



October 28, 2009

Dear Client,

During the third quarter, both the economy and financial markets continued to heal, as consumer confidence improved and other economic and financial indicators became more positive. These improvements were experienced worldwide with many emerging markets showing special strength. Unemployment was the important exception; unfortunately, history shows that during most economic recoveries, markets first start to recover, then the economy begins rebounding and lastly, employment improves.

The strong recovery experienced by global financial markets during the second quarter continued throughout the June-September period (see Exhibit 1). Equity markets around the world moved higher, adding to the already robust year-to-date performance. Third quarter returns for most fixed income and hedge funds also were positive, with the strongest returns seen in the higher risk areas (e.g., high yield, emerging markets).

<b>Exhibit 1</b>		
<b>Total Return of Equity, Fixed Income and Hedge Fund Indices *</b>		
	<b><u>3Q 2009</u></b>	<b><u>Year-to-Date</u></b>
	<b>(6/30/09 - 9/30/09)</b>	<b>(12/31/08 - 9/30/09)</b>
<b><i>Major Equity Indices</i></b>		
	%	%
S&P 500 Index	15.6	19.3
Russell 3000 Index (Total US market)	16.3	21.2
Russell 2000 Index	19.3	22.4
MSCI All Country Ex-US Index (Net)	19.7	36.4
MSCI EAFE International Index (Net)	19.5	29.0
MSCI Emerging Markets (Net)	20.9	64.5
<i>Source: Bloomberg, MSCI</i>		
<b><i>Major Fixed Income and Hedge Fund Indices</i></b>		
	%	%
Barclays Capital US Aggregate Bond Index	3.7	5.7
Merrill Lynch US High Yield BB-B Bond Index	11.2	39.6
JPMorgan GBI Global ex-US Index Hedged in USD	2.0	2.0
JP Morgan EMBI Global Index (Emerging markets)	10.2	26.3
HFRX Equal Weighted Strategies Index (Hedge Funds)	4.3	9.0
<i>Source: Bloomberg, PIMCO, HFRI</i>		

\* Including price appreciation plus dividends and/or interest.

### Financial Markets' Performance

Equities started their recovery faster and more aggressively than anticipated by most investors and substantial improvements have been registered in your portfolios. However,

additional improvements still are needed to return to the market highs. Volatility will continue, although in our view, at a much lower level than in the recent past. We feel that the gradual economic recovery we are experiencing will sustain the improving trend in the financial markets.

US equities benefited mainly from the prospects of the recession nearing its end and better-than-expected reported quarterly earnings. To this point, S&P 500 operating earnings rose to \$13.81 in the second quarter up from \$10.11 in the first quarter and an historically low -\$0.09 in the 4Q 2008<sup>1</sup>. Lower quality stocks continued to lead performance, as often is the case at the beginning of a market turnaround. Value stocks outperformed growth and small caps topped large caps.

Equities in both international developed and developing markets posted strong gains driven by improving economic conditions. The weak US dollar magnified these positive gains for non-dollar denominated investments. Year-to-date, emerging markets maintained their substantial outperformance, although during the quarter the performance differential between emerging and developed markets narrowed considerably. Japanese stocks, although positive, continued to lag far behind, as the local economy continues to struggle with slow growth and a strong Yen.

Recently, there has been much discussion about “too much too soon” and a probable strong market correction. Our view is that market fluctuations are normal and corrections are to be expected; unfortunately, the intensity of these movements is uncertain and unknown to everyone. However, investors normally are cushioned against these events through proper asset allocation that incorporates their investment objectives, risk tolerance and liquidity needs. Although concerns about “too much too soon” might be valid, we suggest taking to heart Mae West’s famous quote, “Too much of a good thing is wonderful.”

On a more serious note, the magnitude of recent events was of such an unusual nature (i.e., a hundred year flood or a three standard deviation event, etc.) that, although it could be repeated at any time, the probability of such an event is extremely low. Therefore, it is important to be cautious, but not excessively so, while taking advantage of the investment opportunities currently available in global financial markets. We believe very strongly that, for most investors, market timing is counter-productive.

Despite the strong recovery in equities, investment opportunities are still available. During the recession, corporations substantially cut costs, depleted inventories, reduced production and strengthened their balance sheets. As the economy continues to recover from one of the worst recessions in the post-WWII era, companies should see profits improve due in part to rising revenues, along with increased productivity, slow growth in labor costs and currently low interest rates.

