

Commentary

What a difference a quarter makes! A few months ago the U.S. economy appeared to be simply going through a soft patch. Now the perceived risk of recession has increased, brought on by the European mess, our own debt problems, dysfunctional governments, and slowing growth in China and other emerging markets.

The question is: how much bad economic news has already been priced into the markets? We've been pondering this difficult question, especially as the poor outcomes being considered are not a certainty, stock market valuations are not unreasonable (and might be considered cheap in some segments), and corporate earnings and balance sheet health have not significantly deteriorated.

Due to uncertainties with regard to the disparate set of outcomes, we are maintaining a neutral stance in equities. This does not mean we are insensitive to volatility or the potential for another downturn in prices. We make every effort, particularly within the equity space, to minimize downturns through the use of hedged strategies and active management (which generally leads to a focus on high quality companies paying dividends). We also maintain a healthy exposure to core fixed income in our portfolios as well as to assets that can act as a systemic portfolio hedge in times of turmoil. If we come to the conclusion that a prolonged and deep recession is imminent and further losses likely, we will act accordingly. Thus far, however, we have mixed indications that a prolonged recession will be the case.

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.

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

12505 Park Potomac Avenue
Suite 400
Potomac, MD 20854

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

CONVERGENTWEALTH.COM

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

OVERVIEW OF THE EQUITY AND FIXED INCOME MARKETS

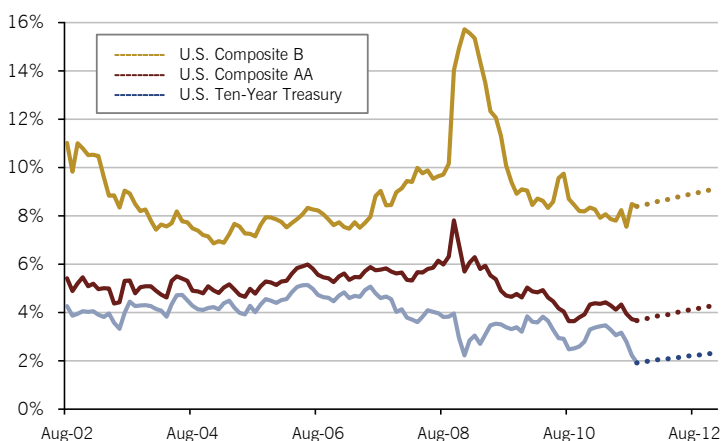
S&P 500 PRICE

Stocks fell in September for the fifth month in a row, and the S&P 500 is on the precipice of joining other market segments such as small cap and international stocks in a bear market (commonly defined as a decline of 20% from a recent peak). Concerns that sovereign debt problems in Europe could spark a global recession continue to pressure financial markets.



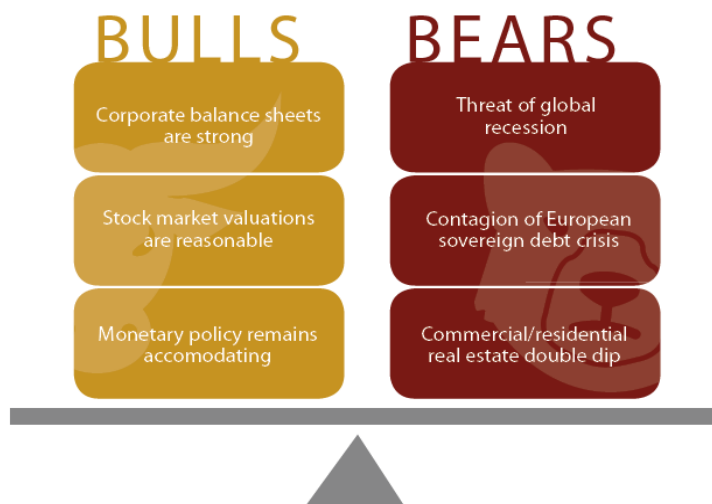
CREDIT YIELDS

U.S. Treasury yields continue to fall, with the ten-year note at one point yielding 1.71% during the month, the lowest level since the 1940s. The spread between Treasuries and high yield corporate bonds has widened significantly as the high yield markets have lagged in the risk selloff.



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 while underweight developed international and long/short equity.



APPENDIX

Summary.....	Page 3
The Credit Markets	Page 4
The Economy and the Consumer	Page 5
The Economy and Suppliers	Page 6
U.S. Corporations	Page 7
Investor Flows and Liquidity	Page 8
Fear Measures	Page 9
Real Estate	Page 10
Currency	Page 11
Borrowing	Page 12

