

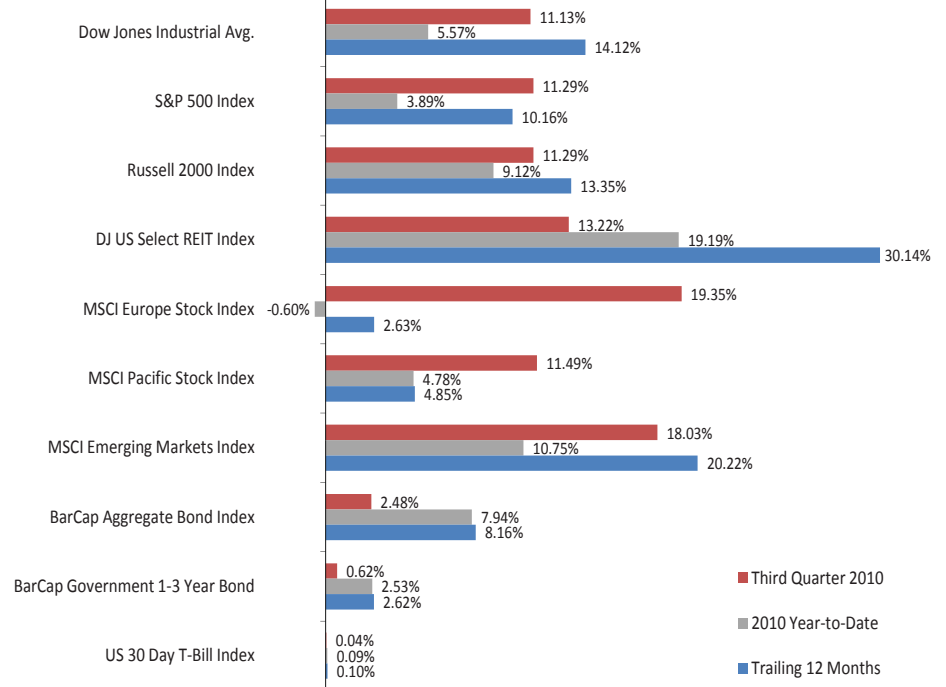
WORLD MARKET SURVEY

Strong Corporate Profits Buoy US Stock Markets

The performance of the US stock market during the third quarter, although notably positive, failed to calm the jangled nerves of individual investors. Following the negative returns incurred in the second quarter, the month of July got off to a good start, with the S&P gaining nearly 9%. But by the end of August, the market had surrendered almost all those gains, and investor nervousness was palpable. However, another vigorous rally started in early September and the quarter ended with gains of more than 11% for both the S&P 500 and the Russell 2000. The S&P 500 needed a strong quarter in order to recover from a decline of 6.5% from the first of the year through June 30. The net gain on the index from January through September now stands at 3.9%. The smaller US firms that appear in the Russell 2000 Index are now up 9.1% for the year to date.

(continued on page 10)

Index Returns: Third Quarter 2010, Year-to-Date, & Trailing 12 Months



MORE LIKELY THAN NOT

Investors who exited the equity markets during the financial crisis of 2008 and 2009 face a difficult question: when to get back in, if ever? In 2015, will we look back on the crisis as having continued through the Second Crash of 2010, and the Disaster of 2011? Or will we, rather, recall 2010 as the beginning of the Great Bull Market? Investments offering an expected return in excess of the risk free rate have uncertain future payoffs. If you knew that the US economy was entering the second phase of a “double-dip” recession,¹ would you take the plunge? If not, then at what point would you feel comfortable investing your money in assets with uncertain payoffs?

Most investors are familiar with charts that illustrate relative positions of investments on a risk/return scale, such as the one on page 2. Though highly stylized, the chart makes intuitive sense, because it suggests a relationship, perhaps linear, between risk and reward, that most people well understand. Investors unwilling to assume risk must be satisfied with the lower risk-free Treasury rate. Should they wish to earn a greater return, they shall have to own riskier assets. Investors have the expectation – never the guarantee – that such investments will, on average, produce greater wealth. Of course, the chart conveys only a sliver of information regarding the

