Market Insight

Third Quarter 2013

Fed Concerns Dominate Third Quarter

Highlights

The Fed surprised many with its decision not to taper bond purchases in September. Buoyed by continued Fed support, the third quarter rewarded stock investors and reassured bond holders. Though risks lie ahead, LPL Financial Research does not believe the current bull market, the best four-and-a-half year bull market since WWII, is over. Though volatility may increase, we believe the foundation is in place for stocks to post further gains and bonds to provide modest positive returns over the balance of the year.

- **Economy** – The U.S. economy continues to grow at a sluggish pace as the fourth quarter begins. Despite a pickup in the pace of growth in the second quarter to 2.5%, as measured by gross domestic product (GDP), growth will be challenged to reach 2.0% during the just-completed third quarter. Consumers continue to spend, jobs are being added, Federal Reserve (Fed) policy remains supportive, but government spending remains a drag.
- **Stocks** – The strong year for stocks continued in the third quarter. As has been the case throughout the year, investors had plenty to worry about, including the Fed pulling back stimulus, the related sharp rise in interest rates, a possible U.S. military strike in Syria, and the budget battle in Washington. But the stock market climbed the wall of worry and moved higher. The S&P 500 returned 5.2% during the third quarter, bringing its year-to-date return to 19.8%.
- **Commodities** – Commodities endured a volatile third quarter but ended with gains of 2.1% based on the Dow Jones-UBS Commodity Index. Commodities took investors on a bumpy ride as oil and metal markets reacted to the events in Syria and unpredictable Fed policy, but garnered some support from reassuring emerging market data. The broad commodity index is down 8.6% year to date in what has been a challenging year.
- **Bonds** – Fixed income generally fared well in the third quarter thanks largely to continued support from the Fed. For most of the quarter, yields rose as markets continued to try to digest the prospect of the Fed starting to rein in its bond purchases. Following the Fed's decision to delay tapering on September 18, 2013, yields began to retreat, sending the 10-year yield down to 2.62% at quarter end. Thanks to the strong September, the Barclays Aggregate Bond Index finished with a 0.57% quarterly gain, although the index is still down 1.89% for the year.

For insight into our forecasts, please see our *Mid-Year Outlook 2013* publication.

1 Q3 At a Glance

Q3 GDP*	2.0%
S&P 500 Index	5.2%
Barclays Aggregate Bond Index	0.57%
DJ-UBS Commodities Index	2.13%

Source: FactSet,Bloomberg, LPL Financial 09/30/13

*Bloomberg consensus

Figures for S&P, Barclays Aggregate and DJ-UBS Commodities Index are total returns from 7/1/13–9/30/13

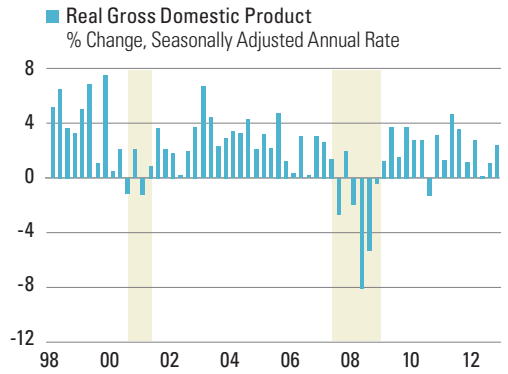
All indices are unmanaged and cannot be invested into directly. The returns do not reflect fees, sales charges or expenses. The results don't reflect any particular investment. Past performance is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Please note: all return figures are as of September 30, 2013 unless otherwise stated.

LPL Financial

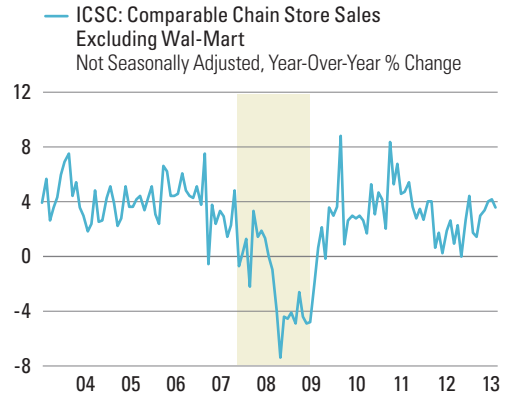
2 The U.S. Economy Continues to Grow at a Sluggish Pace



Source: Bureau of Economic Analysis, Haver Analytics 09/30/13

Shaded areas indicate recession.

3 Consumers Continue to Spend Despite Higher Taxes and Modest Income Growth



Source: ICSC, Haver Analytics 09/30/13

Shaded areas indicate recession.

The International Council of Shopping Centers (ICSC) is a global trade association of the shopping center industry.

Slow Growth Continues for the U.S. Economy

The U.S. economy continues to grow at a sluggish pace as the fourth quarter begins. Despite a pickup in the pace of growth in the second quarter to 2.5%, as measured by gross domestic product (GDP) [Figure 2], growth will be challenged to reach 2.0% during the just-completed third quarter once all the data are reported. Consumer spending has remained resilient. Jobs are being added, albeit gradually. The housing recovery has continued. Retail sales are still chugging along at a near 4% growth rate despite these challenges [Figure 3], roughly in line with consumer income gains over the past 12 months based on the latest personal consumption and income data (August 2013). And the Fed remains very accommodative, having maintained its bond-purchase program (quantitative easing) throughout the quarter. But government spending remained a drag on growth throughout the third quarter and will continue to through year end.