SUMMARY

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

<p>CREDIT MARKETS 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>↓ ↓ ↓</p>	<p>Mixed Neutral to Bullish Neutral to Bullish Bullish Bearish</p>	<p>Notes Fed "twist" flattens Treasury yield curve but it remains steep Fed keeping short-term rates low; less worried with inflation despite turmoil, low TED spread = little liquidity anxiety spreads of high yield debt to Treasuries have widened</p>
<p>THE ECONOMY AND THE CONSUMER Consumer Confidence and Unemployment U.S. Consumer Income and Spending LEI and ECRI</p>	<p>↓ ↓</p>	<p>Neutral to Bearish Bearish Neutral Neutral</p>	<p>confidence at recession-type levels on worries about jobs incomes are falling, which may impact spending leading indicators rising at a slower pace while ECRI slips</p>
<p>THE ECONOMY AND SUPPLIERS ISM Manufacturing Index Baltic Dry Index and Commodities Retail Sales</p>		<p>Neutral Neutral Neutral Neutral</p>	<p>expanded in September but near lowest level in two years BDI remains stagnant while oil has declined significantly fall sales holding up surprisingly well so far</p>
<p>U.S. CORPORATIONS Corporate Earnings Stock Market Valuations Stock Market Technicals</p>		<p>Mixed Neutral to Bullish Neutral to Bullish Bearish</p>	<p>corporations are healthy due in part to overseas sales valuations reasonable - trailing 12-month P/E below average S&P 500 50-day average < 200-day average</p>
<p>INVESTOR FLOWS AND LIQUIDITY Money Market Funds Assets Mutual Fund Liquidity Ratio Mutual Fund Cash Flows</p>	<p>↓</p>	<p>Neutral to Bearish Neutral to Bearish Bearish Neutral</p>	<p>cash at an increasing % of stock market capitalization mutual fund managers holding low levels of cash highest level of stock outflows since 2008 selloff</p>
<p>FEAR MEASURES Stock Market Volatility Correlations U.S. Short Interest</p>		<p>Neutral to Bearish Neutral to Bearish Neutral Neutral</p>	<p>VIX jumps to over 40 -- investors are stressed spiked higher in August/September risk-off shifts short interest has surged during the downturn</p>
<p>REAL ESTATE Mortgage Applications and Pending Sales Residential Delinquencies and Defaults Residential/Commercial Property Price Indices</p>		<p>Bearish Bearish Bearish Bearish</p>	<p>pending home sales are still weak below peak levels, but likely to remain high for some time may be finding a bottom as prices inch off recent lows</p>
<p>CURRENCY U.S. Dollar Foreign Purchases of U.S. Securities U.S. M1 Money Supply and Velocity</p>		<p>Neutral Neutral Neutral Neutral</p>	<p>U.S. dollar has surged in flight to safety foreign purchases of U.S. bonds still at high levels M1 at unprecedented levels, but velocity is low</p>
<p>BORROWING U.S. Household Debt U.S. Savings and Debt Service Ratio U.S. Consumer Loan Charge-Off Rates</p>		<p>Neutral to Bearish 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 high historical levels</p>

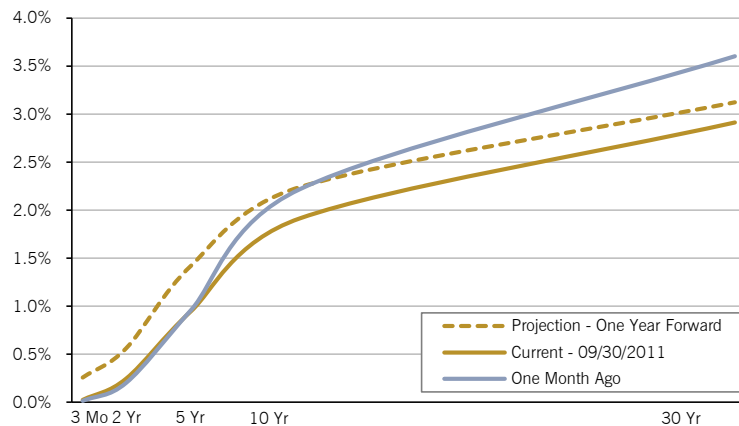
Note: The arrows indicate the directional change from the prior month's reading (i.e., a shift from "Bullish" to "Neutral to Bullish" is viewed as a negative change).

THE CREDIT MARKETS

U.S. TREASURY YIELD CURVE

The Treasury yield curve shifted significantly lower and flatter in September as the Federal Reserve announced a new bond buying plan (dubbed "Operation Twist") designed to lengthen the duration of its portfolio by purchasing long-term Treasury bonds while selling short-term debt. Spooked investors also contributed to lower yields as they retreated from risk assets to government bonds.

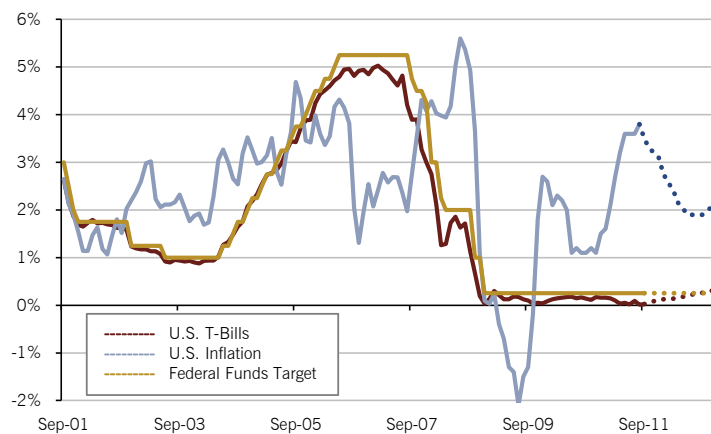
Advantage: Neutral to Bullish



T-BILLS, FEDERAL FUNDS, AND INFLATION

The U.S. central bank appears to be more worried about weak economic growth than fears of inflation. To help spur the economy, short-term interest rates will be kept near zero through mid-2013.