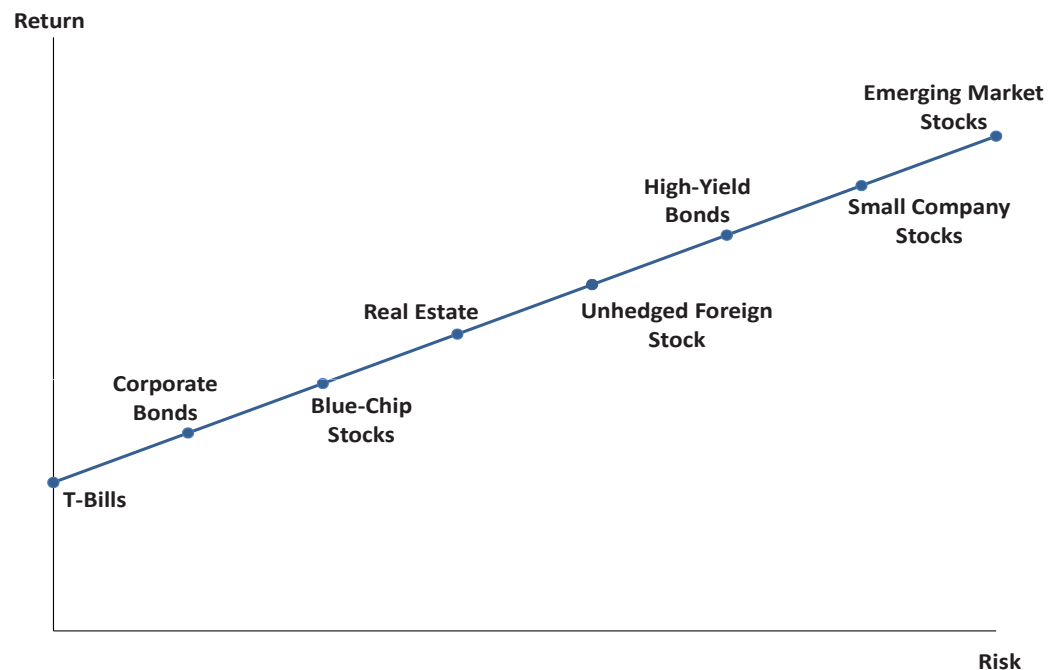
benefits of diversification. In fact, it may foster the incorrect impression that a safe portfolio is a portfolio of safe investments, or that a risky portfolio is a portfolio of risky investments. Such, of course, is not the case – two risky investments with differing return patterns can combine to form a low-risk portfolio, and a “safe” portfolio allocated entirely to US Treasuries can of course be devastated by unexpected inflation.

The chart nevertheless provides valuable insights. In fact, it illustrates a fundamental principle of Modern Portfolio Theory: there

1. The National Bureau of Economic Research (NBER) announced on September 19, 2010 that the recession that had begun in December 2007 had officially ended in June 2009. This was the longest recession since World War II. Any future economic downturn would be treated as a new recession rather than one continuous recession.

SEE PAGE 9 FOR NEWS ABOUT SCHULTZ COLLINS LAWSON CHAMBERS

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is a risk/reward tradeoff that operates across capital markets. Nobel Prize winner William Sharpe mathematically formulated the risk/reward tradeoff in terms of asset price dynamics. Sharpe's Capital Asset Pricing Model [CAPM] argues that if profit-maximizing investors decide that investment A offers a less favorable reward-to-risk profile than investment B, they will sell A – driving its price downwards – and buy B – driving its price upwards – until the prices of A and B have arrived at a new equilibrium.

The market always seeks equilibrium, but never quite reaches it. The flow of new information into the capital markets is ceaseless, and traders constantly readjust their positions accordingly. When you look at the minute-by-minute price changes for the Dow Jones or NASDAQ or S&P 500 averages, you witness the magnitude of these adjustments as they unfold dynamically.

There is Never Ever a Free Lunch

CAPM has an amazing mathematical corollary: *In equilibrium, all investments have the same risk-adjusted expected return.* The only reason the S&P 500 has a higher expected return than a 30-day Treasury is because it is more risky – in any single period the S&P 500 can generate either positive or negative returns, but, over many periods, investors anticipate that its average return must be greater than

the 30-day Treasury yield. If this positive expected return – i.e., the risk premium – did not exist, no one would want to own the S&P 500 – this, in fact, is the doomsday scenario that is the theory du jour of the gold bugs. However, if the expected risk premium is not sufficient to reward risk-averse investors, the only solution is for the price of the S&P 500 to decline. At the new lower price, the S&P 500's expected return is higher than it had been. How far will the price decline? Exactly to the point where investors are indifferent – i.e., equally satisfied – between holding a low return T-Bill with no short-term risk and a higher expected return equity position with investment risk.

Stated otherwise, the CAPM says that capital markets, in equilibrium, offer investors no free lunch. If your goals require a return higher than the risk-free rate, you must either invest in riskier assets or trim back your goals. Yet if you take risk and receive the expected premium, you can't really pat yourself on the back. High payoff ventures *must* carry a discount rate factor appropriate to their risk. Given identical payoffs, the present value of a future risky investment is worth less than the present value of a risk-free investment, all else equal. If, in equilibrium, all investors have the same expected risk-adjusted return, then all investments must plot on a straight line like the one in the chart above. This fact is the fundamental theorem of Modern Portfolio Theory and

CAPM says that capital markets, in equilibrium, offer investors no free lunch.

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is probably as true as the axiom that a straight line is the shortest distance between two points. However, context is all: across the surface of the planet, there is no such thing as a straight line.

Over the long run, it is more likely than not that the return on a high risk asset class will be greater than that on a low risk asset class. An asset class is a set of financial assets sharing common statistical, legal, and fundamental characteristics. A single stock – think Enron or BP – is merely an undiversified bet on the fortunes of one company, wherein risk is primarily idiosyncratic to the particular firm. Investing, unlike ownership of a commercial enterprise, is not an all-in bet on a single stock. But how long is the long run? If you knew that an economic catastrophe was on the horizon, would you invest in risky assets? When markets rise, do you encourage your investment advisor to save you from positive returns? When markets fall, do you plead with your advisor to save you from market risk? In the world of CAPM, the last two questions are the same.

