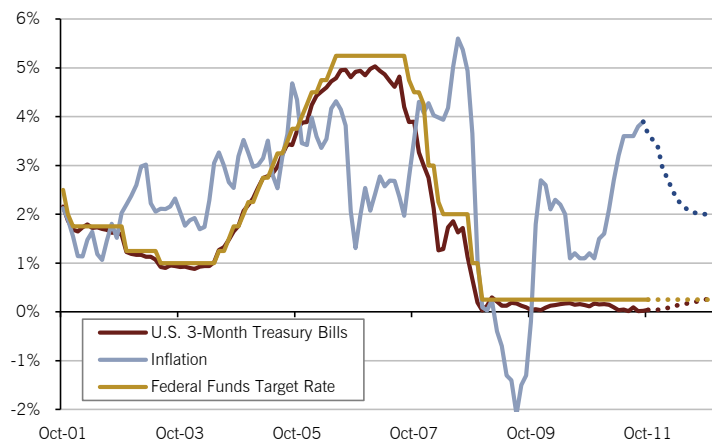
**Advantage: Neutral to Bullish**



**T-BILLS, FEDERAL FUNDS, AND INFLATION**

The Federal Reserve is holding off on any new actions, as they believe economic growth is strong enough to keep the economy from sliding into recession. However, inflation is expected to moderate. Short-term interest rates will be kept near zero through mid-2013.

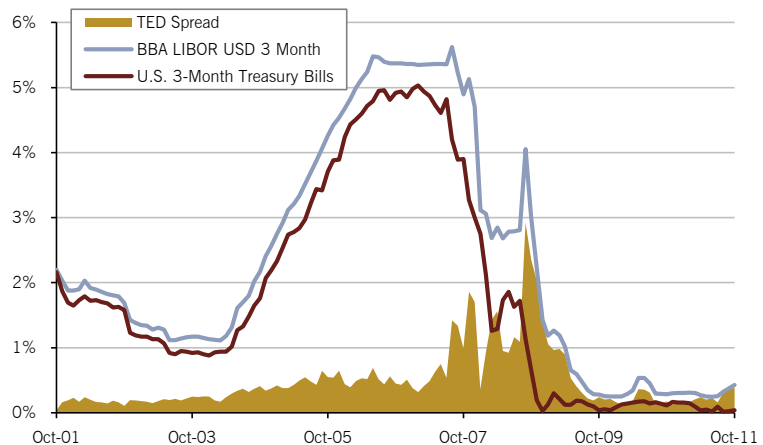
**Advantage: Neutral to Bullish**



**LIBOR/T-BILL RATES AND TED SPREAD**

The TED spread is a measure of the tightness of the credit markets, as illustrated by the difference between T-Bill yields and LIBOR yields. Despite problems in Europe, spreads remain relatively low (a slight increase) and indicate credit markets are not overly concerned about near-term liquidity challenges.

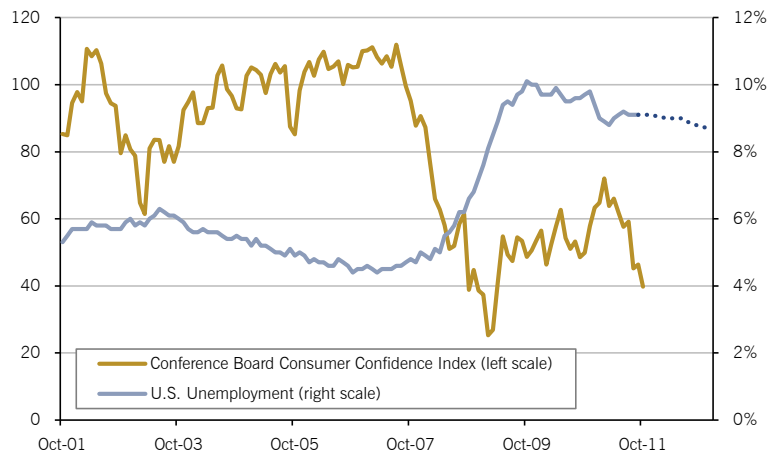
**Advantage: Bullish**



**CONSUMER CONFIDENCE AND UNEMPLOYMENT**

Consumer confidence dropped to its lowest level in over two years as Americans remain worried about job prospects. Fears are that low confidence levels (far below readings signifying a healthy economy) could restrain consumer spending, which accounts for about 70% of domestic economic activity.