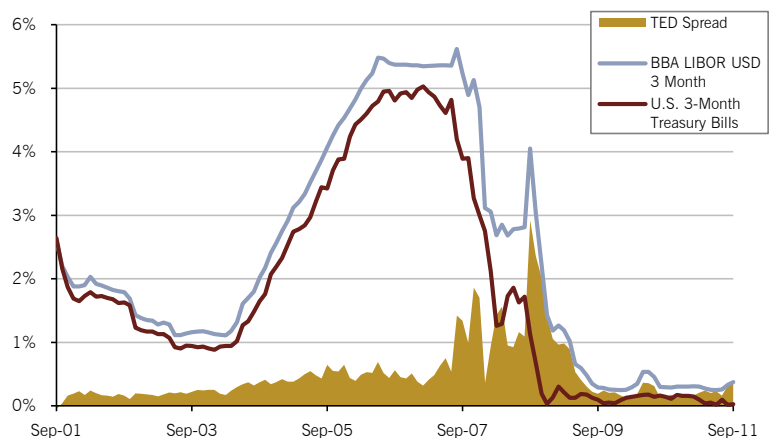
Advantage: Neutral to Bullish



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 and indicate credit markets are not yet overly concerned about near-term liquidity challenges.

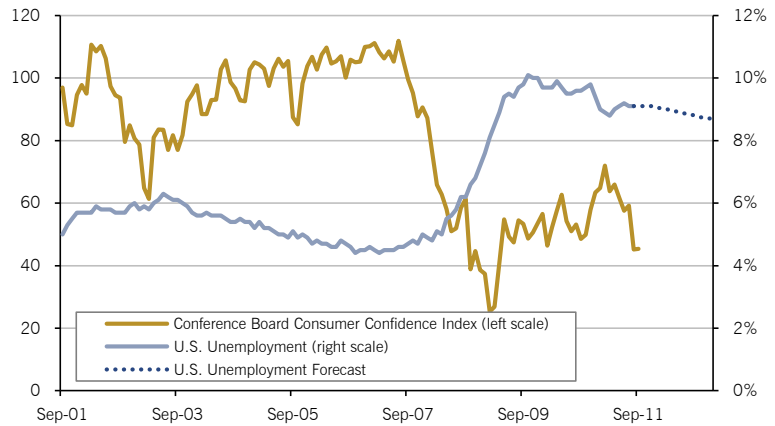
Advantage: Bullish



CONSUMER CONFIDENCE AND UNEMPLOYMENT

Consumer confidence remains near the lowest level in over two years as weakness in the stock market, a poor jobs environment, and an uncertain global economy have U.S. consumers increasingly worried about the short-term outlook.

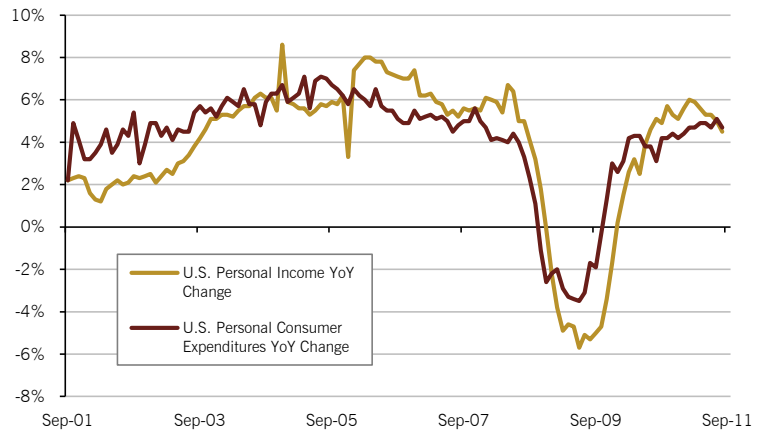
Advantage: Bearish



U.S. CONSUMER INCOME AND SPENDING

Consumer spending appears to be slowing as incomes have dropped, wages are stagnant and unemployment is high. Because consumer spending accounts for about 70% of domestic economic activity, a sustained decline could push the country into recession.

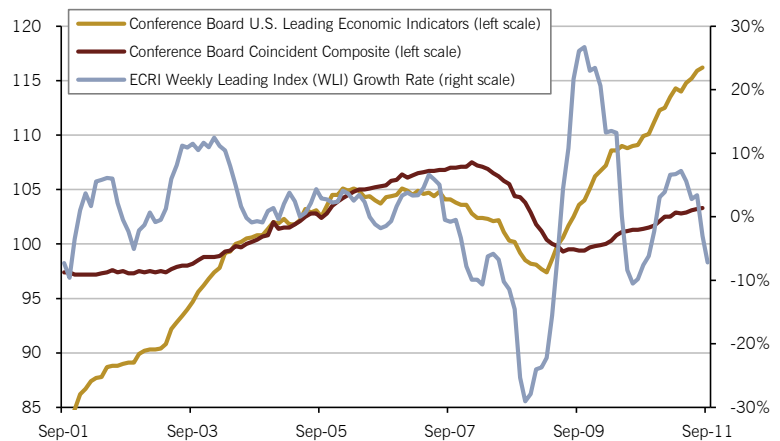
Advantage: Neutral



LEI AND ECRI

The U.S. index of leading economic indicators (LEI) continues to trend upward, helped by the Federal Reserve's low interest rate policy, though the pace of growth is slowing. Meanwhile, the leading index from the Economic Cycle Research Institute has shown some significant weakness and is approaching recession-type levels.