One way to test a theory is to see how well it predicts empirical events. CAPM says it is more likely than not that, in the long run, assets will plot in the vicinity of a straight line that has a positive slope. The slope may change over time, but, in general, risky assets will occupy a high-return position on the line, and low risk assets will occupy a low-return position. The argument has two parts: (1) a probabilistic part (“it is more likely than not”), and (2) a substantive assertion that the real world will unfold more or less as predicted by the risk/return chart. Let’s take each part in turn.

Probability comes in Three Flavors

Strong laws of probability: there is a one in fifty-two chance that a card randomly selected from a well shuffled deck will be the ace of clubs. The strong laws of probability were originally developed during the Renaissance, mostly to help gamblers make smart bets. They are also called Classical Laws of Probability. If you doubt the strong laws of probability, the casinos will be happy to provide you with a laboratory in which you may try to disprove them.

Weak laws of probability: we cannot say precisely what will or will not happen but, through repeated trials, we can tabulate the relative frequency of results to form an educated opinion regarding the outcome. The temperature at which a metal melts

is not always the same, but by making many trials and recording the results of each, we can determine with reasonable precision a temperature range that is serviceable for most practical purposes. The weak laws of probability reflect a relative frequency approach to probability. The key to the relative frequency approach is the ability to make repeated trials under strictly controlled conditions. If event A happens M times in N trials, then the probability (relative frequency) of A is M/N.

Subjective laws of probability: these are opinions regarding a person’s intensity of belief. Anyone who visits a doctor can understand that a diagnosis is in essence an educated opinion as to the presence of a specific affliction. A rational agent holds beliefs which are revised as new information (e.g., results of medical tests) becomes available. The subjective laws were first formulated by British cleric and mathematician Thomas Bayes in the 18th century, and are commonly known as Bayesian rules of probability. Bayesian rules outline how probabilistic opinions may change over time as you acquire new information.

Query: Is the question, “what do you think the market will do over the next year?” best interpreted under strong, weak, or subjective laws of probability?

The Toss of a Coin

Let’s toss a fair coin ten times and record the sequence of outcomes, where heads represents success and tails represents failure. If the tosses yield the sequence of results shown in the table below, the frequency of success will unfold as shown in column three.

Trial	Outcome	Success Rate
1	t	0/1
2	t	0/2
3	t	0/3
4	h	1/4
5	t	1/5
6	h	2/6
7	h	3/7
8	t	3/8
9	h	4/9
10	t	4/10

But how long is the long run? If you knew that an economic catastrophe was on the horizon, would you invest in risky assets?

MORE LIKELY THAN NOT

When it comes to the markets, there is no such thing as a repeatable trial.

Halfway through the sequence, the empirical results indicate only a 1 in 5 success rate. For a small number of trials, the relative frequencies can fluctuate significantly with each new trial. Any two sequences of relative frequencies may look very different initially. We know, however, that the expected relative frequency of heads is 50% as the number of trials grows larger – i.e., “over the long run.” We can take some comfort in this knowledge, because repeated trials manifest statistical regularity – provided that the conditions of the trial remain constant. But if, as with investing, the experiment cannot be performed under controlled conditions, we can have but little basis upon which to calculate the true odds of success, no matter how long the sequence of trials.

The Market is Not Controlled

When we discuss the stock market’s monthly historical returns we can accurately state that the majority of returns fall within a 0% to 2% range, and only rarely do monthly returns exceed $\pm 15\%$. In fact, we can build relative frequency tables with exquisite accuracy by making finer and finer partitions of monthly returns. However, it is difficult to justify making a statement like: a typical recession lasts between 10 and 20 months; and, as the economy recovers the stock market makes up all losses within 12 to 30 months. Such a statement implies that, if a long-term investor knew a financial downturn was imminent, it would be a matter of relative indifference because of past return history. Indeed, you could go one step further and make the statement that an investor holding a 50% stock / 50% T-Bill portfolio for 100% of the time is, over the long term, safer than an investor holding 100% stock for 50% of the time and 100% T-Bills for the remaining time.

The number of recessions is not sufficient to produce a high confidence level for recovery predictions.

But we have little justification for using either assertion as a guide to future investing, because economic conditions always differ from period to period – there is no way to generate stock market returns from a controlled experiment. When it comes to the markets, there is no such thing as a repeatable trial. Additionally, even if such statements make sense in a context of repeated trials – hundreds of months of return history – they would still suffer from a small sample bias. The number of recessions is not sufficient to produce a high confidence level for recovery predictions. In the interest of full disclosure, however, the statement regarding the safety of a balanced asset allocation can be mathematically proven under certain assumptions regarding the independence of periodic returns and the statistical

properties of their distribution over time. But this “proof” is akin to the proof that a straight line is the shortest distance between two points. Like the CAPM theory, the proof may or may not meet empirical tests.

Consider the following statements:

- It is likely that the global economy will enter a double-dip recession.
- It is unlikely that there will be a major earthquake in San Francisco next year.
- It is likely that the patient will survive the operation.

These statements are hard to interpret. Does the speaker have an agenda that colors the analysis? Are they verifiable? The common thread in all of them is that neither strong nor weak laws of probability are of much help. For example, if you are the patient considering an operation, you wish to know *your* chances of success – not the general success rate. The only way it could be determined is if you were to undergo repeated operations – not something that you will do. You may be younger or older than the average patient and you may be in better or worse health. Subjective probability is necessarily imprecise.