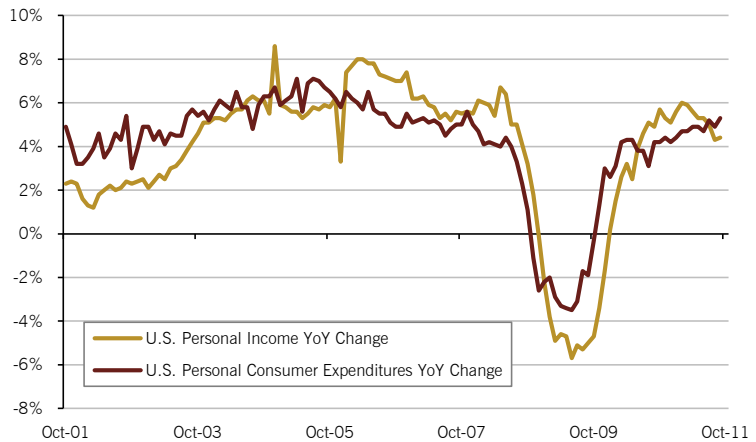
**Advantage: Bearish**



**U.S. CONSUMER INCOME AND SPENDING**

Consumer spending activity has somewhat surprisingly kept up even as incomes have dropped (particularly on an inflation-adjusted basis). Most economists believe spending will start to be restrained until hiring picks up.

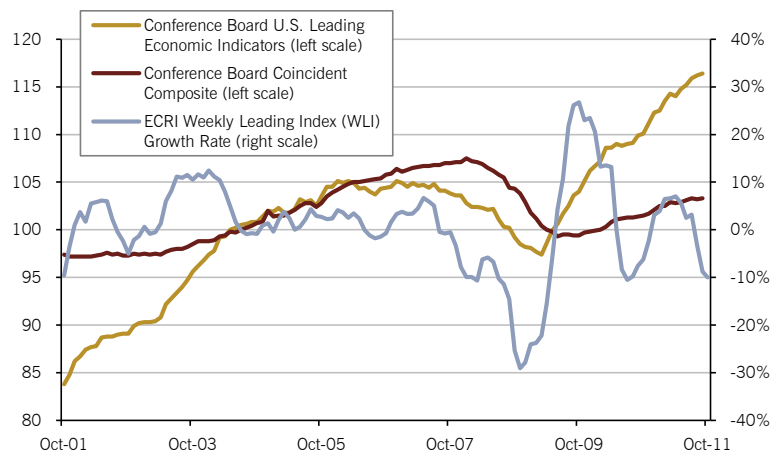
**Advantage: Neutral**



**LEI AND ECRI**

The U.S. index of leading economic indicators (LEI) continues to trend upward, though the pace is moderating and suggests a slow rate of growth in coming months. Meanwhile, the leading index from the Economic Cycle Research Institute has shown significant weakness and is now predicting recession (such calls, while reliable, often come early).

**Advantage: Neutral to Bearish**



**ISM MANUFACTURING INDEX**

The ISM report is a national survey of purchasing managers covering numerous metrics. A reading over 50 indicates expansion relative to the prior month, while a reading under 50 indicates contraction. In October manufacturing activity slowed to 50.8, just off the lowest level in two years yet still expansionary.

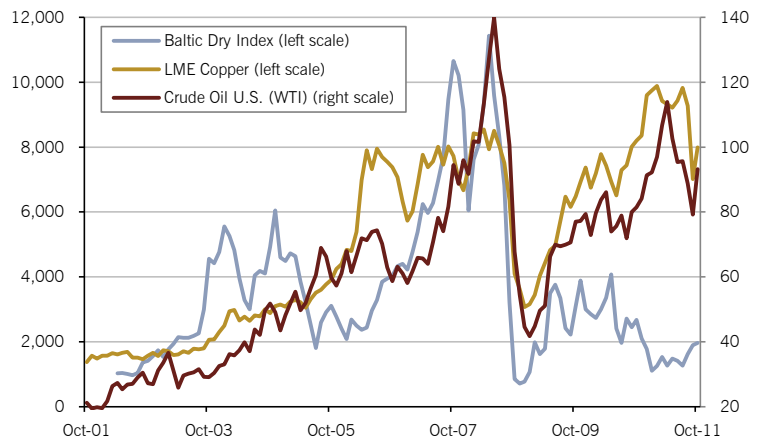
**Advantage: Neutral**



**BALTIC DRY INDEX & COMMODITIES**

Commodities such as copper and oil rebounded in October as worries of slowing global economic growth subsided a bit. However, the Baltic Dry Index remains stagnant.