Another potential boost for stocks is the enormous amount of cash still sitting in investors’ accounts. Despite the significant drop in volatility, an apparent improvement in sentiment, near-zero percent yields on Treasury Bills and extremely low returns on other short-term investments, investors are reluctant to commit funds to equities even now. However, total

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<sup>1</sup> J.P. Morgan Asset Management, *Guide to the Markets 4Q/2009*, pg 14

risk aversion has abated as \$220 billion has been invested in bond funds since the beginning of the year (see Appendix A compiled by J.P. Morgan Asset Management). As spreads in the bond market continue to narrow, the risk/reward ratio for equities should improve.

During the quarter, yield spreads continued to tighten across the board with most bond sectors experiencing substantial returns, ranging from 3.7% in the total US bond market (as measured by the Barclay's Capital US Aggregate Bond Index) to 11.2% in the high yield sector. Despite the apparent appetite for risk, many investors still were hedging their positions by purchasing US Treasuries, pushing the 10-year yield down to 3.3%. It is unlikely that such strong returns will continue since spreads on fixed income securities are nearing normal historical levels. However, there still are plenty of inefficiencies remaining from the 2008 financial meltdown that may provide opportunities for above-average returns in the coming year.

## **Economic Growth**

After a difficult recessionary period, economists expect US growth to accelerate during the second half of 2009 to an annualized 3%-4%<sup>2</sup> level. Fiscal stimulus and a pick-up in cyclical areas such as housing construction and inventory restocking should contribute to the higher growth. However, with unemployment quite high, consumer spending is not expected to rebound as rapidly.

Some economists expect US GDP to grow by 2.0% in 2010 (see Exhibit 2 below). Yet, other economists estimate growth at 4%, which is still below the 5+% level of rebound normally seen in a recovery. This sub-normal growth can be partly attributable to the continued tight credit markets and the higher unemployment level. A positive for near term growth is that the US government has allocated only 41% of the total funds designated for the stimulus program, with a mere 17% spent so far<sup>3</sup>, meaning the stimulus will continue to affect the economy during 2010 and likely even in future years.

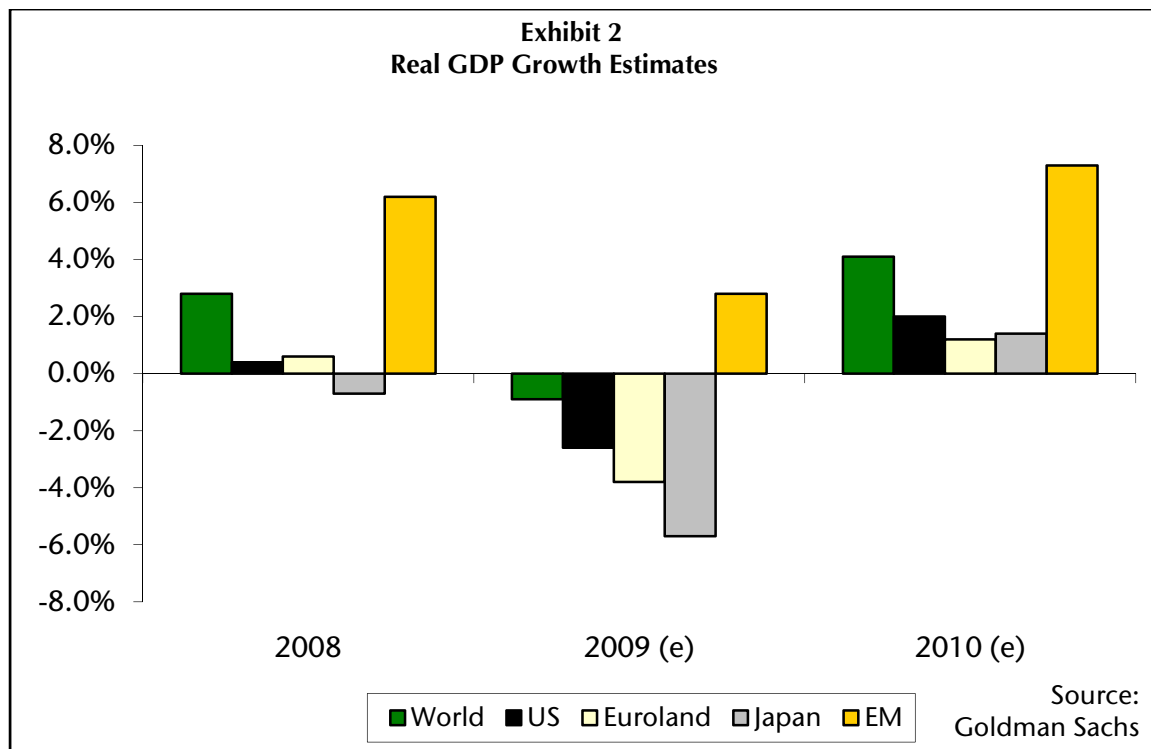
US unemployment is expected to continue rising through the end of 2009 and perhaps during the first quarter of 2010, or longer. Historically, unemployment falls gradually as the US economy strengthens after a recession, restraining short-term growth in consumer spending.