Government Spending Drag Beginning to Ease

Consumer spending is helping the economy grow, as is business spending. But another major piece of the U.S. economy, government spending, is pulling in the opposite direction due to cuts to government spending prescribed by the sequester. The economy continues to be hampered by reductions in government spending levels, although the drag will be less in the third quarter than in the second, and it has helped the U.S. government bring down the deficit significantly. Nonetheless, the government drag will persist and create a headwind against the U.S. economy over the balance of the year. Take the government out of picture, and the pace of growth for the U.S. economy would be respectable at around 3%, in line with long-term averages and near its potential.

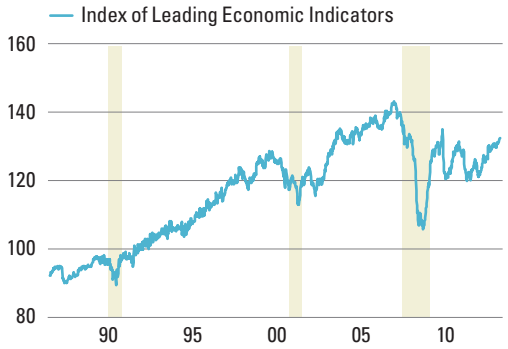
Job Growth Just Plodding Along

Unfortunately, the pace of improvement in the labor market matches the sluggish pace of U.S. economic growth. After a strong first quarter, when over 200,000 new jobs per month were created, the pace of improvement has slowed markedly. From April through August, an average of just 164,000 new jobs were created per month. This pace is below that which would typically be seen at the current stage of an economic recovery and contributed to the Fed's decision not to taper bond purchases. Should the current pace of economic growth continue at or near 2%, a meaningful uptick in new jobs created is unlikely. While the unemployment rate, last reported at 7.3% (August 2013), has edged slightly lower in recent months, the drop has coincided with a drop in the workforce participation rate, suggesting little true improvement in labor market conditions.

Quantitative Easing (QE)

The continued slow pace of U.S. economic growth, along with spare capacity in labor and product markets, has continued to keep inflation well contained. This benign inflation picture, along with well-anchored inflation expectations by consumers and reflected in markets, contributed to the Fed's decision not to taper its bond purchases in September—a surprise

4 Leading Economic Indicators Suggest Very Low Probability of Recession



Source: Economic Cycle Research Institute, Haver Analytics 09/30/13

Shaded areas indicate recession.

The index of leading economic indicators (LEI) is an economic variable, such as private-sector wages, that tends to show the direction of future economic activity.

to many—and is a reason why the Fed may choose not to taper at its next policy meeting in October. Low inflation (as well as the Fed) also helped pull the yield on the 10-year Treasury note back to the low end of its recent range between 2.6% and 3.0%.

Leading Indicators Suggest Very Low Likelihood of Recession

Based on the Leading Economic Index (LEI), a recession in the United States remains highly unlikely despite the sluggish pace of U.S. economic growth, stagnation in Europe, and the risk of a major policy mistake in Washington. The LEI can be a useful, fact-based, forward-looking tool to determine where the U.S. economy may be headed [Figure 4].

Overseas Economies Have Stabilized

Our assessment of Europe is that it has stopped getting worse, but few signs of meaningful improvement are evident to us as the third quarter ended. German Chancellor Merkel's convincing re-election in September helped on the margin by removing a risk, but the region continues to struggle to grow as banks, consumers, and businesses continue to repair their balance sheets and businesses' access to credit is constrained. After contracting by 0.2% during the first quarter of 2013, the sixth straight quarterly contraction, the Eurozone economy managed to grow just 0.3% in the second quarter.

Europe is getting some help from recent stabilization of growth in China. Although many emerging markets continue to struggle with prospects for tighter Fed policy, the economic growth picture in China, the biggest emerging market economy, has started to improve. But while a hard landing appears unlikely for China, the growth trajectories of several other key emerging market countries, notably India, have not improved. Europe is heavily dependent on emerging market exports (roughly 60% of exports based on the latest Census data), and relies on emerging markets to help boost growth.

Stocks Continued Strong Gains During the Third Quarter

The strong year for stocks continued in the third quarter. As has been the case throughout the year, there was plenty for investors to worry about, including the Fed tapering its bond-buying program, a sharp rise in interest rates, a possible U.S. military strike in Syria, high oil prices, and the budget battle in Washington that led to the first government shutdown in 17 years as the quarter ended. Meanwhile, a fight with higher stakes looms on the federal debt limit in mid-to-late October. But, as has happened throughout the current bull market, the stock market fought through these challenges and climbed the "wall of worry." The S&P 500 returned 5.2% during the third quarter, its third straight quarterly gain, bringing its year-to-date return to 19.8% as of September 30, 2013. The S&P 500 is more than 150% higher than when the bull market began on March 9, 2009 (as of September 30, 2013), making this four-and-a-half year bull market the strongest since WWII.