To the uneducated mind, this fact may lead to the conclusion that the opinion of an amateur is as valid as that of an expert – who is to say which one is right? The danger, however, is a mindless and unproductive subjectivism. To the educated mind, subjective probabilities lead in a number of productive directions including: (1) conditional probability analysis and, (2) theoretical modeling. Is there a theoretical framework that helps us interpret and give meaning to financial market events? This brings us to the second part of the CAPM theory – the prediction that, over the long run, assets tend to plot on an upwardly sloping line in risk/return space.

How has CAPM Fared on Planet Earth?

At this point we ponder the unlikely hypothesis that, as investment advisors, we have knowledge of future events. The experiment starts on the date when SCLC began business – January 1, 1995 – an admittedly arbitrary starting point that carries a high risk of biasing the future results. Our first customer arrives and assures us that he is eager to implement and maintain a portfolio allocated 70% to equity and 30% to

MORE LIKELY THAN NOT

fixed income, diversified among various asset classes (capital markets). We explain to him that markets are not susceptible to analysis under either the strong or weak laws of probability; that past performance is not a guarantee of future performance; and that portfolio results over any particular period may differ greatly from statistical expectations. None of these caveats shake his resolution. Quite naturally, he asks what we think the market will do over the next few years. He is surprised by our precise answer: "In the fifteen years between 1995 and the end of 2009 there will be (1) a world-wide liquidity crisis prompted by Asian banking problems and a run on the Russian Ruble [1998], (2) the bursting of the tech bubble and the NASDAQ stock index decline of approximately 80% [2000 - 2001], and (3) the worst global recession since the Great Depression [2008 - 2009]." Gulp! With this, the investor decides that it is more prudent to keep funds in T-Bills after all.

But let's see how that decision played out. The charts that follow provide insight into the performance during the 5, 10, and 15 year periods beginning January 1, 1995 of the fearful investor's T-Bills, of other asset classes (see the table on page 8 for a key to the data labels), and of a hypothetical 70-30 diversified model portfolio of the sort he had decided was too risky. The horizontal axis [risk] measures the standard deviation of returns, the vertical axis [geometric return] measures the compound annual return for the period under consideration. The "capital

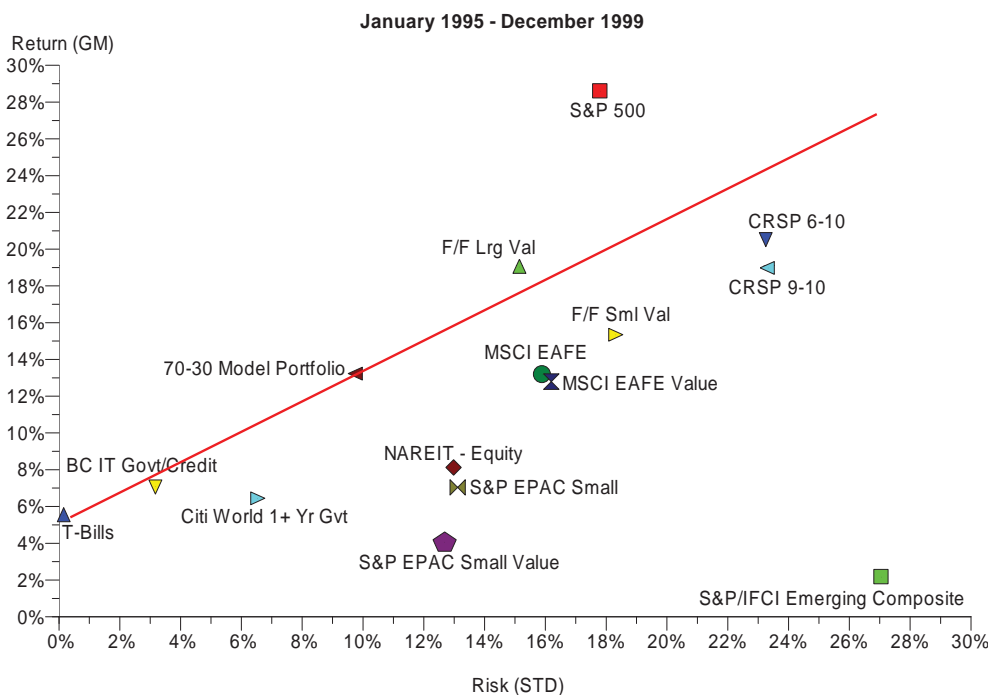
allocation" line connects the risk-free asset to the diversified portfolio - and mirrors the straight line of the stylized risk/return graph presented earlier. Asset classes with a risk-adjusted return higher than that of the diversified portfolio plot above the line, and those with a lower risk-adjusted return plot below it.