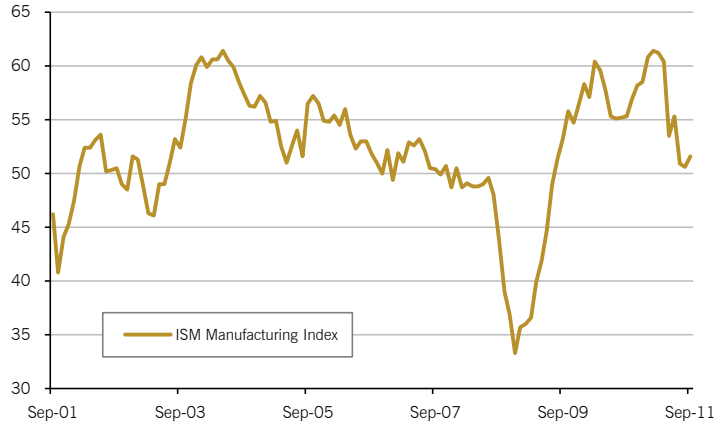
Advantage: Neutral



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. As of September, manufacturing activity remains expansionary at 51.6, just off the lowest level in two years.

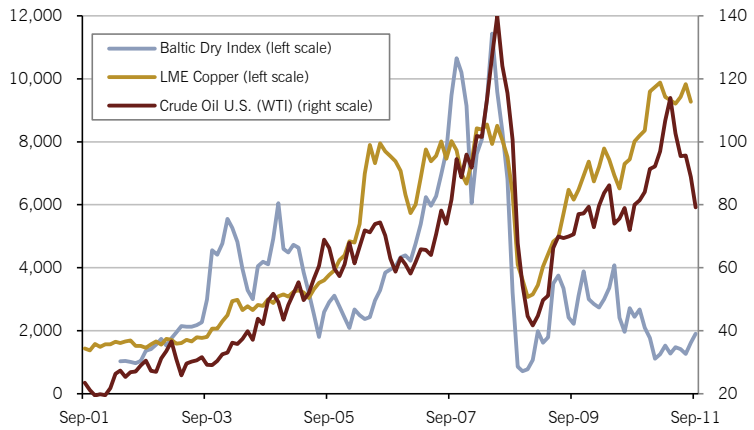
Advantage: Neutral



BALTIC DRY INDEX & COMMODITIES

The Baltic Dry Index remains stagnant. Meanwhile, demand for copper has hit a plateau while oil has fallen sharply on fears of slowing global economic growth.

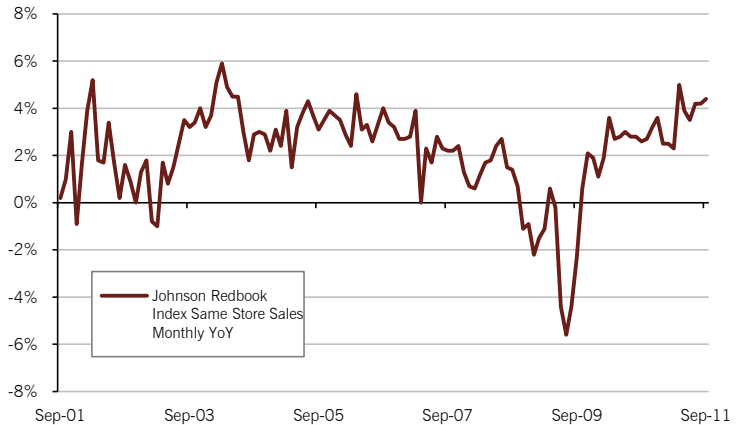
Advantage: Neutral



RETAIL SALES

Retail sales figures can be an indicator of economic recovery. Sales figures have been generally strong in the back-to-school season, despite the rocky stock market.

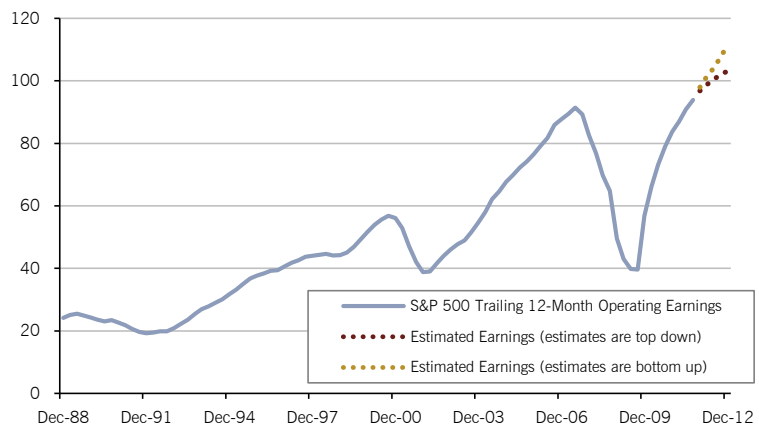
Advantage: Neutral



CORPORATE EARNINGS

Despite a slowdown in the domestic economy, bottom-up earnings estimates remain optimistic, projecting a record year in 2012. However, it is possible that company guidance may be less rosy on concerns that consumer spending might decline.