5 Path to Quarterly Gains for Stocks Was not a Straight Line

Source: FactSet, LPL Financial 09/30/13

The S&P 500 Index is an unmanaged index, which cannot be invested into directly. The returns do not reflect fees, sales charges or expenses. The results don't reflect any particular investment. Past performance is no guarantee of future results.

6 Strong Quarter for Cyclical Sectors, Not So for Rate Sensitive Sectors
Ranked by Third Quarter Returns

Sector	Q3 2013 (%)	YTD (%)
Materials	10.3	13.5
Industrials	8.9	23.9
Consumer Discretionary	7.8	29.1
Health Care	6.8	28.5
Technology	6.6	13.4
S&P 500	**5.2**	**19.8**
Energy	5.2	15.4
Financials	2.9	22.9
Consumer Staples	0.8	16.1
Utilities	0.2	10.1
Telecom	-4.4	5.7

Source: FactSet, LPL Financial 09/30/13

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Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

The asset classes are represented by the ten S&P 500 Global Industry Classification Standard (GICS) indexes.

Economic improvement may have been the biggest factor driving investor confidence. Beginning in June, U.S. economic data, though still not great, began to improve and, perhaps more importantly, consistently exceeded expectations. For example, the widely watched Institute for Supply Management (ISM) manufacturing index rose from 49 to 57, and the unemployment rate fell from 7.6% to 7.3%. The economic data overseas, notably from China, also started to get better. Outside of better data, the market got a lift from some healing in the bond market after significant volatility in late May through June. The market gained some level of comfort with the Fed policy outlook early in the quarter, while the central bank's surprising decision not to taper its bond purchases on September 18 also provided some support for stocks as the S&P 500 set a fresh all-time high that day.

The path for stocks during the quarter was not a straight line, nor was it in the prior quarter when taper fears first surfaced back in May 2013. The quarter began with a very strong July and a return of 5.1% for the S&P 500. Then another bout of taper fears, along with escalating tensions in Syria, led stocks lower in August. The S&P 500 lost 2.9% for the month, just its second down month in 2013, and experienced its largest pullback of the quarter (-4.6%) from August 2 through August 23, 2013. Stocks then staged another rally in September, historically a weak month for stocks, sending the S&P 500 up another 3.1%. Gains peaked on September 18, the day the Fed announced it would not taper bond purchases, before falling seven of eight days to end the quarter.

Cyclical Sectors Continued Strong Performance

Cyclical sectors fared well again during the third quarter while defensive sectors and the most interest rate sensitive sectors lagged. After unusually strong defensive (and higher yielding) sector performance when stocks rallied double-digits during the first quarter, cyclical (economically sensitive) sectors have paced the market's gains since. The sectors at the top of the quarterly rankings—materials, industrials, and consumer discretionary—are consistent with the improvement in the global economic outlook during the third quarter, especially in the United States. Meanwhile, the market's insatiable thirst for yield early in the year has been replaced by a greater focus on fundamentals and valuations. These cyclical sectors also carry the most "beta," or market sensitivity, and tend to perform better when the broad stock market rises. The higher-yielding sectors were hurt by rising interest rates much of the quarter, but failed to get a lift from the pullback in interest rates that occurred following the Fed's decision not to taper. For the year, consumer discretionary and health care are the top-performing sectors, both of which benefit from the resilience of U.S consumers.

Cyclical sectors are economically sensitive and typically have stronger performance as economic and market conditions improve.

Defensive sectors typically are less economically sensitive and tend to perform relatively better in more challenging economic and market environments.

7 Small Caps and Developed Foreign Markets Stood Out

Asset Class	Q3 2013 (%)
Developed Foreign	11.6
Small caps	10.2
Growth	8.1
Large caps	6.0
Emerging Markets	5.9
Value	3.6

Source: FactSet, LPL Financial 09/30/13

Based on Russell 1000, Russell 3000 Growth and Value Indexes, Russell 2000, MSCI EAFE, MSCI EM Index

Total returns from 7/1/13–9/30/13

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Mid-capitalization companies are subject to higher volatility than those of larger capitalized companies.

Small cap stocks may be subject to a higher degree of risk than more established companies' securities. The illiquidity of the small cap market may adversely affect the value of these investments.

Value investments can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time.

Small Caps Stood Out

Small cap stocks continued their impressive 2013 with a strong performance during the third quarter. The Russell 2000 Index, which reached a new all-time high in September, (as did the S&P 500 Index), benefited from a number of factors, including its U.S. focus, a more cyclical and less interest rate sensitive sector mix, a high beta, and strong earnings growth relative to that which was being delivered by large caps, based on the Russell 1000 Index. According to FactSet consensus estimates, the Russell 2000 Index is expected to produce 11% earnings growth in 2013, compared to 6% for the large cap Russell 1000 Index. Stable credit markets have also helped, as smaller companies tend to require more access to capital markets than their larger peers. The strong small cap performance was broad-based, as nine of 10 small cap sectors outperformed their large cap counterparts. The Russell 2000 Index returned 10.2% in the quarter, followed by the Russell 1000 Index (+7.7%) and the Russell Midcap Index (+6.0%). Small caps have led year to date with a 27.7% return (through September 30, 2013), ahead of the 24.3% and 20.8% returns for mid and large caps, respectively.

