SELECTOR® Money Management
2011 Third Quarter Review

The story of the third quarter centers around the last week of July and the first week of August. The first three weeks of July equities basked in the glow of the late June rally, and within the comfortable confines of a trading range that offered mildly favorable prices. The last week of July equities turned south once again, seemingly bent on revisiting the bottom of that trading range yet again. However, this time they did not stop, and even accelerated their drop as they passed through their starting price levels for the year. The first four trading days of August equities made four huge swings in opposite directions over four consecutive days which proved to be a short-term cornerstone for prices, albeit at a new and lower trading range.

Major market indexes spent the rest of August and all of September traveling within this new trading range. You may remember the old truism that 'what was once support, when broken, becomes resistance.' Rather than swinging higher from zero to +10%, as in the first trading range of 2011, major market indexes are now dipping from zero to -10%. This is not nearly as much fun, and compels prudent money managers to re-evaluate the 'what-ifs' for when the trading range is broken to the upside or to the downside. The upside would most probably be contained within the trading range that dominated prices the first seven months of the year. The downside, however would become more problematic.

At the end of the third quarter the S&P 500 Index rested with a loss of -8.68%, declining -13.87% from the end of June. The S&P 400 Mid Cap Index finished the third quarter down -13.02%, falling -19.88% during the third quarter. And the Russell 2000 Small Cap Index ended the third quarter down -17.02 %, dropping -21.87% in the third quarter. International equity markets, which had been demonstrating relative strength in the first half of 2011 versus domestic equities, experienced even stronger reversals. The S&P Europe 350 ended the third quarter down -15.04% year-to-date, a -22.49% change during the third quarter. All in all, this represents a dramatic reversal, especially when one considers that it occurred over a very volatile two week period. The eight weeks that followed, while still volatile, essentially pounded in another trading range, and this one was subterranean.

When you look at the other end of the spectrum you find the hard-to-love/easy-to-mistrust long-term government bonds. In spite of all the negative conventional wisdom, from their historic low interest rate appeal, to their incredible inflation vulnerability, to their unmatched volatility in the fixed income circuit, there sits the Barclays Capital U.S. 20+ Year Treasury Bond Index up +31.44% year-to-date, soaring +29.21% in the third quarter alone. Other bond indexes also demonstrated relative strength, though none on the scale of long-term government bonds. The Barclays Capital U.S. TIPS Index is up +10.59% year-to-date despite immeasurable inflation numbers, and the S&P National Municipal Bond Index is up +8.93% in spite of a threat of wide-spread municipal default. The broader benchmark Barclays Capital U.S. Aggregate Bond Index finished the third quarter with a gain of +6.65%. High yield bonds suffered a portion of the equity markets fate, with the iBoxx $ Liquid High Yield Index falling -6.23% in the quarter and finishing the third quarter down -1.88%.

Equity market leadership has shifted to the utilities sector. The Dow Jones U.S. Utilities Index is up +9.24% year-to-date. The Dow Jones U.S. Pharmaceutical Index is up +5.14% through the third quarter and the Dow Jones U.S. Health Care Index is still in positive territory for the year, up +1.51%. The Dow Jones U.S. Real Estate Index slipped to -6.79% year-to-date. The roughest performances year-to-date include the Dow Jones U.S. Regional Banks Index, -25.64%, the S&P Latin America 40 Index, -26.90%, and finally the Dow Jones U.S. Home Construction Index, at -31.17%.

When financial markets make overly dramatic short-term moves, like bond markets' move higher and international equities' move lower, even experienced investors can find their patience tested. Portfolio adjustments may be warranted, but nobody wants to chase markets that have suddenly soared higher then reasonable, or sell markets that have tumbled lower than justifiable. The fourth quarter of 2011 definitely holds the key to the year. And right now the Bulls and the Bears are evenly divided.

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