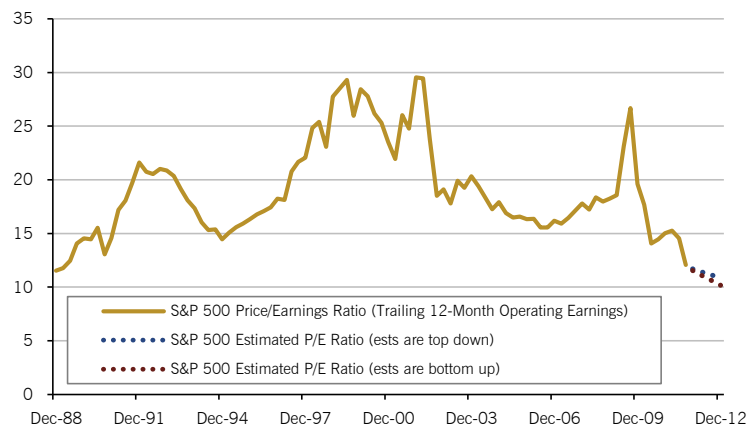
Advantage: Neutral to Bullish



STOCK MARKET VALUATIONS

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

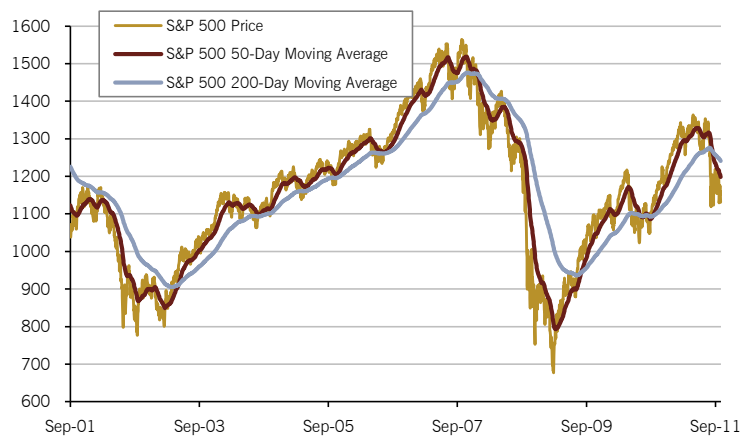
Advantage: Neutral to Bullish



STOCK MARKET TECHNICALS

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

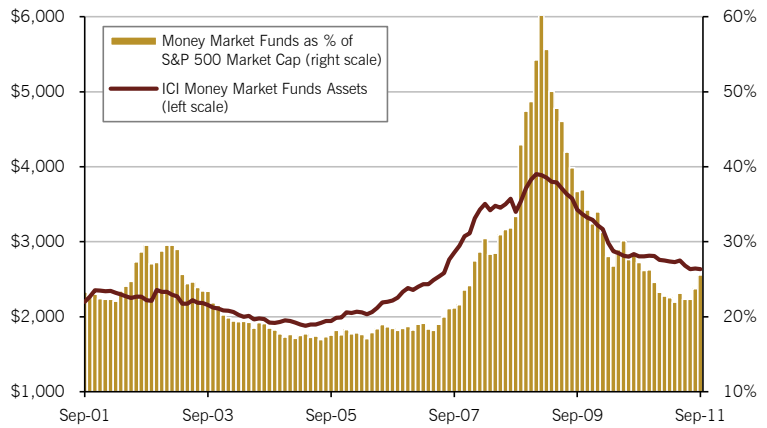
Advantage: Bearish



MONEY MARKET FUNDS ASSETS

Even though they yield close to zero, money market funds are becoming an increasing percentage of stock market capitalization due to equity market declines.

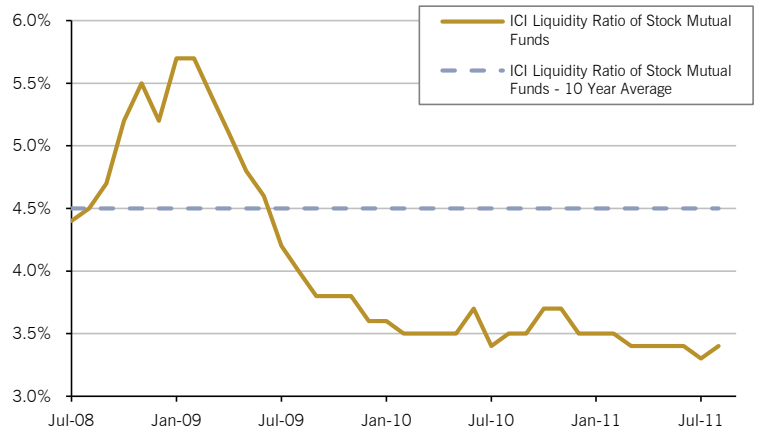
Advantage: Neutral to Bearish



MUTUAL FUND LIQUIDITY RATIO

As stocks tumbled in 2009, mutual funds were bearish and sitting on significant cash. Since then, most of that cash has been put to work (meaning little in additional cash to invest) and managers are holding an unusually low level of dry powder.

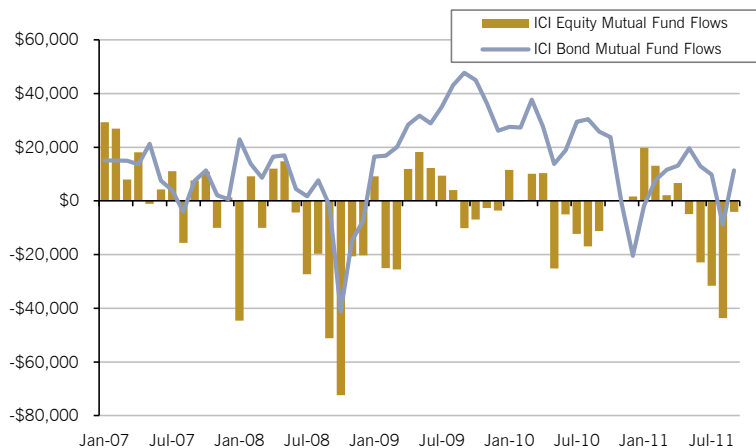
Advantage: Bearish



MUTUAL FUND CASH FLOWS

Year-to-date, stock mutual funds have seen nearly \$65 billion in redemptions while bond funds have seen \$75 billion in inflows. Investors clearly do not want to sit through another 2008/2009 type of stock market meltdown.