Fifteen Pretty Bad Years

The fifteen years we have just survived were not a particularly good time to hold risky assets. This is manifest in the systematic decrease in the slope of the capital allocation line as the holding period lengthens. The decision to remain in cash during a particularly volatile period earned the investor an approximately 4% average annual return. The diversified portfolio would have averaged approximately 8% annually (expenses and taxes are not considered). Subtracting the risk free return from the model portfolio return provides us with a measure of the equity risk premium, which during this period was 4%. Interestingly, during this single 15 year period, empirical results were close to CAPM expectations:

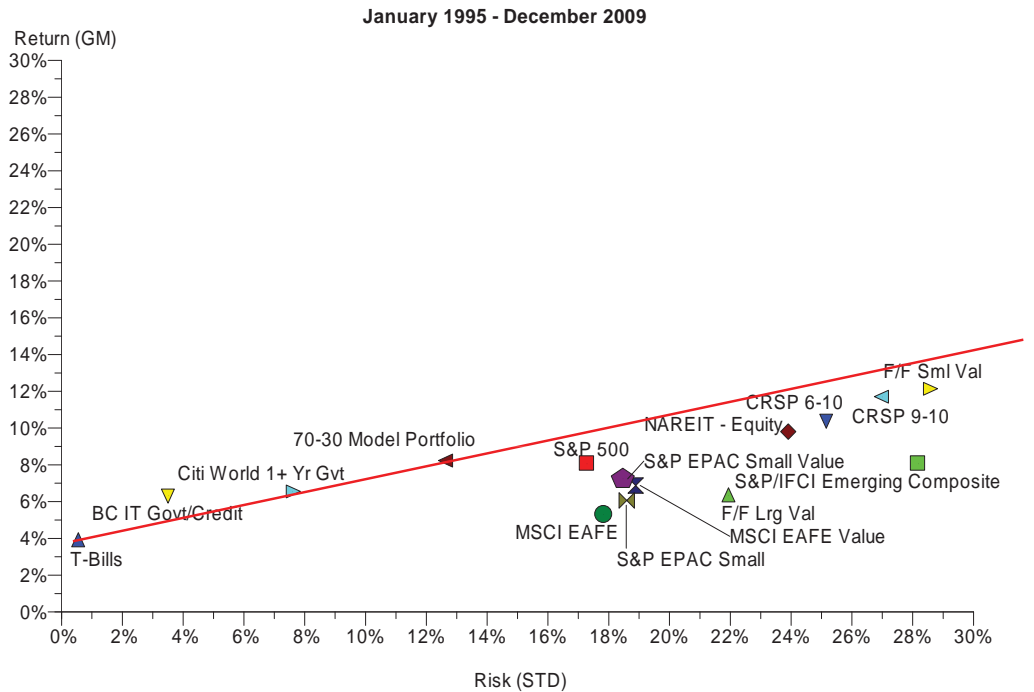
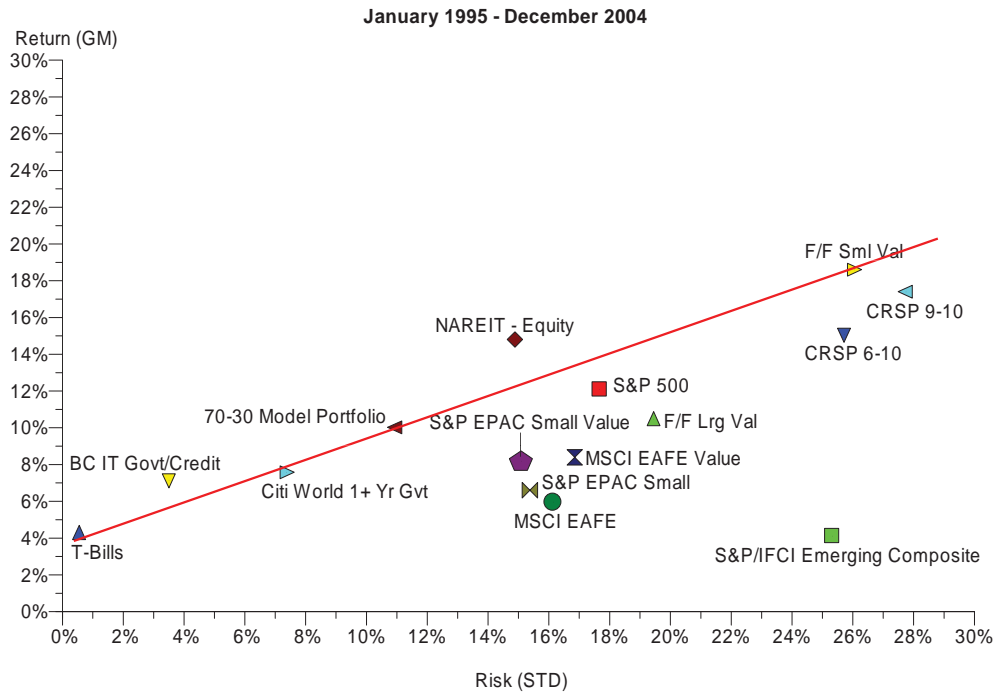
- The dispersion of assets away from the capital allocation line lessened as the planning horizon increased; and,
- The diversified portfolio provided superior risk-adjusted performance compared to most individual investment choices.

The fifteen years we have just survived were not a particularly good time to hold risky assets.



The diversified portfolio provided superior risk-adjusted performance compared to most individual investment choices.