Given the importance of consumption in GDP, the consumer is a critical component of any economic recovery. However, there are other parts (e.g., inventories, equipment and housing) that individually are not as important but, when aggregated become significant. Currently, these other segments are at unsustainably low levels and will most likely be the driving force behind the economic recovery as they improve, supported at a lower level by consumer spending. Given the large stimulus package, the government segment of GDP may play a larger relative role during this recovery period than it has in the past. JP Morgan estimates that under current conditions a 3-4% GDP growth could be achieved over the next year. Risks to this estimate include: continued tight credit for both consumers and businesses, deterioration in the commercial real estate market and unexpected changes in the unemployment trend.

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<sup>2</sup> J.P. Morgan

<sup>3</sup> Fed Reserve Chairman Ben Bernanke, [www.recovery.gov](http://www.recovery.gov)

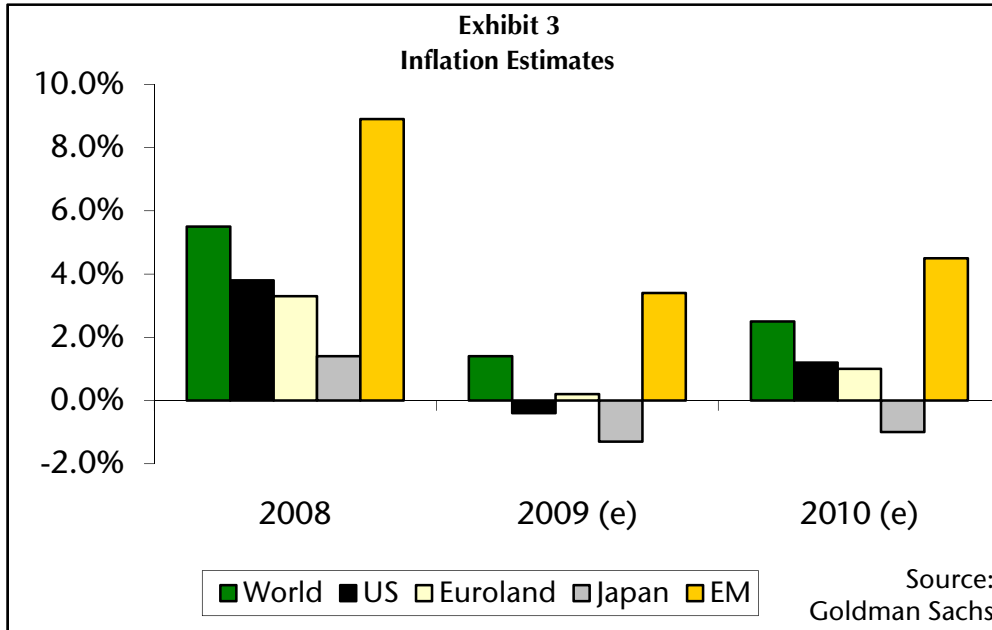


European GDP growth is estimated to have turned positive in the third quarter, but also is projected to show slow growth in 2010. Japanese net exports contributed to positive GDP growth in the second quarter, but domestic demand remains weak and 2009 growth is estimated to remain negative. Projected Japanese GDP growth for 2010 ranges from slightly negative to slightly positive.