Growth Style Resurgence Continued on Strong Technology Sector Performance

In terms of style, growth outperformed value during the third quarter for the first time since the first quarter of 2012, based on the Russell 3000 style indexes for broad market cap representation. The biggest driver of the improved performance for growth was improved performance by technology, the biggest growth sector. Conversely, underperformance by the value-heavy financials sector was a drag on value's relative performance. Historically, growth has tended to perform better in slow economic growth environments, when earnings growth is scarce, although investors seeking yield in value stocks in the low interest rate environment have derailed this pattern much of this year. Growth outperformance was broad-based, like small cap outperformance, as the growth style outperformed its value counterpart in seven of 10 sectors. During the quarter, the Russell 3000 Growth Index returned 8.5%, compared to 4.2% for the Russell 3000 Value Index. The strong third quarter pushed growth ahead of value for the year, 21.8% to 20.7%, as of September 30, 2013.

Looking beyond U.S. markets, the story of the quarter for equities was the strong rebound in developed foreign markets, Europe in particular. After underperforming substantially in the first half of the year, Europe emerged from recession during the spring and early summer and helped European equity markets recover. Economic conditions in Europe have stopped getting worse, but growth remains anemic and further outperformance may require some acceleration in growth, a tougher task. In addition, a sizable portion of Europe's outperformance was driven by a weaker US dollar versus the euro and British pound. Nonetheless, solid gains in Europe helped the developed foreign market benchmark, the MSCI EAFE Index, return a solid 11.6% during the third quarter, well ahead of the U.S. broad market averages. Other key developed foreign markets, including Japan, Hong Kong, and Australia, performed well but trailed gains in Europe during

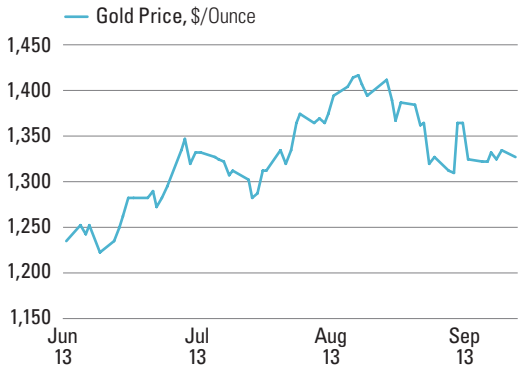
the quarter. Year to date, the MSCI EAFE Index has returned 16.6%, which is still behind the 19.8% return for the S&P 500 Index.

International and emerging markets investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Emerging Markets Improved vs. First Half Underperformance

The emerging markets comeback from significant underperformance in the first half of the year is not nearly as far along as that in developed foreign markets. Overall, with a 6% return during the third quarter, the MSCI Emerging Markets Index did slightly better than the S&P 500. But the benchmark is still down for the year as of September 30, 2013, with a 4% loss. While the broad asset class has struggled this year, the improving economic growth picture in China was recognized by markets as Chinese stocks posted double-digit returns in the quarter based on the MSCI China Index. An improving global economic backdrop helped several other key emerging market countries, including Brazil and Korea, while other countries struggled with prospects for tighter Fed policy, deteriorating growth, and capital outflows, such as India and Indonesia, which weighed on the performance of emerging market equities overall.

8 Syria Tensions, U.S. Policy Concerns, and the Fed Helped Gold Rebound

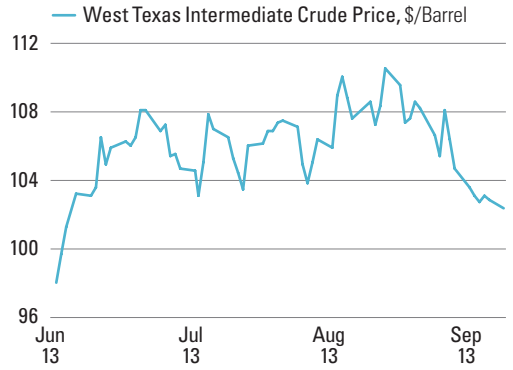


Source: FactSet, LPL Financial 09/30/13

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Precious metal investing is subject to substantial fluctuation and potential for loss.

9 Oil Pulled Back in September as Syrian Tensions Eased



Source: FactSet, LPL Financial 09/30/13

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Tough 2013 for Commodities Continues

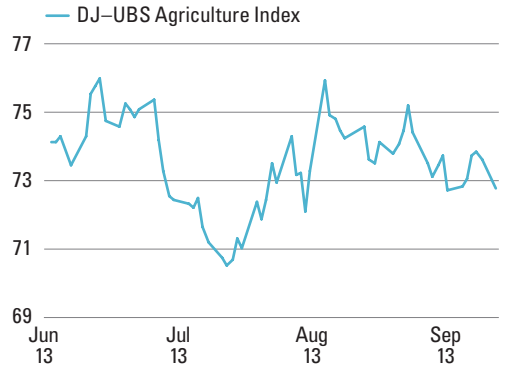
Commodities endured a volatile third quarter but ended with gains of 2.1% based on the Dow Jones-UBS Commodity Index. Commodities began the quarter with modest gains against the backdrop of reassuring emerging market data, some growth-driven inflation concerns, and a weak US dollar. But the group took investors on a bumpy ride as oil and metal markets reacted to the events in Syria and unpredictable Fed policy. With these modest gains, the broad commodity index is down 8.6% year to date in what has been a challenging year.

