Research Update

September 28, 2011

Why Does Long-Term Success Have Periods of Short-Term Struggles?

Highlights

Our success is driven by the commitment to our investment philosophy. This philosophy is the road map for how the LPL Financial Research team makes investment decisions.

The key to making successful, long-term decisions is dependent on "ignoring the noise," discounting emotions, and investing based on facts, not feelings.

Our process does not chase overvalued names, but rather invests in opportunities to be ready for when the market begins to reward these undervalued assets.

We believe that the fundamentals of the market are stronger than what pessimistic and panicked investors perceive.

No investment process works all of the time. The 34-person strong LPL Financial Research team, despite our time tested investment approach and consistent navigation through the markets, as demonstrated over the long term, has found the last few months a frustrating period in which to invest. While we are disappointed that the most recent periods have not lived up to our lofty expectations, we remain completely confident in our investment approach over the long term.

Our success — and we would argue the success of any investment team — is driven by the commitment to its investment philosophy. This philosophy is the road map for how the LPL Financial Research team makes investment decisions. However, from time to time, this investment process roadmap does not deliver the level of performance that we strive for. The primary reason is that any investment process, including our approach, has biases. At times, it is these biases that are the cornerstone of our long-term outperformance, as they point us in the direction of market opportunities, either within or outside of the market benchmarks, in order to pursue and oftentimes succeed at outperformance. However, when the market is not rewarding this team's unique investment approach, short-term underperformance can occur. That being said, we view short-term underperformance not as failure, but rather opportunity as we have great confidence that this time-tested approach will revert back to its history of strong relative return potential.

Our Process

The LPL Financial Research investment process focuses on three distinct, but complementary tenets: Fundamentals, Valuations, and Technicals.

- **Fundamentals** involve looking into multiple factors to best glean an objective view of the overall health of the economy, the market, and sector/industry groups. Common fundamental factors include statistics like earnings, employment, economic growth rates, and housing data, to name just a few.
- **Valuations** refer to the concept that the price that one pays for an investment is one of the most important factors driving future returns. In fact, there is only one way to make money in investing: buy opportunities at a low price and sell them at a higher price. The better the entry point, the better the returns.

- **Technicals** are the science of analyzing the historical return behavior of markets to predict their potential future movements.

The LPL Financial Research investment process uses the intersection of these three factors to make the portfolio decisions within all of our recommended models. While they have been successful in the past, these factors have not been rewarded as of late.

Our Fundamental Views

We believe that over the long term, emotional decision making is a primary source for underperformance as little good occurs when gut reactions override thoughtful analysis.

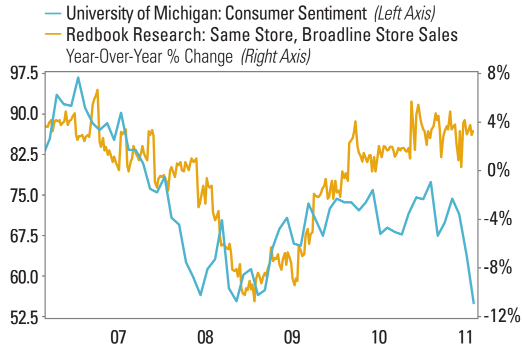
Fundamental analysis is the use of objective economic and market data to best understand the overall characteristics of the market. Our process uses this objective fundamental data, rather than emotional and subjective sentiment data, because we believe that the key to making successful, long-term decisions is dependent on "ignoring the noise," discounting emotions, and investing based on facts, not feelings. We believe that over the long term, emotional decision making is a primary source for underperformance as little good occurs when gut reactions override thoughtful analysis.

However, over the short term, market fundamentals have not mattered to this market. Rather, the current market has largely ignored the actual prevailing fundamentals and instead is reacting to emotion, fear, and panic. The bottom line is that the fundamental data supports our belief and positioning that the economy is growing slowly and continuing in its recovery from the Great Recession of 2008. Below are a few fundamental observations.