On average, emerging markets weathered the financial recession well, although they saw less positive economic growth than seen during 2007. Asia ex-Japan growth was up almost 6% year-to-date. Latin America and Central and Eastern Europe saw mildly negative growth, but not to the same degree as in the developed economies. Asia's positive growth was fueled by China and India. Well-coordinated Chinese stimulus programs, as well as central bank action and budding financial stability, allowed for the partial recovery of global trade and demand. Forecasts for the emerging markets in 2010 are projected at a very positive 7.3%, again buoyed by China and India, with Latin America and Emerging Europe projected to grow by close to 4% and 2%, respectively.

### **Inflation and Interest Rates**

In 2009, year-end inflation is estimated to be low with possible negative numbers for the US and Japan (see Exhibit 3 below). In 2010, inflation projections continue at low levels with estimated negative numbers for Japan and somewhat higher, but reasonable, numbers for emerging markets.



In the US economy, given current high unemployment and low capacity utilization levels, we estimate that serious inflation risks will not be a major concern for the foreseeable future. However, we will consider proactively adding or increasing exposure to inflation protected securities, real estate and commodities, when appropriate, to mitigate potential long-term inflation risk.

Considering the estimated current low inflation risk, as well as the early stage of the economic recovery, we believe that the Federal Reserve (Fed) will most likely maintain its accommodative stance and hold interest rates at very low levels for the near future. When the Fed develops a strong conviction that a relapse in economic growth is unlikely, it gradually will (or aggressively, if required) reduce the level of liquidity from the market and start raising the interest rates it controls. On the other hand, as the Treasury floods the market with its short and intermediate-term debt, there is a risk that interest rates on its securities could start increasing from their current very low levels.

### Currency

The US dollar rose substantially against a basket of major currencies at the end of 2008, as panic caused many investors to turn to the dollar as a safe-haven currency. The dollar declined as investors calmed, but by the end of the third quarter it had not yet reached its March 2008 low point (see Exhibit 4 below).

It is interesting to note that, despite the widespread negative commentary about the US and its currency, investors still turned to the dollar rather than the other “strong currencies” when the crisis arose. We also believe that discussions of replacing the dollar as a global reserve currency are oftentimes political and may be premature. The stability of the US political system and the flexibility and wealth of the economy should help maintain that status for years to come, as was the case during recent financial crises.

#### Exhibit 4

However, it is clear to us that the US dollar nonetheless will gradually erode versus emerging markets' currencies over the long term. We do not expect the Euro/Dollar relationship to progress in the same fashion. The developed nature of the Eurozone economy and its mild growth prospects should maintain the exchange rate between the two currencies fluctuating in a more 'range-bound' level for the foreseeable future.

A country's economic strength is an important component in the future development of currency relationships. One important aspect not to be overlooked is the serious demographic issue (i.e., lack of population growth) that will be faced by Europe and Japan in the future. This, in turn, will adversely impact the growth of their economies. To some extent, although the US faces the same problem, it is not as serious in relative terms and has been mitigated by more robust formal and informal immigration, as well as a more open view of the subject.



At current levels, we believe that overall the dollar is attractively priced and makes for more competitive US exports. Additionally, some positive developments sometimes are overlooked, such as the reduction in the Current Account Deficit which has declined substantially from -6.5% of GDP in the fourth quarter of 2005 to -2.8% of GDP during the second quarter of 2009. However, given the uncertainty of most economic variables, we normally hold in most of our clients' portfolios a healthy exposure to non-US currencies (via investments in international equities and fixed income), which provides diversification benefits and also mitigates currency risk.

#### Conclusion

Since the market's March low, robust returns have been found across asset classes in the global equity and fixed income markets. Those asset classes that sold off the most at the end of 2008 and through the start of 2009 (e.g., high yield, emerging markets, small cap, real estate), rallied the strongest during the last six months. Given this rebound, many investment opportunities for potential large gains have been realized and, as a whole, we believe the market now is priced much closer to fair value. However, ample opportunities remain across asset classes, especially in large, multinational growth companies that as a whole did not experience as great a rebound. Although 2009's rally lifted most companies regardless of quality (since the sell-off had been so severe), we believe going forward that those companies with stronger fundamentals will outperform. In most developed international markets, as well as in some emerging markets, we still see possibilities for good returns. In the fixed income arena, we estimate most of the returns going forward probably will be reasonable, but closer to the historical norm, rather than the very high returns experienced year-to-date. However,

there are still plenty of opportunities where we can take advantage of large discrepancies in valuation that have not yet been corrected.

