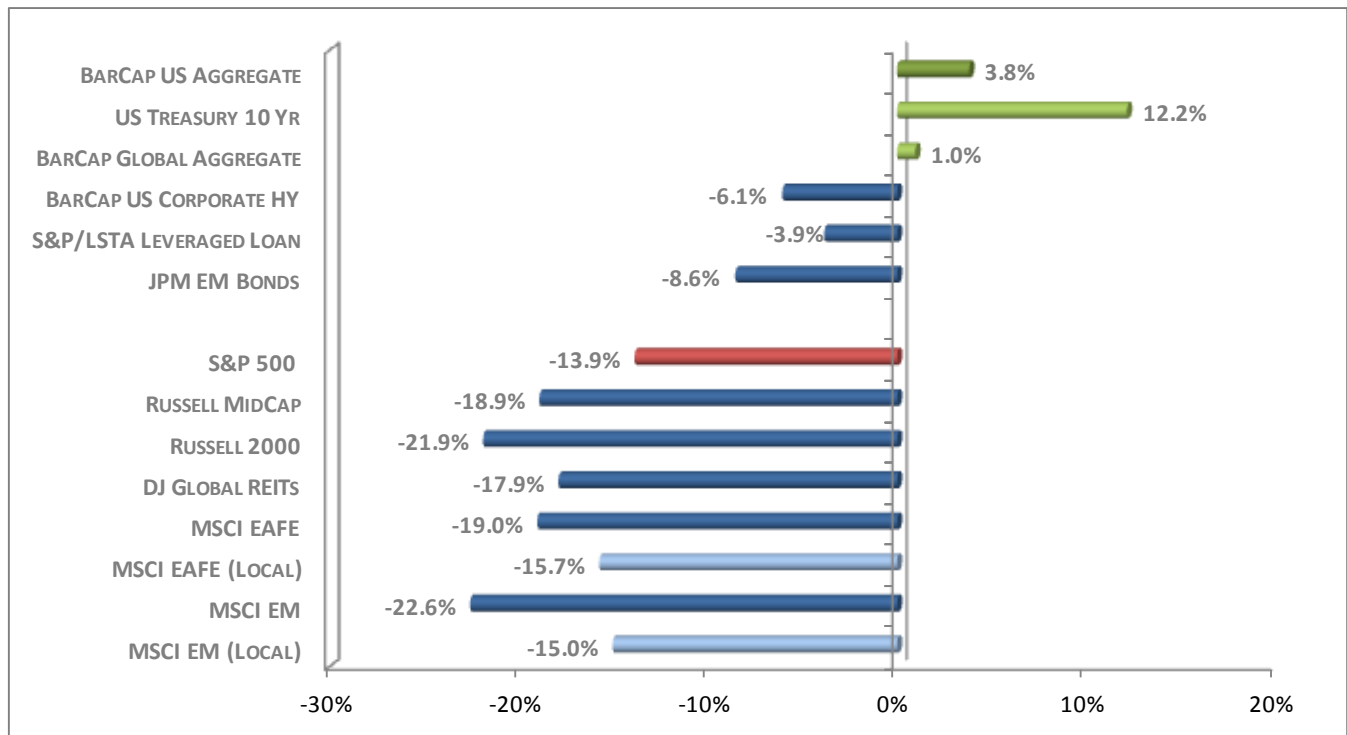


October 17th, 2011

COMMENTARY

“No news would be good news.” – Whitney George

The last several months have been characterized by excessive market volatility driven by deteriorating macroeconomic conditions and political paralysis on both sides of the Atlantic. Several events occurred during the quarter that shook investor confidence. Standard & Poor’s downgraded the U.S. credit rating on August 5th in response to growing debt concerns. The “soft patch” that began in the first half of the year became more problematic as continued mixed economic data rekindled fears of a double-dip recession. Finally, and arguably the most problematic, debt troubles in Greece escalated and European officials failed to present a comprehensive plan to contain the problem. Second quarter Gross Domestic Product came in well below expectations at a mere 1.3%. The pace of economic growth clearly slowed with a mounting concern that the Euro-zone credit problems may derail the global recovery. In the end, riskier assets sold off indiscriminately as a prodigious flight to safety dominated the investment markets.



Most global equity indices neared or achieved bear market status, commonly defined as a fall of 20.0% or more, during the quarter. Market losses were generally worse overseas, particularly in Europe as the continent’s debt crisis raised the likelihood of a recession. Emerging markets were one of the hardest hit by this retreat from risk, with several countries’ equity indices down in excess of 25.0% for the quarter. Even currencies succumbed to the flight to safety with the Euro (€) dropping over 6.5% against the dollar in the month of September alone. Emerging market currencies also declined as the diversified basket of currencies fell more than 7.0% in the quarter.

Fixed income assets, outside of U.S. Treasuries, were not immune from the risk off trade that took hold in the equity markets. Spreads, the incremental return investors demand for holding non-Treasury bonds, widened in many bond sectors to their highest levels in years as market participants repositioned holdings with a strong bias toward U.S. Treasuries. The exodus from riskier fixed income assets picked up steam in September propelling federally-backed fixed income securities to their best quarterly return in decades.