**Advantage: Neutral**



**RETAIL SALES**

Retail sales figures can be an indicator of economic recovery. Sales rose in recent months, led by auto dealers, and helped ease fears of recession. Longer-term, however, high unemployment could be a challenge to sustaining consumer spending levels.

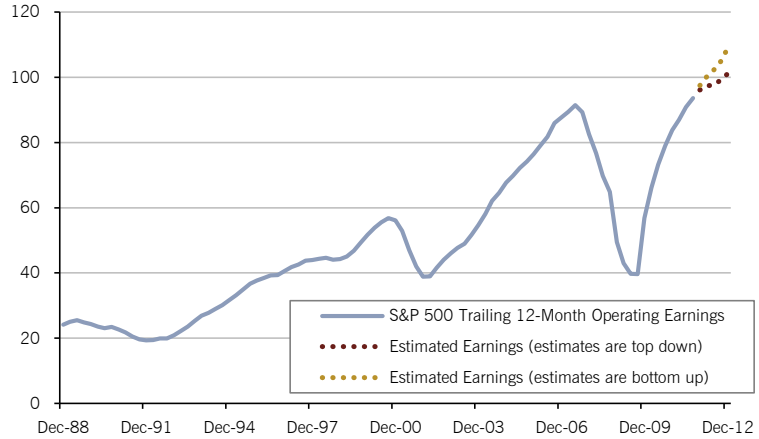
**Advantage: Neutral**



**CORPORATE EARNINGS**

Q3 earnings are coming in relatively well, and S&P continues to project a record year in 2012. However, it is possible consumer spending might eventually stall, leading to disappointing earnings increases.

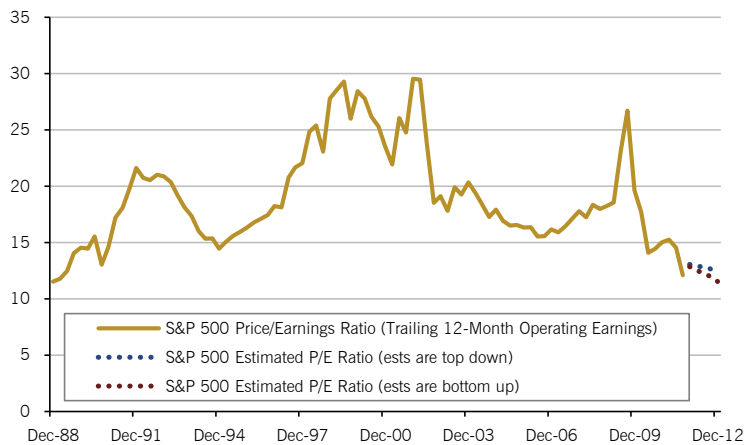
**Advantage: Neutral to Bullish**



**STOCK MARKET VALUATIONS**

Trailing 12-month P/E valuations for the S&P 500 look reasonable and remain below historical averages thanks to still-robust earnings.

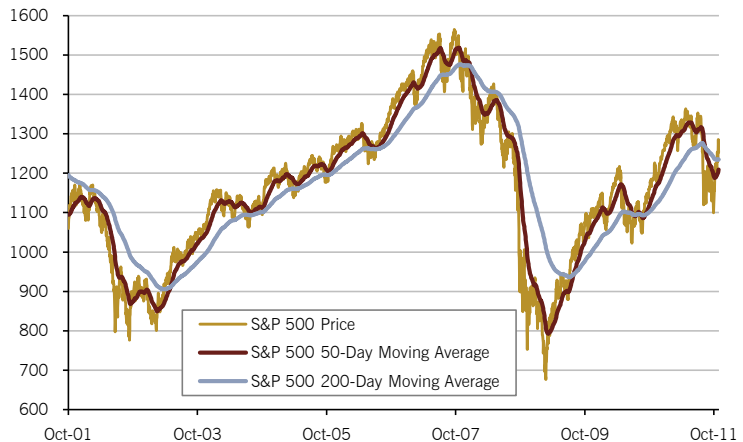
**Advantage: Neutral to Bullish**



**STOCK MARKET TECHNICALS**

The level of the S&P 500 50-day moving average is below the 200-day moving average (the so-called "Death Cross"), which is interpreted by many as a bearish signal.