Precious metals were among the best-performing commodity sectors in the quarter, triggered in part by a flight to safety related to the threat of a U.S. military strike on Syria, but also by prospects for improving Asian demand and concerns over the budget battle in Washington. Gold rose 8% as the China outlook improved (China is the world's largest gold consumer), while silver fared even better with an 11% gain. Late in the quarter, precious metals experienced some selling pressure amid Fed taper fears, but stabilized following the Fed's surprising no taper decision. Industrial metals also benefited from the improving growth picture in China and several other key emerging market countries.

West Texas Intermediate (WTI) crude oil remained elevated due to heightened risk in the Mideast and ended the quarter about 8% higher, near $102 per barrel. Crude oil is among the best-performing commodities for the year with a 10% advance. Unseasonably warm weather and abundant supply dragged natural gas prices lower, making it the worst-performing major commodity in the quarter.

Agriculture was unable to reverse its recent downtrend. Tighter supply and worries of wetter-than-normal conditions in August briefly lifted prices

10 Seasonal Bounce for Agriculture Was Short-lived

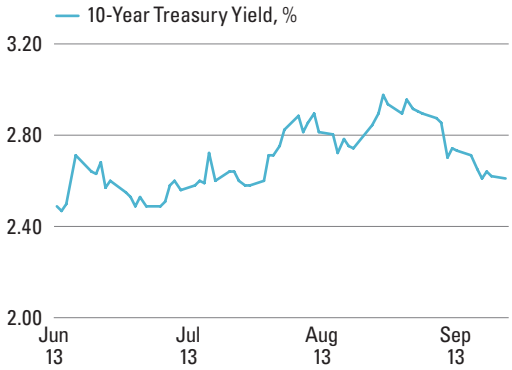


Source: FactSet, LPL Financial 09/30/13

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

The Dow Jones - UBS Agriculture Index is an unmanaged index which cannot be invested into directly. The returns do not reflect fees, sales charges or expenses. The results don't reflect any particular investment. Past performance is no guarantee of future results.

11 Bond Yields Reversed Lower in September as Taper Fears Proved Misplaced



Source: FactSet, LPL Financial 09/30/13

The risks associated with investment-grade corporate bonds are considered significantly higher than those associated with first-class government bonds. The difference between rates for first-class government bonds and investment-grade bonds is called investment-grade spread. The range of this spread is an indicator of the market's belief in the stability of the economy.

Credit quality is one of the principal criteria for judging the investment quality of a bond or bond mutual fund. As the term implies, credit quality informs investors of a bond or bond portfolio's credit worthiness, or risk of default.

Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity and redemption features.

before reports later in the quarter suggested supply was still strong from higher acreage use. Among individual commodities, only cocoa and cotton are higher year to date on greater supply disruptions and poor weather in key production areas overseas.

Fixed Income – Taxable: Fed Helps Provide Stability and Fuels Bond Market Gains

Fixed income remained investors' primary focus in the third quarter and generally fared well thanks in large part to continued support from the Fed. For most of the quarter, yields rose as markets continued to try to digest the prospect of the Fed starting to rein in its bond purchases. The 10-year Treasury, which ended the second quarter at 2.52%, peaked for the quarter at 2.98% on September 5. Following the Fed's decision to delay tapering on September 18, yields began to retreat, sending the 10-year down to 2.62% at quarter end, up only 13 basis points for the quarter compared to a 62 basis point rise in the second quarter. Thanks to the strong September, the Barclays Aggregate Bond Index finished with a 0.57% quarterly gain, although the index is still down 1.89% for the year, as of September 30, 2013. Credit spreads narrowed over the quarter, leading to a particularly strong quarter for high-yield corporate bonds, while the intermediate part of yield curve was the sweet spot in terms of duration.

With duration playing a smaller role this quarter, credit risk was rewarded with high-yield corporates leading all major domestic fixed income sectors with a 2.28% return. With some improvement in the economic backdrop this year, while corporate defaults remain low, high-yield corporates have also led the bond market year to date with a 3.73% return based on the Barclay's High-Yield Index.

Bank loans continued to attract investors for their limited interest rate sensitivity and were again among the sector leaders for the quarter with a 1.17% return. But unlike the prior quarter, when duration drove sector outperformance, the improving credit environment played a larger role in the third quarter.