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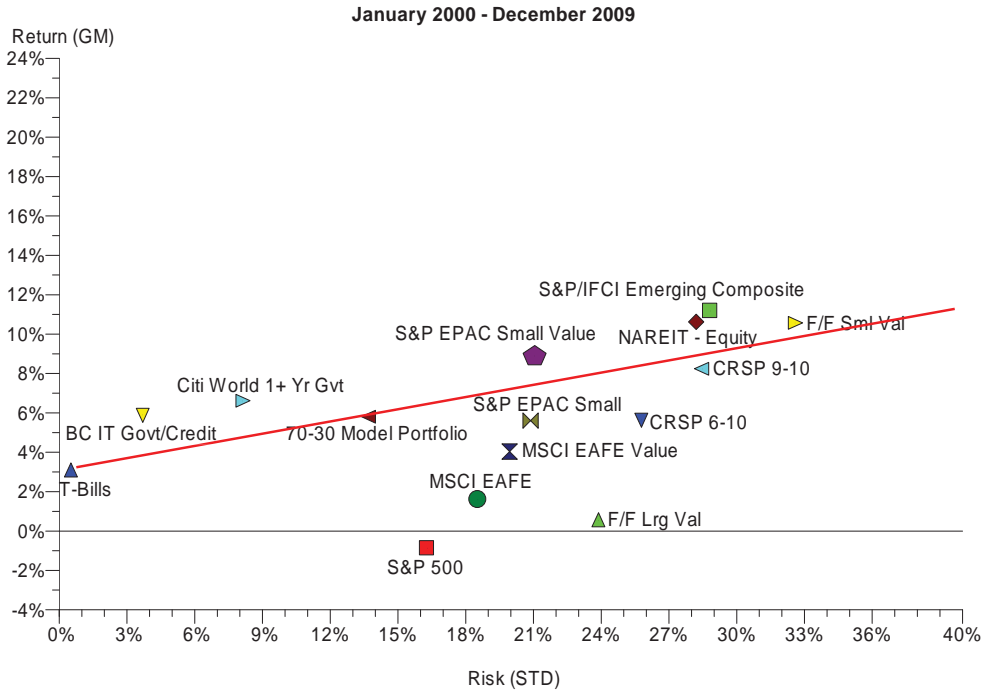
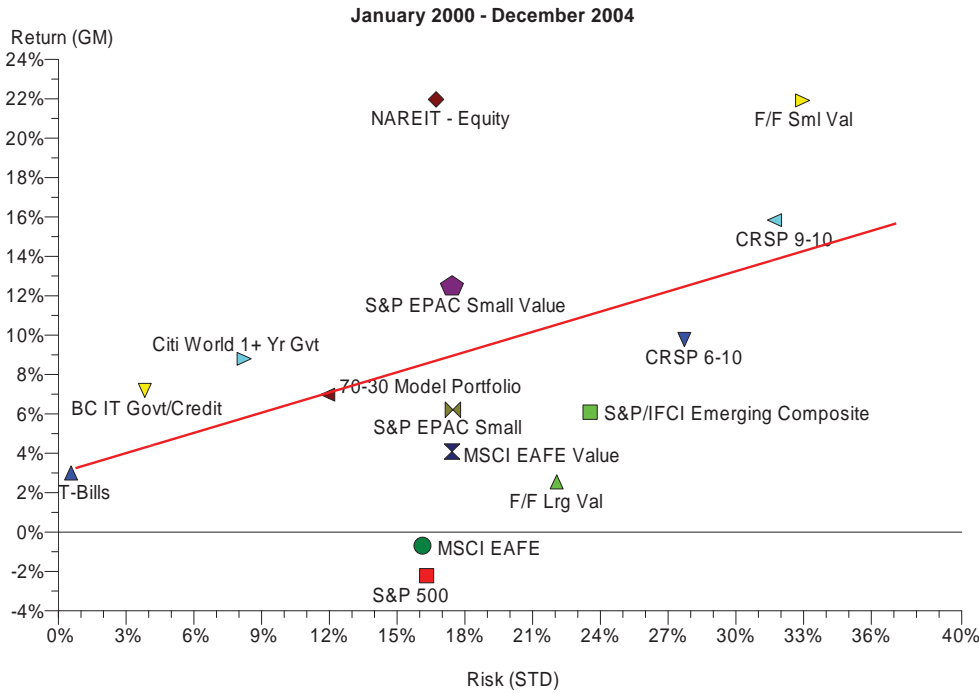
What about starting a 70-30 portfolio in 2000? This portfolio would have been buffeted by the NASDAQ meltdown, the 9/11 recession, the onset of two foreign wars, and the great recession ...

Ten Awful Years

What about starting a 70-30 portfolio in 2000? This portfolio would have been buffeted by the NASDAQ meltdown, the 9/11 recession, the onset of two foreign wars, and the great recession that NBER says ended last year. The charts on page 7 provide

snapshots of this portfolio's performance versus those of its constituent asset classes at its fifth and tenth anniversaries. This was the "Lost Decade" for stocks: the fixed income asset classes held steady, while at both the five and ten year marks, the S&P 500 had posted a negative return for each period, plotting *below* the x axis. The big stocks of developed