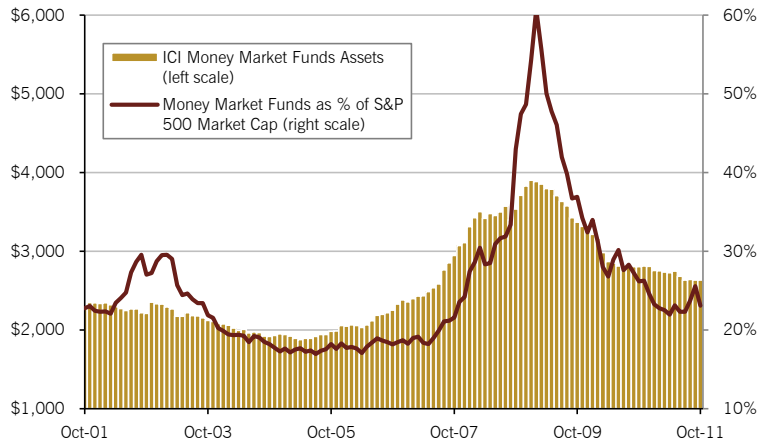
**Advantage: Bearish**



**MONEY MARKET FUNDS ASSETS**

Assets in money market funds continue to slowly decline, though they remain above the typical levels seen before the credit crisis. Given historically low yields (near zero), many investors have shifted out of cash and into short-term bond funds.

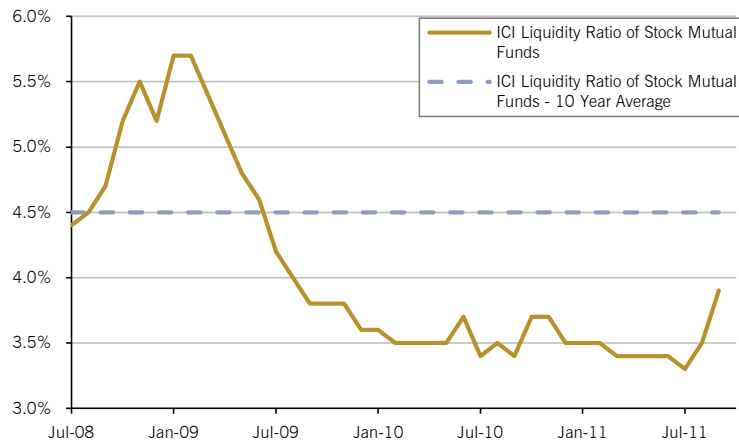
**Advantage: Neutral**



**MUTUAL FUND LIQUIDITY RATIO**

Mutual funds have been sitting on unusually low levels of cash, which is viewed as bearish as it means little additional dollars to invest. However, they raised some cash in the recent sell-off, which might need to be put back into stocks at some point.

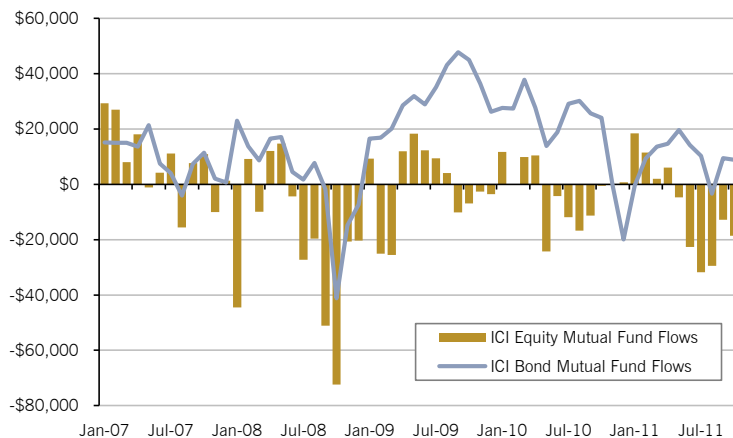
**Advantage: Neutral to Bearish**



**MUTUAL FUND CASH FLOWS**

Investors continued to redeem from stock mutual funds in October (the sixth consecutive month of outflows) in spite of the relief rally. It is possible that investors simply do not want to take a chance on another market meltdown, but also that a secular shift towards income generating investments is taking place.