- The balance sheets of corporate America are the strongest they have been in many decades as strict cost controls, decent sales growth, and a deleveraging of debt have left businesses with more cash in their coffers than ever before. This strong position for companies means they are better poised now to withstand economic downdrafts and are better situated to fuel growth through enhanced spending, share buybacks, acquisitions, raising dividends, and hopefully soon, additional hiring of staff.
- Buoyed by surging auto production and sales following the disruption caused by Japan's springtime natural disaster, economic growth this quarter for the United States is poised to be not only the fastest of the year, but also to be faster than the first two quarters of the year combined. The U.S. economy grew at a 1.0% pace in the first quarter and 0.4% in the second quarter. The third quarter is on pace to grow at a 2–2.5% rate.
- The Index of Leading Economic Indicators (LEI), which is a grouping of several economic statistics that are usually predictive of future economic conditions, continues to suggest slow growth and not a double-dip recession. In fact, LEI posted a solid and better-than-expected 0.5% gain in August—marking the third straight month of re-acceleration in the year-over-year growth of the LEI, which suggests that a recession is unlikely.

While this fundamental data is relatively positive on the growth of the U.S. economy and supportive of opportunistic investments, the market has largely ignored these fundamental facts. Rather, the market is being driven

1 Consumers Say They Lack Confidence, But Continue to Spend



Source: University of Michigan, Redbook, Haver Analytics, LPL Financial 09/17/11

2 Negative Consumer Sentiment Typically Predicts Strong Market Returns

Consumer Sentiment	S&P 500 Price Gain Over Next Twelve Months
Less than 60	+23.1%
Less than 70	+18.5%
Less than 80	+13.1%
87 (average)	+10.8%
Greater than 90	+10.8%
Greater than 100	+8.1%
Greater than 110	-1.2%

Source: University of Michigan, Standard & Poor's, Haver Analytics, LPL Financial 1978 through 9/21/2011

almost entirely on emotional fear and panic, regardless of whether or not the data supports the gloomy mood of investors. One great way to illustrate this is to look at Chart 1, which shows consumer confidence relative to consumer purchases. Over time, these two measures are highly correlated as the more confident consumers feel, the more likely they are to spend money. However, the recent periods have seen a near historic disconnect, as consumers are filling out surveys suggesting a dismal outlook, but not significantly adjusting spending.

Consumers are acting differently than they are feeling. The fundamental data shows that consumers, which make up nearly 70% of the U.S. economy, are going to the malls and spending at levels not seen since 2007. However, that fundamental data flies in the face of the sentiment data, which suggest consumers are as gloomy and pessimistic as they were at the depths of the 2008 recession.

Our process is to invest in the fundamental facts, not wavering sentiment. While a bad mood can certainly cast a cold, wet blanket on the market, as it has over the short run, we believe that it is the actions of consumers, not their often changing emotional views that should dictate the long-term direction of spending and consumption as well as the price levels of the markets. In fact, historical evidence shows that consumer confidence has consistently been a contrarian indicator for the stock market—the worse consumers feel, the better the gains over the coming year. As shown in Chart 2, since 1978, the lower the level of consumer sentiment, the stronger the stock market gains over the coming year, and likewise, the more optimistic consumers are, the weaker the subsequent stock market performance. When consumers are very pessimistic with sentiment below 60, as it is today, over the following 12 months the S&P 500 has posted a 23% gain, on average.