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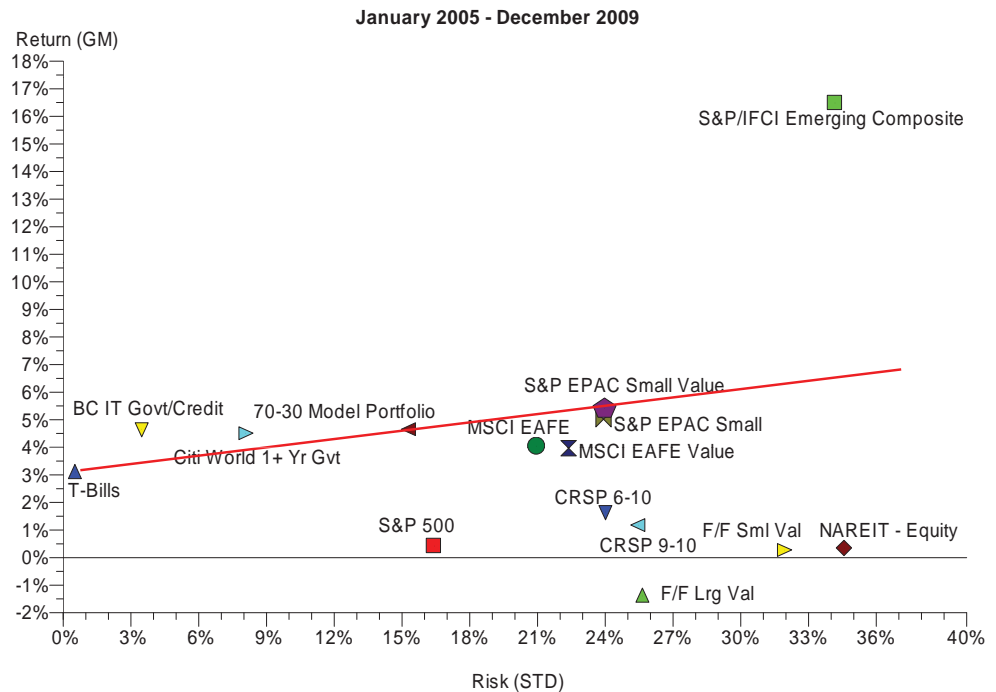
... the high flyers of 2004 – Real Estate (NAREIT Equity), and US Small Cap Stocks (F/F Small Value) and Micro Cap Stocks (CRSP 9-10) – had by 2009 fallen back to Earth.

foreign economies, proxied by the MSCI EAFE, fared almost as badly. Note also how the high flyers of 2004 – Real Estate (NAREIT Equity), and US Small Cap Stocks (F/F Small Value) and Micro Cap Stocks (CRSP 9-10) – had by 2009 fallen back to Earth. Yet despite suffering through this ordeal, the compound

return advantage – i.e., the equity premium – of the 70-30 portfolio amounted to approximately 3% per year over the 10 year period. In other words, the model portfolio averaged approximately 6% annually, while the short-term Treasury asset class averaged approximately 3% annually.

Indeed, the CAPM cannot be empirically tested, because its predictions concern future expectations, and the available data are inapposite, because they are historical realizations.

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Five Catastrophic Years

OK, let's get really serious: what if the portfolio had begun its career in 2005? It would have done pretty well at first, but after two years of handsome gains, in 2007 it would begin to decline, at first steadily – and then in the fourth year it would crash. The financial crisis of '08 and '09 would deal it a devastating blow. Nevertheless, by the end of 2009 it would have earned a positive risk premium of 2% (approximately 5% for the portfolio vs. 3% for the short-term bond) for the period. The chart above provides a snapshot.

Caveat, Investor!

While suggestive, these charts in no way prove the validity of the CAPM. Indeed, the CAPM *cannot* be empirically tested, because its predictions concern future expectations, and the available data are inapposite, because they are historical realizations. The best that we can say is that CAPM may be a reasonable place to start in designing an investment program. Financial economics since the 1980s has asked, “how reasonable?” The CAPM seems to be precisely applicable only under highly restrictive conditions. Remember: a straight line is the shortest distance between two points only if the world is flat.

Key to Asset Class Data Points in Charts

S&P 500	US Large Cap Stock
F/F Lrg Val	US Large Cap Value Stock
CRSP 6-10	US Small Cap Stock
F/F Sml Val	US Small Cap Value Stock
CRSP 9-10	US Micro Cap Stock
NAREIT - Equity	US Securitized Real Estate
MSCI EAFE	Foreign Large Cap Stock
MSCI EAFE Value	Foreign Large Cap Value Stock
S&P EPAC Small	Foreign Small Cap Stock
S&P EPAC Small Value	Foreign Small Cap Value Stock
S&P/IFCI Emerging Composite	Emerging Markets Stock
T-Bills	1-Year Treasury Bills
BC IT Govt/Credit Interm	US Intermediate Bonds
Citi World 1+YR Govt	World Government Bonds

This article outlines a rationale, based largely on the CAPM, for establishing a strategic asset allocation target and “staying the course.” For alternative viewpoints on asset management, written at an intermediate to advanced level, please visit our website (www.schultzcollins.com) to access a forthcoming two-part article appearing in The Banking Law Journal written by Patrick Collins: “Trustee Asset Management Elections: Portfolio Performance Evaluation and Preferencing Criteria.”

NEWS OF SCHULTZ COLLINS LAWSON CHAMBERS

Cliff has joined Schultz Collins Lawson Chambers as an Investment Advisor. He will work primarily with our private clients, developing solutions to complex questions involving portfolio design and implementation. Ken will also specialize in modeling investment programs with a high probability of meeting an investor's income requirements during retirement.

