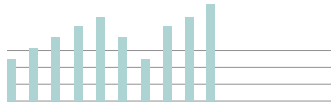


## Investment Snapshot

October 2011



## Third Quarter 2011 Market Review

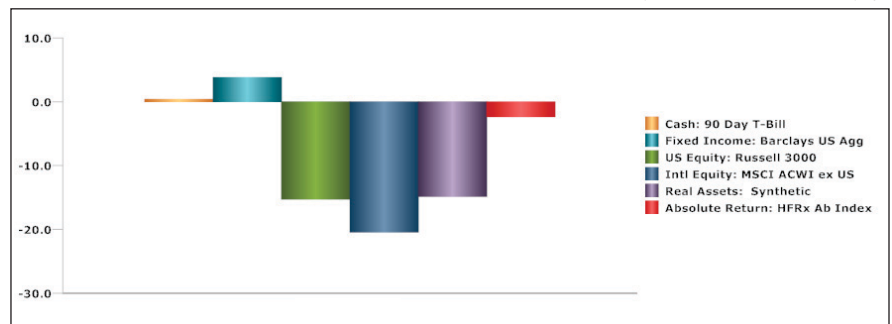
The third quarter sent investors on a roller coaster ride, with extreme volatility returning to the markets and global equities falling into bear market territory. Uncertainty prevailed as the quarter started with a nerve-rattling debt ceiling debate, and ended with an unresolved sovereign debt crisis accompanied by concerns that emerging market growth may stall. With more economists falling into the recession camp each day, aided by seemingly paralyzed policy makers and daily volatility that tears at confidence, the bears seemed to have the wind at their back.

Despite the fears, we believe it is possible to avoid a recession because the underlying fundamentals are much better than the market implies. We believe there are opportunities the hyperactive market and gloomy consensus have provided for long-term investors.

### ***Flight to Safety***

*Q3 was characterized by a flight to safety. Investors chose safe harbors in cash or U.S. Treasuries at the expense of every other asset class. Fixed income outperformed other asset classes for the quarter. The Fed's operation twist pushed down long-term yields, which resulted in longer term bonds outperforming short-term bonds. International and emerging market bond returns were hurt as investors flocked to the safety of the dollar.*

See performance disclosure on final page



### **Q3 Asset Class Performance**

In equity markets, domestic large cap was the relative winner. International stocks suffered the worst performance. Real estate and natural resources fell in tandem with the world equity market,

but managed to outperform stocks. Hedge funds, consistent with their characteristically lower relative volatility, fared much better than equity markets but were still negative for the quarter.

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**“ If recession is avoided there are some values in cyclical and growth stocks that could get a nice bounce...”**

**Tactical Positioning in 4th Quarter**

Earlier in the year, we reduced our exposure to riskier assets. Now that recession fears have increased, we are taking additional steps to further protect portfolios. These include increasing exposure to hedge, cash and high quality stocks. We continue to overweight emerging market stocks, but given the challenges these economies face we have reduced our positions. If recession is avoided there are some values in cyclical and growth stocks that could get a nice bounce; we are looking to opportunistically add to positions.

On the fixed income front, it is important to understand the Fed has stated it expects economic conditions to warrant low rates well into 2013, but it has not promised

to keep rates low. After inflation, real rates on the 10-year Treasury are negative. To put this in perspective, real rates have historically been 1.6% during recessions and 2.8% during expansions. If you believe in “reversion to the mean”, rates will eventually increase by at least 3%! We expect rates to remain low for a while, but investors simply aren’t being paid for the risk of purchasing longer-term maturities. Thus, we think it’s prudent to maintain shorter durations and pick up additional yield through modest exposure to less interest rate-sensitive bonds. On the investment grade front, we favor municipal bonds as their yield spreads relative to Treasuries are quite favorable and we believe default fears are declining.

Asset Class	Underweight	Neutral	Overweight
Cash			■
Fixed Income	■		
Domestic Equities		● →	■
Foreign Equities	■ ←	●	
Natural Resources	■ ←	●	
Real Estate	■ ←	●	
Hedge			■

Circles represent previous quarter’s position

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**Signs of Improvement**

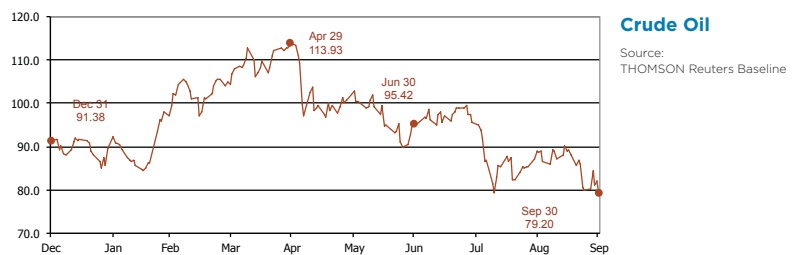
- Weekly retail chain store sales are strong.
- Auto sales are rising.
- Loan demand is rising.
- Durable goods orders are increasing.
- ISM Manufacturing and Service Surveys show expansion.
- U.S. banks are better capitalized.
- U.S. corporations have nearly \$2T in cash.

**The Bull's Case for Growth**

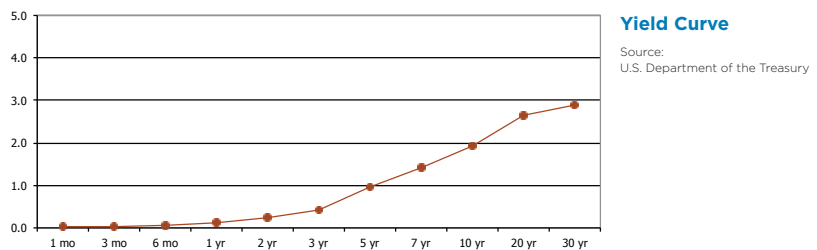
The economy is running lean, evidenced by low business inventories and auto and housing sales running below replacement rate levels. Companies are operating with relatively low staffing levels, and business investment has been modest. Recessions usually occur when these indicators are overheated.