**Advantage: Neutral**

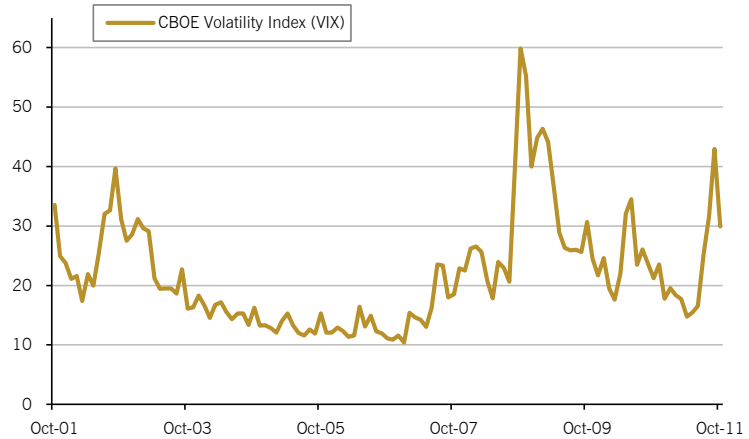


## FEAR MEASURES

### STOCK MARKET VOLATILITY

After spiking in September as the markets sold off, volatility retreated in October as fears of recession receded and signs of progress were seen in Europe. Readings in excess of 30 generally correspond with times of investor fear or uncertainty, while values below 20 are typically associated with less stressful times.

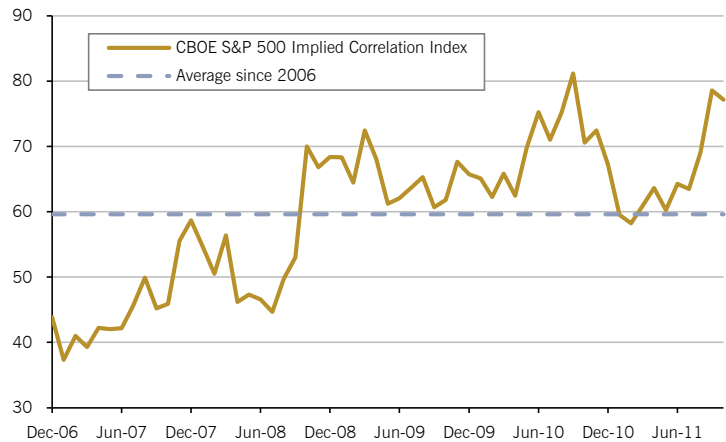
**Advantage: Neutral**



### CORRELATIONS

Correlations between stocks that comprise the S&P 500 remain elevated, as equities have been moving in unison (and knee-jerk fashion) in both sell-offs and rallies. These high correlations indicate a difficult environment for active management as stock pickers have seen limited opportunities to outperform.

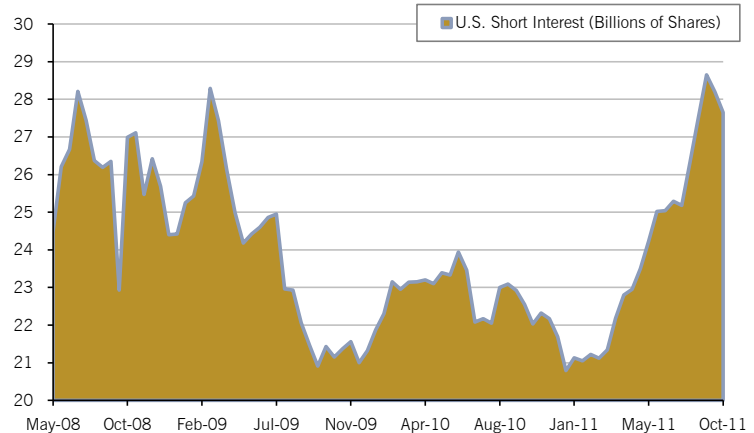
**Advantage: Neutral**



### 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. Short interest surged during the recent downturn, and covering may have helped spur October's rally.