Advantage: Neutral

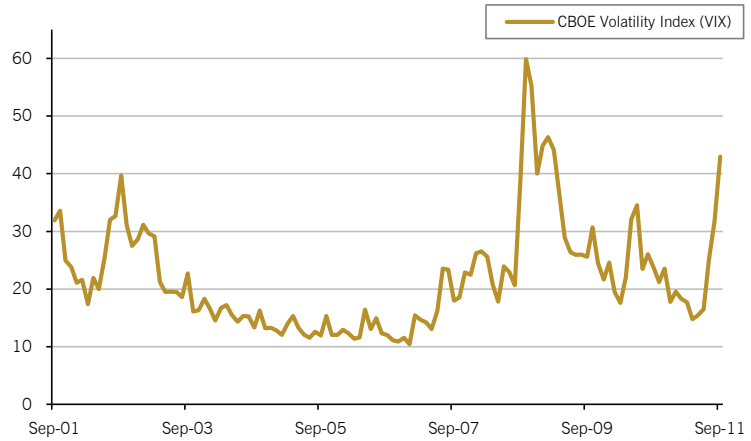


FEAR MEASURES

STOCK MARKET VOLATILITY

Volatility, as measured by the Chicago Board Options Exchange Volatility Index (VIX), spiked in September to levels not sustained since the credit crisis in 2008/2009. 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.

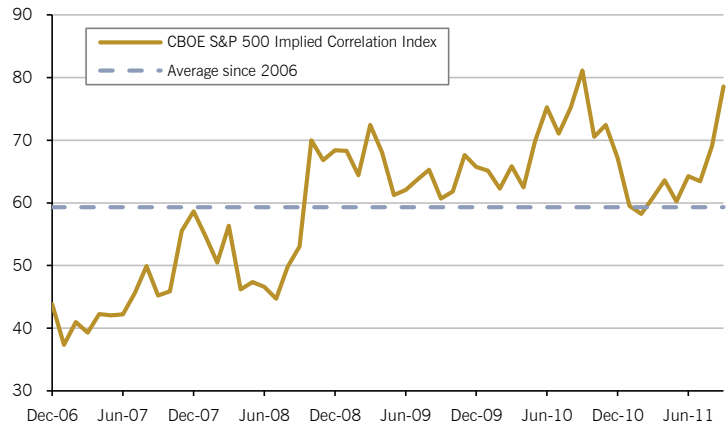
Advantage: Neutral to Bearish



CORRELATIONS

Correlations between stocks that comprise the S&P 500 have spiked in the recent selloff as selling has been indiscriminate. These high correlations indicate a difficult environment for active management as stock pickers have seen limited opportunities to outperform.

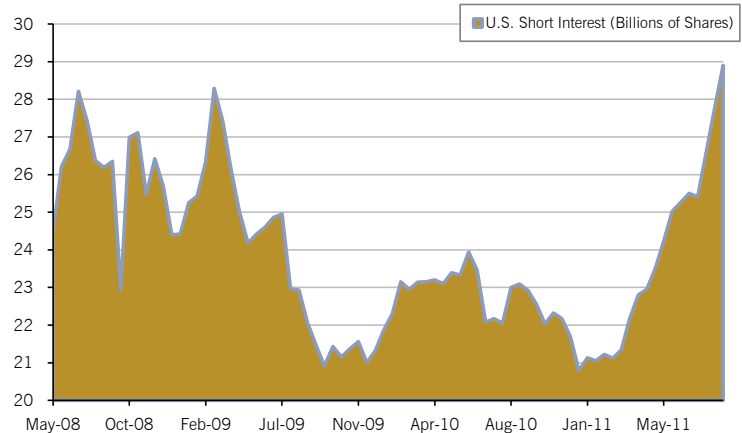
Advantage: Neutral



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 has surged during the recent downturn.

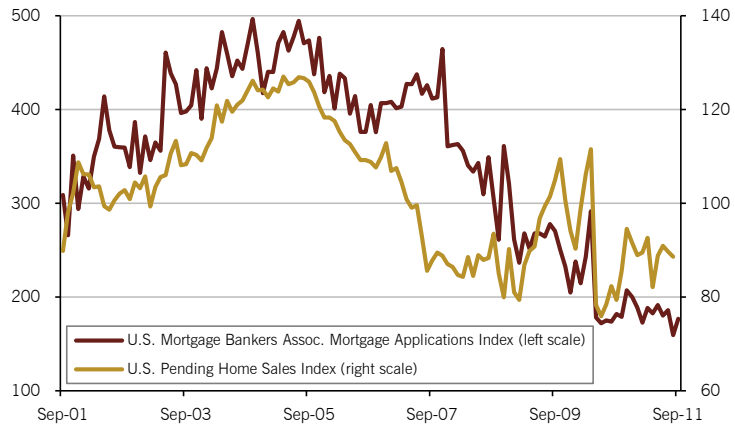
Advantage: Neutral



MORTGAGE APPLICATIONS AND PENDING HOME SALES

The housing market remains weak, despite low prices and record low mortgage rates (though refinancings may be seeing some increase). Economists remain hopeful that sales might improve once banks resolve their foreclosure issues and the labor market shows signs of life.