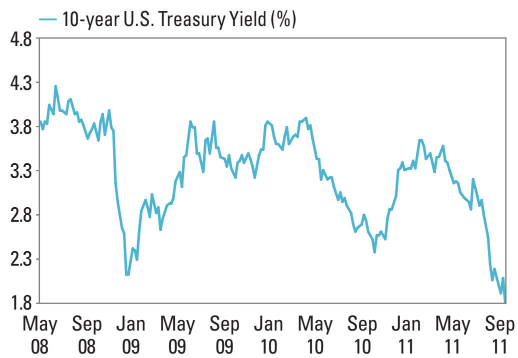
While emotion can be a powerful force over the short run, it is our belief that eventually the market trades on fundamentals rather than feelings. While it can seem unnatural and even be painful to position portfolios counter to the market's "gut," we believe that at times it is important to go against our primal instincts and invest on the facts. As a result, the fundamental portion of our process has led us to remain more opportunistic in the face of a declining market, which has led to our portfolios not being rewarded over the short run. However, we remain committed to our investment process. And, fundamentally, we see many opportunities in a market that is emotionally blinded by fear and thus, does not see that prices are too low to reflect the actual strength of the U.S. economy. Should we notice the fundamentals of the market deteriorating, we will quickly shift out positions from opportunistic to defensive. But until then, we remain opportunistically positioned awaiting the market's bad mood to end such that it aligns its prices with its fundamentals. As Warren Buffet so eloquently said "be fearful when others are greedy and be greedy when others are fearful." Now is certainly a time to be greedy and opportunistic as fear is at a premium.

Our Valuation Views

The LPL Financial Research investment process seeks to buy attractively valued investments and sell overvalued opportunities. The premise is the basic axiom of investing: buy low and sell high. However, this part of our process has not been rewarded as of late as the prices of attractively valued opportunities become cheaper and overvalued opportunities continue to be purchased by those investors overcome with emotion and fear.

Our discipline regarding valuation is to sell portfolio winners as they move from attractive opportunities to overvalued investments. While this valuation component to our process is one that works over the long run, investments that are trading above their intrinsic value can continue to move higher, in spite of their overvalued status. Our process does not chase overvalued names, but rather invests in opportunities — sometimes too early — to be ready for when the market begins to reward these undervalued assets.

3 Treasury Yields Are At Record Lows

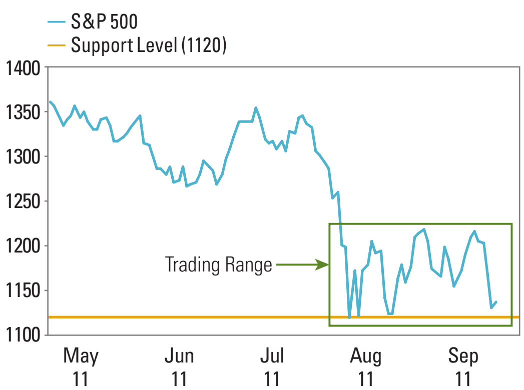


Source: FactSet, LPL Financial 09/15/2011

One example of an investment that has been avoided by our valuation discipline, but has done extremely well (and is a component of our benchmark) is U.S. Treasury securities. Despite the 10-year Treasury starting off the year at already low yields (and thus high prices), the fear and panic of investors has driven up demand for the perceived safety of owning high-quality bonds, like Treasuries. As a result, the 10-year Treasury has risen in price and the corresponding yields have plunged from 3.3% at the start of the year to about 1.8% today [Chart 3]. This represents all-time low yields (and thus all-time high prices) as investors have flocked to seemingly safe haven trades, like Treasuries, at even greater rates than they did during the depths of the recent recession. While not holding Treasuries has hindered relative returns, we believe that following the valuation component of our investment philosophy and avoiding overvalued investments will eventually lead to portfolio success down the road.

Areas where we have been deploying capital based on attractive valuations are selective equities, such as Japan, small cap, cyclicals, high-yield bonds, and bank loans. Because the market appears to be pricing in a far greater likelihood for a return to recession than the data actually indicates, stock valuations are cheap versus their historical averages. The S&P 500 Index trailing price-to-earnings (P/E) ratio, a measure for how much the market values a dollar's worth of corporate earnings, is at 13 (the lowest since 1990) and the forward P/E ratio is 11 (same as the March 2009 low). Essentially, the market is as cheap, or even cheaper, now than it was during the depths of the 2008–2009 recession. Within fixed income, higher yielding credit positions, like corporate bonds, high-yield bonds, and bank loans offer attractive valuations compared to the lofty valuations of Treasuries. While the market has not rewarded these opportunistic asset classes lately — given its favoritism for overvalued defensive names — we strongly believe, and our investment process supports, that prices matter over the long term.