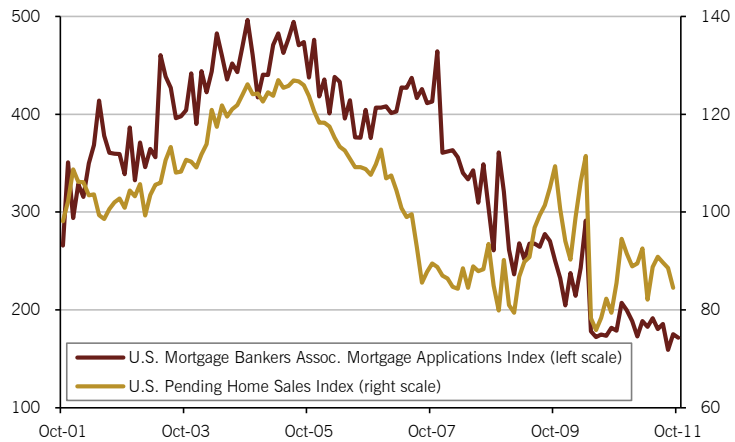
**Advantage: Neutral**



**MORTGAGE APPLICATIONS AND PENDING HOME SALES**

Mortgage applications and pending home sales resumed their decline despite low prices and record low mortgage rates. Depressed consumer sentiment, high unemployment, the prospect of additional foreclosures adding to supply, and difficulty accessing credit continue to weigh on the real estate market.

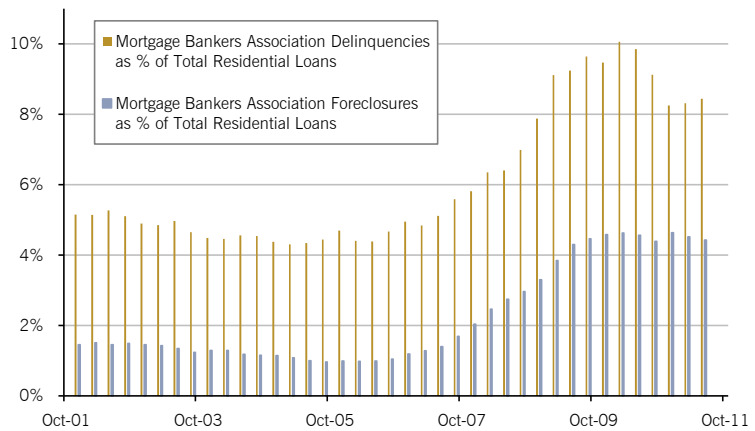
**Advantage: Bearish**



**RESIDENTIAL DELINQUENCIES AND DEFAULTS**

Despite attempts by mortgage servicers to find alternatives for delinquent borrowers, mortgage foreclosures remain elevated due to the sluggish economy and the high level of unemployment. Many expect the overall rate to slowly trend lower but remain above typical averages for some time.

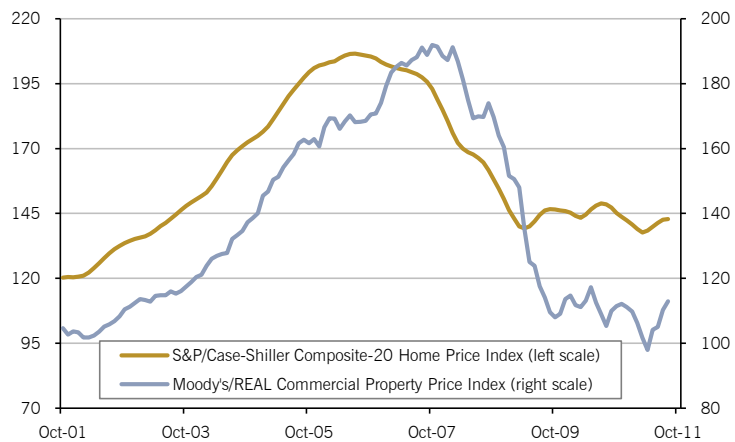
**Advantage: Bearish**



**RESIDENTIAL/COMMERCIAL PROPERTY PRICE INDICES**

Home prices appear to have stabilized in some markets, while commercial property prices have posted gains for five consecutive months. However, many view this as a potential bottoming process for the real estate market rather than a sign of a sustained recovery.