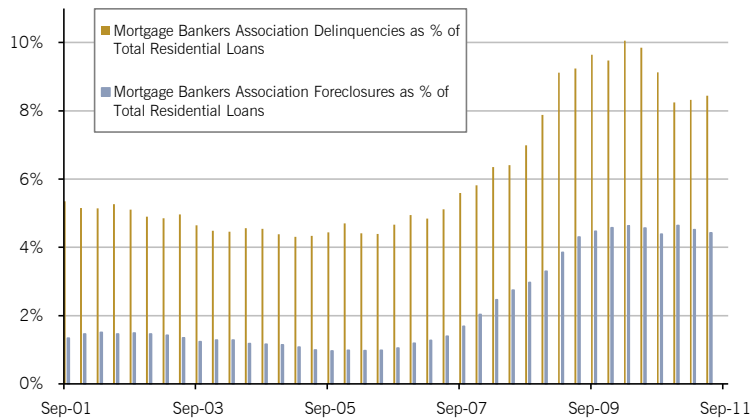
Advantage: Bearish



RESIDENTIAL DELINQUENCIES AND DEFAULTS

Mortgage delinquencies and foreclosures remain elevated but below 2010 peaks. Many expect the overall rate to slowly trend lower but remain above typical averages for some time.

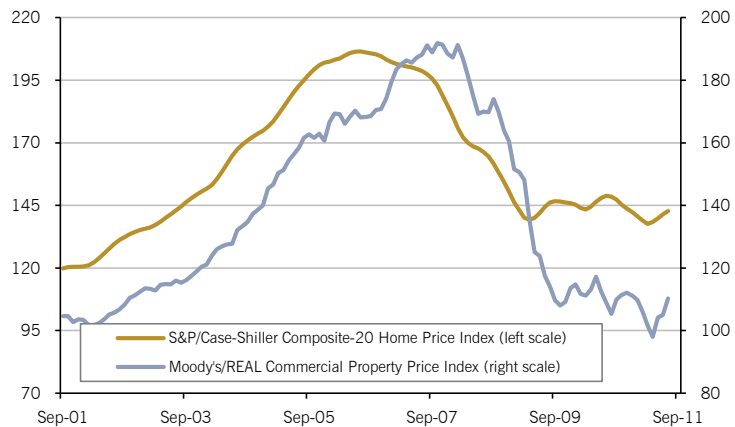
Advantage: Bearish



RESIDENTIAL/COMMERCIAL PROPERTY PRICE INDICES

Home prices appear to have stabilized in some markets for the time being, albeit at much lower levels as compared to prior years.

Advantage: Bearish

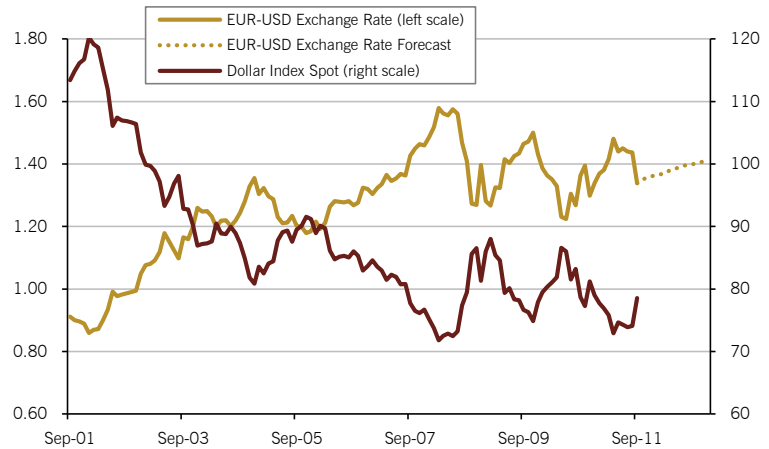


CURRENCY

U.S. DOLLAR

The U.S. dollar strengthened significantly in September, especially against emerging-market currencies, as nervous investors sought safety in the U.S. currency. However, over the longer-term, 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.

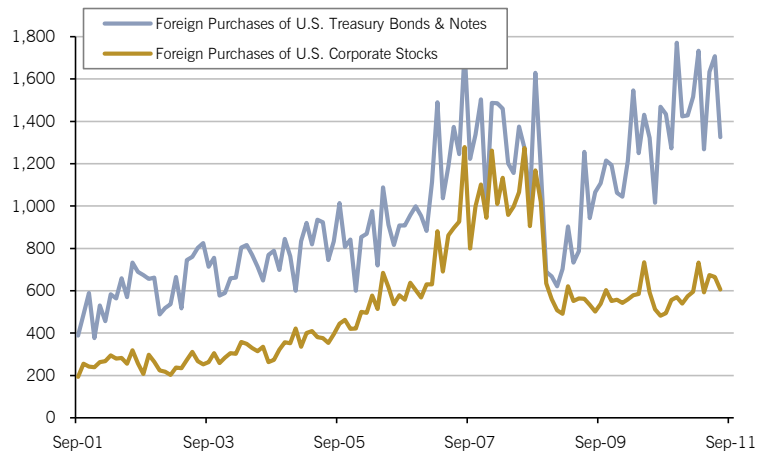
Advantage: Neutral



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

Foreign purchases of U.S. bonds have remained heavy. A longer-term worry is that high government debt levels could cause major foreign buyers, such as China, to either demand higher U.S. interest rates or stop buying Treasuries altogether.