Duration still differentiated performance in the third quarter, although far less significantly than it did in the second quarter. Intermediate-term bonds fared best based on the Barclays government and credit indexes. Longer duration bonds generally lagged, in particular among high-quality government bonds but within credit as well, as they have for the year. Year to date, short duration has been the best place to be, while intermediate government and investment-grade corporate bonds in 2013 have outpaced the broad bond market, as measured by the Barclays Aggregate Bond Index.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

Bank loans are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk.

Preferred stock investing involves risk, which may include loss of principal.

Mortgage-backed securities are subject to credit, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, and interest rate risk.

Treasury inflation-protected securities (TIPS) help eliminate inflation risk to your portfolio, as the principal is adjusted semiannually for inflation based on the Consumer Price Index—while providing a real rate of return guaranteed by the U.S. government.

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12 The Fed Helped Several Key Fixed Income Sectors Recover in the Third Quarter
Ranked by Third Quarter Returns

Sector	Q3 2013 (%)	YTD (%)
Foreign Bonds (Unhedged)	4.06	-3.37
High-Yield	2.28	3.73
Bank Loans	1.17	3.60
Mortgage-Backed Securities	1.03	-1.00
Foreign Bonds (Hedged)	1.01	0.98
Emerging Market Debt	0.87	-7.43
Investment-Grade Corporates	0.82	-2.62
Barclays Aggregate	**0.57**	**-1.89**
US Treasuries	0.10	-2.01
Municipal Bonds	-0.19	-2.87
TIPS	-0.70	-6.74
Preferred Securities	-2.17	-1.74
Municipal High-Yield	-2.96	-5.08

Source: FactSet, LPL Financial 09/30/13

The indexes mentioned below are unmanaged and you cannot invest into directly. The returns do not reflect fees, sales charges or expenses. The results don't reflect any particular investment. Past performance is no guarantee of future results.

Asset class returns are represented by the returns of indexes and are not ranked on an annual total return basis. It is not possible to invest directly in an index so these are not actual results an investor would achieve.

Asset Class Indexes: Emerging Market Debt – JP Morgan Emerging Markets Global Index; High-Yield – Barclays US High Yield Corporate Index; Foreign Bonds (un-hedged) – Citigroup Non-US World Govt Bond Index (un-hedged); Municipal High-Yield – Barclays Municipal High-Yield Index; Bank Loans – Barclays US High-Yield Loan Index; Invst-Grade Corporate – Barclays US Corporate Bond Index; Municipal – Barclays Municipal Bond Index;Preferred Stocks – Merrill Lynch Preferred Stock Hybrid Index; TIPS – Barclays Treasury Inflation Protected Securities Index; Foreign Bonds (hedged) – Citigroup Non-US World Govt Bond Index Hedged for Currency;Mortgage-Backed Securities – Barclays US MBS Index; Treasury – Barclays US Treasury Index.

A late surge following the Fed's tapering decision helped drive a strong rebound in some of the sectors hit hardest during the spike in rates. Rate-sensitive Treasury Inflation-Protected Securities (TIPS) returned 1.45% in September to end the quarter up 0.70%, although they remain one of the worst-performing sectors on the year with a 6.74% loss. Buoyed by improving economic data and some relief from capital outflows from taper fears, emerging market debt (EMD) surged on the Fed announcement, returning 2.87% in September. EMD still managed only an 0.87% return for the quarter, based on the JPMorgan Global Emerging Markets Bond Index, and not much better than the Barclays Aggregate Bond Index, while the 7.43% loss for the year is worst among all major fixed income sectors. Emerging markets have struggled with uneven growth in China, deteriorating growth trajectories in several key emerging market countries, and prospects for less Fed stimulus. Mortgage-backed securities, one of the sectors supported by Fed purchases, outperformed the broad bond market in the quarter, although returns remain negative for the year. Preferreds, which did not participate in the late September rebound in the bond market, ended September with a modest loss to finish the quarter down 2.17%.

With much of Europe emerging from recession, and a strong euro due in part to the Fed, developed foreign bonds, particularly unhedged, had a strong quarter. Currency-hedged foreign bonds returned 1.01%, while US dollar weakness helped contribute to an impressive 4.01% return for unhedged foreign bonds, the strongest bond sector this quarter. These gains were still not enough to lift this sector into positive territory for the year, as the Citigroup Non-U.S. Government Bond Un-Hedged Index has lost 3.37% year to date.

Among taxable bond sectors, only bank loans and high-yield managed positive returns in the first nine months of the year. Bank loans have benefited from their short duration and above-benchmark yields. High-yield has benefited from higher yields, economic sensitivity, low corporate defaults, and below-benchmark duration.

Fixed Income – Tax-free: Despite September Boost From Fed, Municipal Bonds Struggled in the Third Quarter

High-profile distressed issuers and poor liquidity combined to make it a challenging quarter for municipal bonds. Despite overall improvement in state and municipal budgets, the city of Detroit's bankruptcy filing, the biggest ever for a U.S. city, and threats of more credit downgrades of Puerto Rico, spooked municipal bond holders who were already skittish from the volatility in interest rates. The illiquidity in these markets further exacerbated the sell-off, making for very challenging conditions for municipals, and high-yield municipals in particular.