**Advantage: Neutral to Bearish**

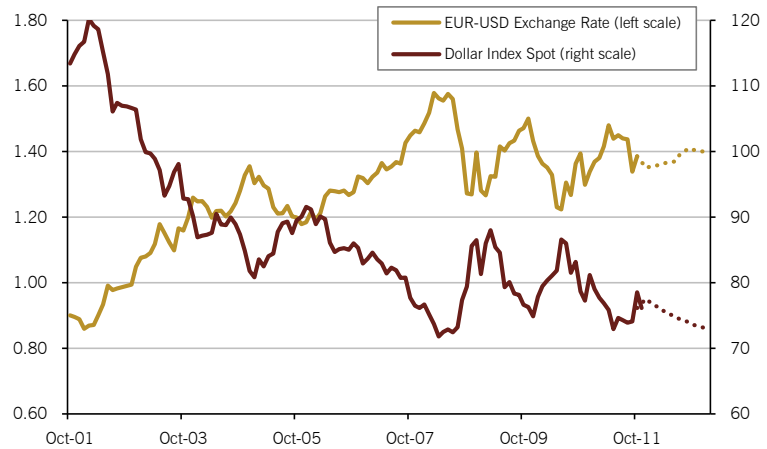


## CURRENCY

### U.S. DOLLAR

The U.S. dollar gave back some of its recent gains in October. Longer-term, we believe slow U.S. economic growth, easy money policies by the Federal Reserve, and the country's heavy debt burden are likely to hinder the greenback.

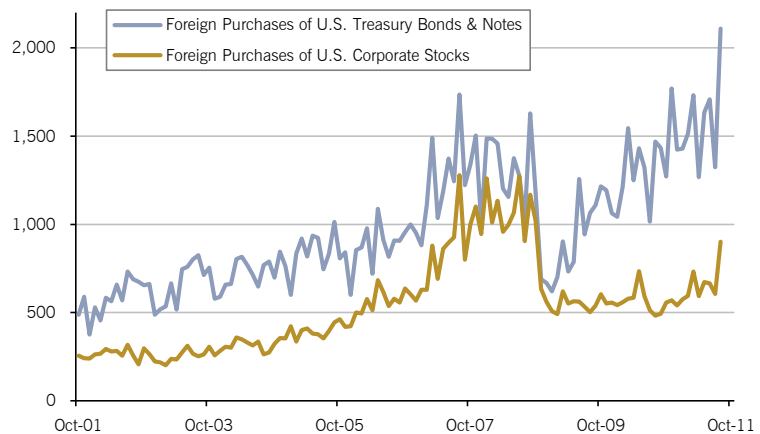
**Advantage: Neutral**



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

Foreign purchases of U.S. securities surged in late summer amid market turmoil and in a flight to safety and dollar-denominated investments.

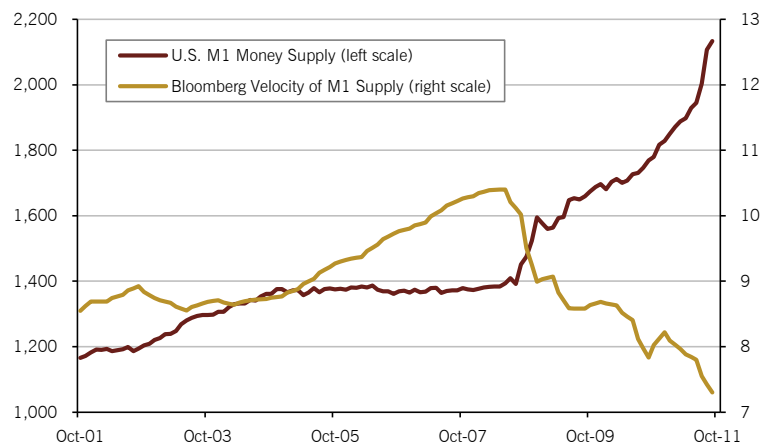
**Advantage: Neutral**



### U.S. M1 MONEY SUPPLY AND VELOCITY

M1 has spiked to unprecedented levels, causing worries of eventual inflation and U.S. dollar weakness. The velocity of money, however, remains low as consumers and businesses are not spending or borrowing at high levels.