Household debt service ratios are down and housing affordability is up strongly, which makes it much more attractive to buy a house than rent. It will still take time to work through the excess housing inventory created by foreclosures, but when housing picks up a major multiplier effect is likely.



Oil and other commodity prices have dropped since May. This acts as a tax cut to companies that use raw materials, and puts more money in the consumer's pocket.



Monetary policy is extremely loose, and the yield curve is normal. Recessions usually occur after the curve has inverted (when short-term interest rates are higher than long-term rates).

Many countries have started easing monetary policy to reaccelerate growth, and others are expected to follow. Japan is also expected to positively contribute to world consumption as they rebuild after the earthquake and tsunami.

### U.S. Recession Risk

- Political wrangling in the U.S. could lead to greater uncertainty further hurting consumer confidence. Let's hope politicians have learned the "circular firing squad" approach is not helping anyone, including themselves.
- Historically, economies whose downturns are caused by excessive debt take longer to recover, because such economies have fewer tools and less capacity available to absorb additional economic shocks while unwinding debt.
- If emerging markets go into recession or their growth slows too quickly, the U.S. would be negatively impacted.

### What Could Trigger a Recession?

#### Sovereign Market and Vulnerability Indicators

(Percent of 2011 projected GDP, unless otherwise indicated) Table Source: International Monetary Fund.

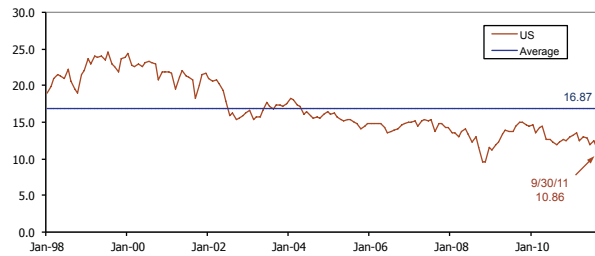
Country	Net General Government Debt (% of 2011 GDP)	Sovereign Credit Rating/Outlook (notches above speculative grade/outlook) As of 8/31/11	
Australia	7.70%	9	Stable
Austria	52.50%	10	Stable
Belgium	79.90%	9	Negative
Canada	34.90%	10	Stable
Czech Republic	n.a	6	Stable
Denmark	1.80%	10	Stable
Finland	-59.70%	10	Stable
France	81.00%	10	Stable
Germany	57.20%	10	Stable
Greece	n.a	-8	Negative
Ireland	98.80%	2	Negative
Italy	100.40%	7	Negative
Japan	130.60%	7	Negative
Korea	30.80%	5	Stable
Netherlands	30.60%	10	Stable
New Zealand	7.80%	9	Negative
Norway	-161.00%	10	Stable
Portugal	101.80%	0	Negative
Slovak Republic	n.a	6	Stable
Slovenia	n.a	8	Negative
Spain	56.00%	8	Negative
Sweden	-20.80%	10	Stable
United Kingdom	72.90%	10	Stable
United States	72.60%	9	Negative

If policy makers in Europe are unable to implement credible plans to contain the sovereign debt crisis, the impact would be felt globally. The deepening of the crisis has finally jolted policy makers to take it more seriously. Since a failure to act would have such dire consequences for all, there's ample incentive for policy makers to get their act together. Fortunately, Europe has many options available if they muster the political will.



Europe may go into recession even if they sort out their debt problems, but it is not clear what the impact would be on the U.S. economy. Emerging market consumers make up more than 30% of global consumption, and this is expected to jump higher in the coming years; hopefully offsetting some of the drag from Europe.

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### Forward 12-month P/E Ratio

Source:  
THOMSON Reuters Baseline.

### Market Valuations Represent Opportunities

The markets appear to be pricing in a mild U. S. recession as the S & P 500 price/earnings ratio (P/E) is currently 10.86 times forward earnings estimates, with an even lower multiple in foreign stocks. As a point of reference, the market's P/E was over 30 going into the 2002 recession and close to 15 just before the 2008 recession. The 20 year average P/E ratio has been 16.87 and typically has been much higher during low interest rate environments. This implies earnings could drop 30% before stocks would look expensive on a historical basis. Imagine the upside potential if we avoid recession and just muddle along? What if we do better than muddle? One caution: while valuations eventually matter, no one cares in the midst of a panic. Should fundamental economic data suggest that a recession is in the cards, stocks will likely sell off, making them even cheaper.

### Stay Diversified and Invested – And Look on the Bright Side!

Staying diversified and invested amidst all the negative headlines and volatility can be difficult. As a wealth manager, we can be perceived as sounding like a broken record or out of touch when giving such basic advice. However, research has shown that individual investors vastly underperform the market due to emotional market timing decisions that seem prudent at the time. Interestingly, over the last 40 years, stocks have been up an average of 25% in the twelve months following the day the consumer sentiment report hits bottom for that particular cycle. We just had a very low reading in August. Although it often pays to be a contrarian, with so much gloom and doom, now might be the right time to be an opportunist.

### Disclosure:

The information and opinions expressed herein may not be suitable for all investors and should not be construed as specific investment, tax, or legal advice or as an offer or recommendation to purchase or sell securities of any kind. Highland's opinions and judgments are based on historical data and current market analyses and are subject to change without notice. Investing in securities may involve risk, including total loss of principal, and as such investors should consult with their investment, tax and legal advisors before pursuing any investment strategy.

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