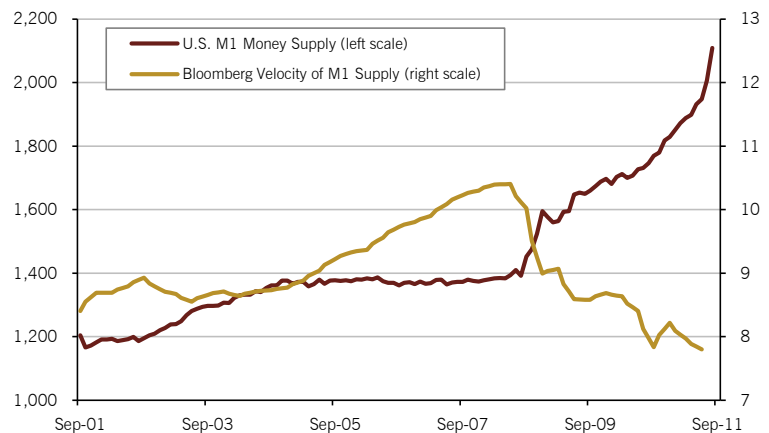
Advantage: Neutral



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

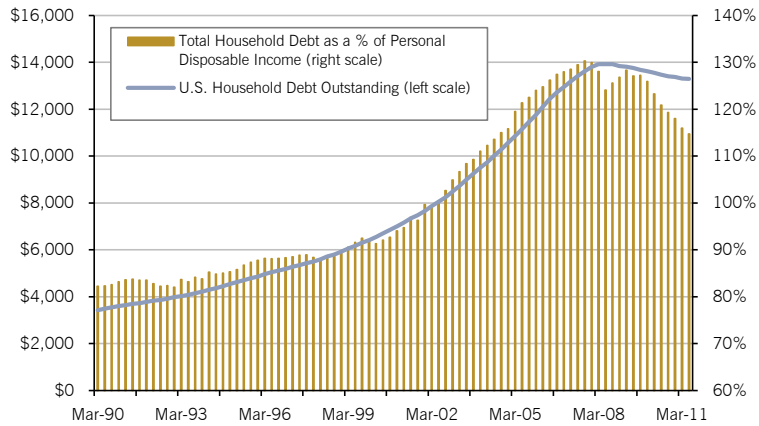


BORROWING

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, continue to decline. However, the ongoing deleveraging cycle and the thrift that accompanies it will likely be a headwind to the economic recovery for several years.

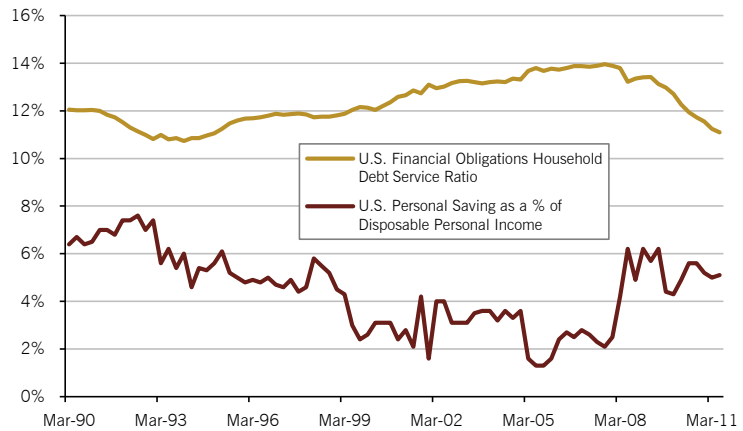
Advantage: Neutral to Bearish



U.S. SAVINGS AND HOUSEHOLD DEBT SERVICE RATIO

The debt service ratio measures the amount households spend on debt payments as a percentage of their earnings. 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.

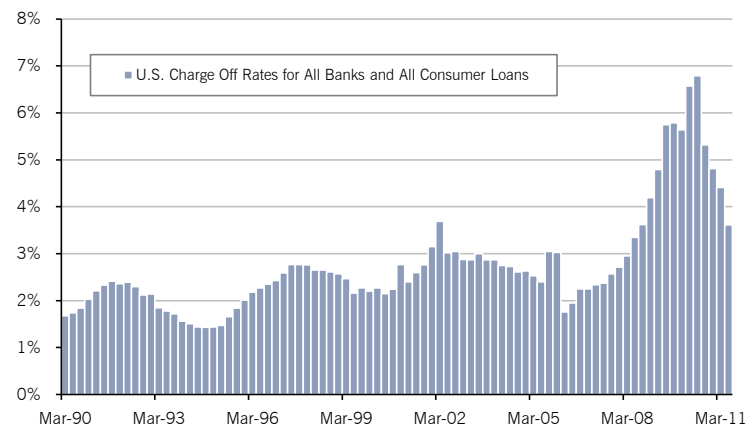
Advantage: Neutral to Bearish



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 for consumers to borrow.

Advantage: Neutral to Bearish



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