EQUITIES

The disparate performance results of major market indices across the globe, as illustrated in the prior chart, provide a glimpse into the challenging market environment over the quarter. Investors quickly shifted from anticipating a second half economic rebound to worrying that the world's developed economies may be heading into a recession. Equity markets moved higher in the first few weeks of the quarter as corporate earnings, merger news and earnings projections came in stronger than expected. However, stocks began to decline in late July as the federal government reached a stalemate on increasing the debt ceiling. The inability of the federal government to come to a resolution signaled that political uncertainty could further hamper growth. Standard and Poor's downgraded the credit rating of U.S. Treasuries primarily because of Washington's reluctance to provide a viable debt reduction plan. The combination of the credit downgrade, political gridlock, slower economic growth, and sovereign debt concerns pushed equity markets considerably lower for the last two months of the quarter.

Roughly 70% of the S&P 500 Index companies reported second quarter operating profits that exceeded analysts' expectations. Aggressive cost cutting persisted for the tenth consecutive quarter and increasing revenues from developing market economies pushed earnings higher. Earnings among S&P 500 companies posted double-digit growth for the seventh quarter in a row. As of quarter end, the S&P 500 Index traded at roughly 12 times current earnings per share (EPS) and 10 times 2012 EPS expectations. These historically low valuation levels, which represent about a 30% discount to the 20-year average, are generally associated with a recession rather than a growing economy. Overall, the more defensive sectors of the market outperformed with Consumer Staples down 4.2% and Utilities the only positive performer up 1.6%. Financials were hit hard as exposure to the credit contagion in Europe became increasingly troublesome and contributed to a 22.8% decline.

International equities, as measured by the MSCI EAFE Index, experienced their worst quarter in 3 years. In Europe, the combination of the continuing credit crisis and slower economic growth weighed on the markets. European equities declined over 22.0%, led by weakness in financial stocks and materials companies. In the United Kingdom, the FTSE 100 fell nearly 13.0% in the third quarter, also led by weakness in financials and materials stocks. In France, the CAC 40 declined over 24.0% due to weakness in shares of bank stocks and industrial companies. In Germany, the outlook for trade diminished as global economic activity slowed. The DAX lost over 25.0% in the third quarter, led lower by automakers and materials stocks.

Emerging market equities, as measured by the MSCI Emerging Markets Index, fell 22.5% in the third quarter as every country in the index declined. Despite much lower debt levels and faster economic growth vis-à-vis the developed markets, fear drove investors to "safety" and emerging markets experienced a rapid outflow of assets. Equity markets in China and Russia were among the hardest hit. Russia, with its rich oil reserves, pulled back notably as the price of oil declined on the prospect of slowing global demand. China has faced rising inflation over the last few quarters and is balancing the prospect of slowing growth and high inflation. Their government's ability to address this delicate issue has increased the ramifications of a policy mistake and during the quarter investors moved assets out of the country.

FIXED INCOME

The fear that embroiled equity markets was equally as impactful within the fixed income landscape. Investors took a categorically risk averse stance in response to considerable and escalating risks emanating from the European debt crisis and increasing concerns surrounding a slowdown in U.S. economic growth. U.S. Treasuries, particularly longer duration, rallied strongly in the third quarter. The 10-yr. Treasury advanced 12.2% recording one of its best quarterly returns ever. The yield on the 10-year Treasury dropped to the lowest level on record late in the quarter as investors were willing to exchange yield for safety. The real yield, which represents the yield on the 10-yr. Treasury minus the inflation expectations over the same period, dropped into negative territory for the first time in more than three decades.

Although Treasuries were the clear winners, investors also preferred other higher-rated domestic sectors. Mortgage backed securities, municipals, and investment grade bonds returned roughly 2.0% to 3.0% in the quarter. However, as credit rating deteriorated so did performance. High yield bonds, after having a very solid first half of the year, were hit hard and dropped over 6.0%. Slightly higher rated bank loan funds also suffered notably after dropping more than 4.0%. International developed market bonds, as measured by the Lipper International Income Funds average posted a loss of 1.7%. Although yields declined within the safest countries, such as Germany, the combination of rising yields in peripheral Europe and falling currency values was too much to overcome. Emerging market debt was particularly hard hit as the less than investment grade rating and falling currency values contributed to a decline of 8.6% in the quarter.

MARKET SUMMARY

Fear gripped the market as the European sovereign debt issues heightened the likelihood of a global recession. However, economic data outside of Europe continues to point toward slow growth rather than recession. Political rather than fundamental issues clearly drove sentiment and investor actions in the quarter. Equity diversification outside of domestic large cap stocks and fixed income diversification outside of Treasuries proved to be detrimental in this environment. Therefore, diversified portfolios struggled and returns were disappointing. However, history indicates that prudent diversification improves overall return and reduces portfolio volatility over longer time periods.

We believe the debt crisis in Europe will be addressed fairly soon. Lack of liquidity rather than insolvency is the primary issue facing the region and politicians seem to be presenting several strategies to improve liquidity and prevent sovereign rates from rising. Granted, progress has been slow, but recently definitive dates have been provided and discussions have increased. The fear associated with the global credit crises has been intense and clearly caused investors to flock to the perceived safety of Treasuries and the U.S. dollar. Consequently, any positive news out of Europe could unleash significant demand for higher yielding bonds and stocks. In addition, many risky assets are priced as if a recession is imminent. Therefore, these assets have attractive upside potential if a global recession is averted and they may not decline much if a recession occurs. The ratio of upside to downside return potential favors the upside and warrants continued exposure to assets that should outperform if sentiment improves. However, there is a great amount of uncertainty surrounding Europe and until the debt issues are resolved the markets will remain volatile and some caution is warranted.

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