Attractive valuations did help prime greater interest, though, while the boost from the Fed helped performance late in the quarter. In fact, high-yield municipals and long municipals topped all major bond sectors, taxable or tax free, in September. Nevertheless, it was not enough to compensate for

prior weakness. High-yield municipals lost 2.96% for the quarter and have fallen 5.1% for the year. High-quality municipals, based on the Barclays Municipal Bond Index, fared better in the quarter, losing just 0.19% after climbing 2.15% in September. As with corporates, short- and intermediate-term municipals have outpaced their long-term counterparts this year as interest rates have risen. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Stock investing may involve risk including loss of principal.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. It is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. The bigger the duration number, the greater the interest-rate risk or reward for bond prices.

Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

Quantitative easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

Default rate is the interest rate charged to a borrower when payments on a revolving line of credit are overdue. This higher rate is applied to outstanding balances in arrears in addition to the regular interest charges for the debt.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise and bonds are subject to availability and change in price.

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Credit risk is the risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation. Credit risk arises whenever a borrower is expecting to use future cash flows to pay a current debt. Investors are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation. Credit risk is closely tied to the potential return of an investment, the most notable being that the yields on bonds correlate strongly to their perceived credit risk.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

Materials Sector: Companies that are engaged in a wide range of commodity-related manufacturing. Included in this sector are companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products, metals, minerals and mining companies, including producers of steel.

Energy Sector: Companies whose businesses are dominated by either of the following activities: The construction or provision of oil rigs, drilling equipment and other energy-related service and equipment, including seismic data collection. The exploration, production, marketing, refining and/or transportation of oil and gas products, coal and consumable fuels.

Health Care Sector: Companies are in two main industry groups—Health care equipment and supplies or companies that provide health care-related services, including distributors of health care products, providers of basic health care services, and owners and operators of health care facilities and organizations. Companies primarily involved in the research, development, production, and marketing of pharmaceuticals and biotechnology products.

Utilities Sector: Companies considered electric, gas or water utilities, or companies that operate as independent producers and/or distributors of power.

Consumer Staples Sector: Companies whose businesses are less sensitive to economic cycles. It includes manufacturers and distributors of food, beverages and tobacco, and producers of non-durable household goods and personal products. It also includes food and drug retailing companies.

Consumer Discretionary Sector: Companies that tend to be the most sensitive to economic cycles. Its manufacturing segment includes automotive, household durable goods, textiles and apparel, and leisure equipment. The service segment includes hotels, restaurants and other leisure facilities, media production and services, consumer retailing and services, and education services.

Telecommunications Services Sector: Companies that provide communications services primarily through a fixed line, cellular, wireless, high bandwidth and/or fiber-optic cable network.

Financials Sector: Companies involved in activities such as banking, consumer finance, investment banking and brokerage, asset management, insurance and investment, and real estate, including REITs.

Industrials Sector: Companies whose businesses manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery. Provide commercial services and supplies, including printing, employment, environmental and office services. Provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

Technology Software & Services Sector: Companies include those that primarily develop software in various fields such as the internet, applications, systems and/or database management and companies that provide information technology consulting and services; technology hardware & equipment, including manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

INDEX DEFINITIONS

The Barclays Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

The Barclays Capital High Yield Index covers the universe of publicly issued debt obligations rated below investment grade. Bonds must be rated below investment-grade or high-yield (Ba1/BB+ or lower), by at least two of the following ratings agencies: Moody's, S&P, and Fitch. Bonds must also have at least one year to maturity, have at least $150 million in par value outstanding, and must be US dollar denominated and non-convertible. Bonds issued by countries designated as emerging markets are excluded.

The Barclays Capital High Yield Municipal Bond Index is an unmanaged index made up of bonds that are non-investment grade, unrated, or rated below Ba1 by Moody's Investors Service with a remaining maturity of at least one year.

The Barclays Capital Long Government/Credit Index measures the investment return of all medium and larger public issues of U.S. Treasury, agency, investment-grade corporate, and investment-grade international dollar-denominated bonds with maturities longer than 10 years. The average maturity is approximately 20 years.

Barclays Capital US Corporate Investment Grade Index measures the performance of investment grade corporate bonds.

Barclays Capital U.S. Intermediate Credit Bond Index measures the performance of investment grade corporate debt and agency bonds that are dollar denominated and have a remaining maturity of greater than one year and less than ten years.

The Barclays Corporate Index is an unmanaged index of publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered. The index includes both corporate and non-corporate sectors. The corporate sectors are Industrial, Utility, and Finance, which include both U.S. and non-U.S. corporations. The non-corporate sectors are Sovereign, Supranational, Foreign Agency, and Foreign Local Government. Bonds must have at least one year to final maturity, must be dollar-denominated and non-convertible, and must have at least $250 million par amount outstanding. Bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade.

The Barclays Mortgage-Backed Securities Index includes 15- and 30-year fixed-rate securities backed by mortgage pools of the Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC), and Federal National Mortgage Association (FNMA).

The Barclays Municipal Bond Index is a market capitalization-weighted index of investment-grade municipal bonds with maturities of at least one year. All indices are unmanaged and include reinvested dividends. One cannot invest directly in an index. Past performance is no guarantee of future results.