Sincerely,

The SOL Capital Management Team

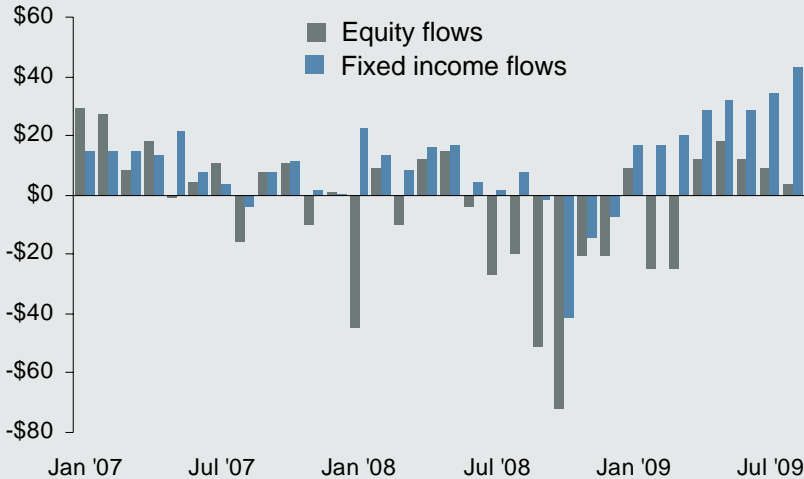
# Mutual Fund Flows

Equities

Billions, USD	AUM	Fund Flows									
		YTD 2009	2008	2007	2006	2005	2004	2003	2002	2001	2000
<b>Domestic Equity</b>	3,375	5	(151)	(48)	11	31	111	130	(25)	54	260
<b>International Equity</b>	1,136	10	(82)	139	148	105	67	23	(3)	(22)	50
<b>Taxable Bond</b>	1,553	175	19	98	45	26	3	39	124	76	(36)
<b>Tax-exempt Bond</b>	420	45	8	11	15	5	(14)	(7)	16	12	(14)
<b>Hybrid</b>	577	3	(19)	23	7	25	43	32	8	10	(31)
<b>Money Market</b>	3,552	(291)	637	654	245	63	(157)	(258)	(46)	375	159

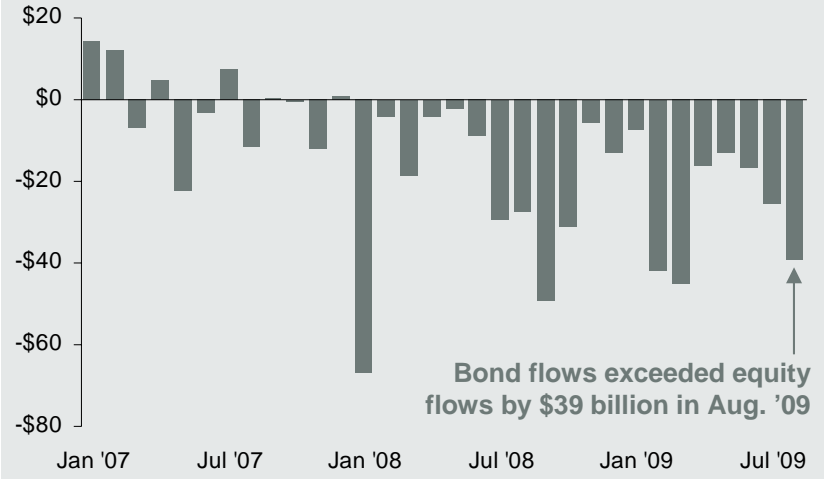
### Net fund flows (monthly)

Billions, USD, U.S. and international funds



### Difference between net flows into stock and bond funds

Billions, USD, U.S. and international funds



Source: Investment Company Institute, J.P. Morgan Asset Management.

Data include flows through August 2009 and exclude ETFs. International equity flows are inclusive of emerging market, global equity, and regional equity flows. Hybrid flows include asset allocation, balanced fund, flexible portfolio and mixed income flows.