**Advantage: Neutral**

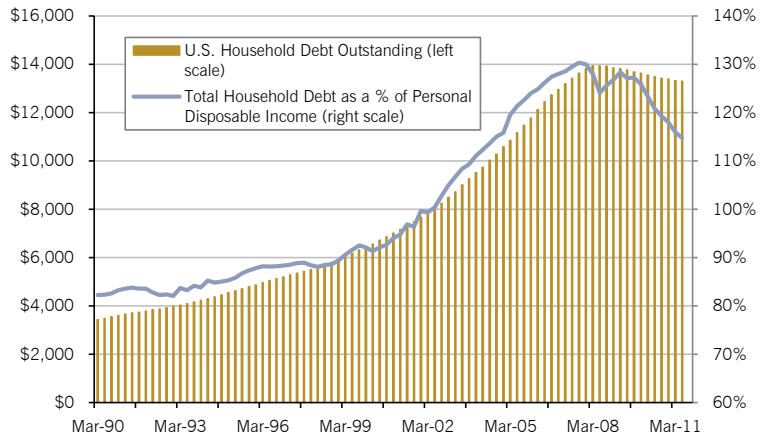


## BORROWING

### U.S. HOUSEHOLD DEBT AS A PERCENTAGE OF DISPOSABLE INCOME

U.S. household debt (including mortgages and consumer credit) and, in particular, the percentage of disposable personal income it represents, continues to decline. However, the ongoing deleveraging cycle and the thrift accompanying it will likely be a headwind to the economic recovery for several years.

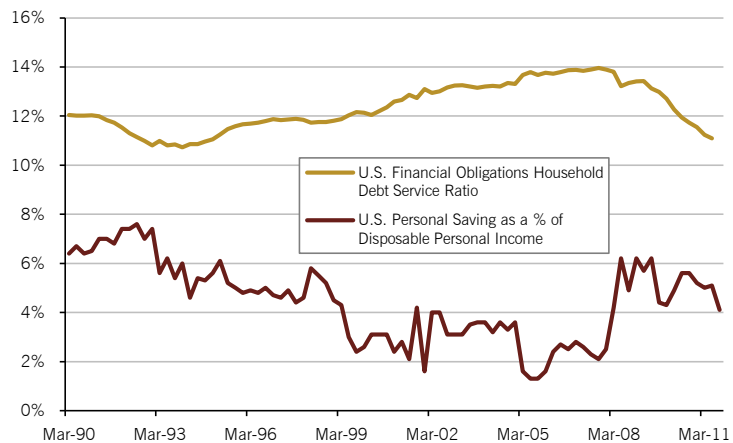
**Advantage: Neutral to Bearish**



### U.S. SAVINGS AND HOUSEHOLD DEBT SERVICE RATIO

Despite the increase in total debt over the past 20 years, lower borrowing costs have eased the burden of servicing this debt, freeing cash flow for other spending. However, if rates rise, so too would debt payments not locked in with fixed rates.

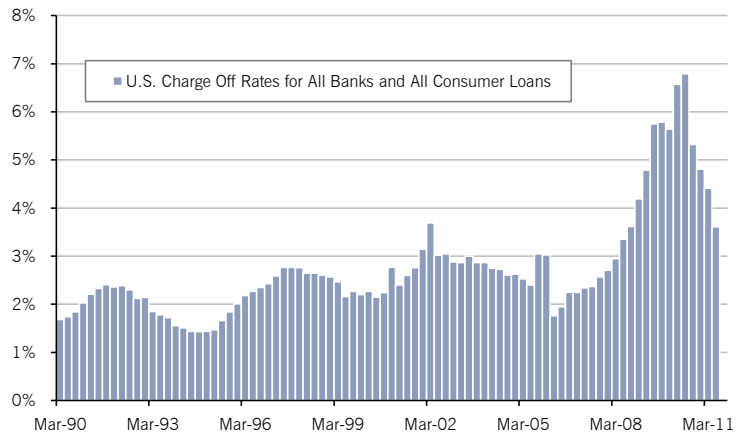
**Advantage: Neutral to Bearish**



### U.S. CONSUMER LOAN CHARGE-OFF RATES

Default rates on consumer bank loans (excluding real estate) have declined significantly, particularly for credit card users. Still, there is not much increase in the willingness of banks to lend or consumers to borrow.

**Advantage: Neutral to Bearish**



## DISCLOSURE

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