The Barclays Treasury Index is an unmanaged index of public debt obligations of the U.S. Treasury with a remaining maturity of one year or more. The index does not include t-bills (due to the maturity constraint), zero coupon bonds (Strips), or Treasury Inflation Protected Securities (TIPS).

The Barclays U.S. Treasury TIPS Index is a rules-based, market value-weighted index that tracks inflationprotected securities issued by the U.S. Treasury. The U.S. TIPS Index is a subset of the Global Inflation-Linked Index, with a 36.0% market value weight in the index (as of December 2007), but is not eligible for other nominal treasury or aggregate indices. In order to prevent the erosion of purchasing power, TIPS are indexed to the non-seasonally adjusted Consumer Price Index for All Urban Consumers, or the CPI-U (CPI).

The BofA Merrill Lynch Preferred Stock Hybrid Securities Index is an unmanaged index consisting of a set of investment-grade, exchange-traded preferred stocks with outstanding market values of at least $50 million that are covered by Merrill Lynch Fixed Income Research. The Index includes certain publicly issued, $25- and $100-par securities with at least one year to maturity.

Citigroup World BIG ex US Index is a market capitilization weighted index that tracks the performance of the international fixed rate bonds that have remaining maturities of one year or longer and that are rated BBB-/Baa3, or better, by S&P or Moody's, respectively. This Index excludes the U.S. and is unhedged USD.

The Dow Jones Industrial Average Index is comprised of U.S.-listed stocks of companies that produce other (non-transportation and non-utility) goods and services. The Dow Jones Industrial Averages are maintained by editors of The Wall Street Journal. While the stock selection process is somewhat subjective, a stock typically is added only if the company has an excellent reputation, demonstrates sustained growth, is of interest to a large number of investors and accurately represents the market sectors covered by the average. The Dow Jones averages are unique in that they are price weighted; therefore their component weightings are affected only by changes in the stocks' prices.

The Dow Jones - UBS Commodity Index is composed of futures contracts on 19 physical commodities. Unlike equities, which entitle the holder to a continuing stake in a corporation, commodity futures contracts specify a delivery date for the underlying physical commodity.

The Institute for Supply Management (ISM) index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

The JPMorgan Emerging Markets Bond Index Global ("EMBI Global") tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the JPMorgan EMBI+. As with the EMBI+, the EMBI Global includes U.S. dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million. It covers more of the eligible instruments than the EMBI+ by relaxing somewhat the strict EMBI+ limits on secondary market trading liquidity.

MSCI EAFE is made up of approximately 1,045 equity securities issued by companies located in 19 countries and listed on the stock exchanges of Europe, Australia, and the Far East. All values are expressed in U.S. dollars. All values are expressed in US dollars. Past performance is no guarantee of future results.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of May 2005 the MSCI Emerging Markets Index consisted of the following 26 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

The MSCI Europe Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in Europe. As of June 2007, the MSCI Europe Index consisted of the following 16 developed market country indices: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom.

The New York Mercantile Exchange (NYMEX) is a commodity futures exchange owned and operated by CME Group of Chicago.

The Russell 1000 Index consists of the 1,000 largest securities in the Russell 3000 Index, which represents 90% of the total market capitalization of the Russell 3000 Index. It is a large-cap, market oriented index and is highly correlated with the S&P 500 Index.

Russell 1000® Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000® Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

The Russell 2000 Index is an unmanaged index generally representative of the 2,000 smallest companies in the Russell Index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index.

Russell 2000® Growth Index measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 2000® Value Index measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.

The Russell 3000 Value Index measures the performance of those Russell 3000 companies with lower price-to-book rations and lower forecasted growth values.

The Russell Mid Cap Index offers investors access to the mid cap segment of the U.S. equity universe. The Russell Mid Cap Index is constructed to provide a comprehensive and unbiased barometer for the mid-cap segment and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true mid cap opportunity set. The Russell Mid Cap Index includes the smallest 800 securities in the Russell 1000.

The Russell Mid Cap Value Index offers investors access to the mid cap value segment of the U.S. equity universe. The Russell Mid Cap Value Index is constructed to provide a comprehensive and unbiased barometer of the mid cap value market. Based on ongoing empirical research of investment manager behavior, the methodology used to determine value probability approximates the aggregate mid cap value manager's opportunity set.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Consumer Price Inflations is the retail price increase as measured by a consumer price index (CPI). Core CPI is a subset of the total Consumer Price Index (CPI) that excludes the highly volatile food and energy prices. It is released by the Bureau of Labor Statistics around the middle of each month. Compare to Personal Consumption Expenditures (PCE); Core PPI; Producer Price Index (PPI).

The MSCI Japan Index is a free-float adjusted market capitalization weighted index that is designed to track the equity market performance of Japanese securities listed on Tokyo Stock Exchange, Osaka Stock Exchange, JASDAQ and Nagoya Stock Exchange. The MSCI Japan Total Return Index takes into account both price performance and income from dividend payments. The MSCI Japan Index is constructed based on the MSCI Global Investable Market Indices Methodology, targeting a free-float market capitalization coverage of 85%.