4 S&P Appears to be Bouncing Off of Support Levels



Source: Standard & Poor's, Haver Analytics, LPL Financial 09/23/2011

S&P 500 is an unmanaged index and can't be invested into directly. Past performance is no guarantee of future results.

Our Technical Views

The third component of the LPL Financial Research investment process is Technicals, which is the use of quantitative analysis to help predict future market performance based on past price history, chart formations, and trading volumes. Technicals arise from the common axiom that "history repeats itself." Though past performance doesn't guarantee future results, in investing, technical analysts can observe chart formations that suggest where buyers and sellers are finding equilibrium (or prices at which they agree upon) and when trends are changing.

Technical analysis currently supports our fundamental and valuation views that it is prudent to be more opportunistic than defensive at this time. As Chart 4 illustrates, the market, measured by the S&P 500 Index, is currently in a consolidation pattern following the abrupt sell-off following the Standard & Poor's downgrade of U.S. debt that resulted from the protracted debt ceiling fiasco in Washington, D.C. The market has established very strong support around 1120 on the S&P 500 Index. During four distinct periods over the last two months, the market has fallen on fears of a double-dip recession and each time, the level around 1120 was the turning point. Support is essentially the level where buyers begin to step in with conviction and purchase the market following a sell-off. On August 8 at 1119, August 10 at 1120, August 19 at 1123, and then again on September 22 at 1129 the market found support around the 1120 level and stopped a sell-off in its tracks. We believe this analysis indicates that portfolios should have an opportunistic stance to benefit from the recent market trends that are favorable for higher price levels for the market.

Disappointed, but Unwavering in Our Commitment

While we are disappointed that the market has not rewarded our portfolio positioning over the last few months, we remain unwavering in our commitment to a philosophy and process that has been built on our investing principals. All three of the tenets of our process are leading the LPL Financial Research team to position against the crowded trade of emotional selling and fear-induced defensive moves. Rather, we believe that the fundamentals of the market are stronger than what pessimistic and panicked investors believe. Valuations for defensive positions, like Treasuries, are at historic highs and our preference is to reposition to areas that have been shunned by investors and offer attractive characteristics and cheap valuations. And, technical analysis is supportive of an opportunistic stance as the market appears to have found strong support, is consolidating, and could be poised for a breakout.

While fear and panic have driven an emotionally charged market over the last few months, we believe that an investment process that values facts over feelings will be rewarded over the long term. There is no doubt that the negative "noise" that started in the gut of nervous investors and has been perpetuated by a media that loves to report on a "train wreck" has been the drumbeat that has driven the market as of late. While our views on Fundamentals, Valuations, and Technicals has not been in alignment with what has worked in this fear-driven market over the short run, we remain fully convicted and stand behind our time-tested investment process. Sometimes the right thing to do is not take the easiest or most comfortable course over the short run. But, it is our commitment to tune out the noise, ignore the emotional feelings, and invest on the facts, as we believe that is the key to long-term, sustainable portfolio success.

We appreciate your continued commitment and trust.

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IMPORTANT DISCLOSURES

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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 a fund shares is not guaranteed and will fluctuate.

Past performance is no guarantee of future results.

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.

The P/E ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

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.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

Asset allocation does not ensure a profit or protect against a loss.

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.

The University of Michigan Consumer Sentiment Index (MCSI) is a survey of consumer confidence conducted by the University of Michigan. The Michigan Consumer Sentiment Index (MCSI) uses telephone surveys to gather information on consumer expectations regarding the overall economy.

Stock investing may involve risk including loss of principal.

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

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.

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

A tool for comparing the prices of different common stocks by assessing how much the market is willing to pay a share of each corporation's estimated future earnings. It is calculated by dividing the current market price of a stock by the earnings per share estimate for the future period.

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.

RES 3332 0911
Tracking #1-009939 (Exp. 09/12)