Ken comes to Schultz Collins with 20 years of experience in financial services. For the past 17 years he worked for Charles Schwab & Co. in several capacities. His research, analysis and commentary were widely distributed among Schwab's financial consultants and retail clients. He represented Schwab's Fixed Income Division on the firm's Investment Strategy Council. Ken also developed considerable expertise in the field of securitized real estate, specializing in evaluating and reporting on REIT's. Most recently, Ken was responsible for leading over ninety relationships with Schwab's high net worth retail clients, representing over \$360 million in assets. Ken received a B.S. in applied economics and a master's degree in Financial Analysis, from the University of San Francisco.

Some of our clients may not be aware that Schultz Collins Lawson Chambers serves as consultant and investment advisor to fiduciaries of corporate retirement programs, primarily 401(k) Plans. We currently consult on more than \$1.4 billion of retirement plan assets for over 30 corporations. Our colleague, Jon Chambers, is a recognized leader in this field and in recent years has shuttled back and forth to Washington DC to consult with the SEC, US Department of Labor (DOL), the General Accounting Office (GAO), and a US Congressional Committee on the need for enhanced disclosure rules within 401(k) Plan investment programs. Recent regulations released by the DOL reflect Jon's recommendations on several key points.

Jon maintains an active speaking schedule. In July, he delivered two presentations at the Western Benefits Conference (WBC) in Los Angeles. His topics were "Benchmarking Service Providers" and "Retirement Income Adequacy: How Behaviors and Assumptions Must Change." WBC is one of the nation's largest regional pension and benefits conferences, attracting about 1,000 pension professionals each year.

On October 5, 2010, Jon hosted a webinar for our corporate clients to discuss interim final regulations under section 408(b)(2) of ERISA. The new regulations significantly enhance the disclosure requirements that apply to service providers to 401(k) and other similar retirement plans. A recorded copy of our webinar is available upon request. On November 9, Jon will present "New Strategies for Volatile Markets: Current Trends in 401(k) Plan Investments" to the San Francisco Chapter of WP&BC (Western Pension & Benefits Conference). Please contact us if you would like an invitation to this event.

As mentioned in our lead article, the Banking Law Journal will soon publish a two part article written by our colleague Patrick Collins, Ph.D., CFA: "Trustee Asset Management Elections: Portfolio Performance Evaluation and Preferencing Criteria." The article explains that trustees must develop investment portfolios that address specific objectives and income requirements in the future. It is common for trustees to rely on past performance as the basis for investment decision making. However, trustees should be aware that confusing past track records (performance measures) with strategies appropriate for future needs (preferencing criteria) can derail an investment program.

SCLC analysts Huy Lam and Bashir Nakhuda recently passed their second level exams for the prestigious and useful Chartered Financial Analyst designation. We offer our congratulations and wish them good luck on the third and final test.

On a more personal note, we are pleased to announce the marriage in June of our colleague Nicole Basso to Mr. Brett VanderGeest. As many of you know, Nicole plays a pivotal role in helping our clients obtain exactly the services they need to keep their accounts running smoothly – and she plays a huge part in putting this publication together each quarter. Mr. VanderGeest is a banker with Bank of America.

... trustees should be aware that confusing past track records (performance measures) with strategies appropriate for future needs (preferencing criteria) can derail an investment program.

WORLD MARKET SURVEY

(continued from page 1)

... nervous individual investors shoveled \$87 billion into bond mutual funds in the third quarter, even as bond yields approached the vanishing point.

According to the Investment Company Institute, those nervous individual investors shoveled \$87 billion into bond mutual funds in the third quarter, even as bond yields approached the vanishing point. That brought the net new investment in fixed income mutual funds this year to a staggering \$620 billion. Meanwhile, individuals appeared to be shunning stocks, with \$43 billion in net outflows from stock mutual funds for the quarter and over \$100 billion withdrawn for the year-to-date. Apparently, the exaggerated market swings and weak long term returns for some market indices have cast doubt on the benefits of stock ownership. Of course, investor sentiment has rarely been a reliable indicator of future market performance.

A Cloud of Uncertainty May Soon Clear

Another piece of accepted wisdom is that the stock market loathes uncertainty and there are several political issues that have exerted a drag on the market. Chief among these will be the outcome of the mid-term elections and, more importantly, the ultimate disposition of the Bush tax cuts as they apply to both ordinary income taxes and the Treasury's take of dividends and capital gains. Currently, US corporations are sitting on a huge cash hoard, equal to nearly 12% of their overall market value, as they wait for clarification of the tax code to decide whether to invest in new plants and equipment, hire more employees, buy back their own stock, or increase their dividend payouts. Any of these steps could register positively on stock prices.

Developed Foreign Market Post Mixed Results

Among foreign stock markets, the European Union pulled back from the brink of its sovereign debt crisis, as fears of a default among several of the continent's weaker nations began to ebb. A series of stress tests applied to 91 of the largest Euro banks seemed to indicate that another meltdown was not imminent. European stocks ended the quarter with a 9% gain in local currency. For US investors, this translated to a 19% gain, as the euro strengthened and the dollar retreated towards the end of the quarter. Like the US, Japan's stock market enjoyed a positive September, with shares up roughly 6%. Even so, the Nikkei stock index remains down 11% for the year.

HIIC's versus BRIC's

For the past several decades, the global stock market has been divided between countries with developed economies, such as the US, Japan and the leading

countries of Europe, and those developing countries, such as Mexico, South Korea, and Taiwan, otherwise known as the emerging markets. In recent months, these characterizations have shifted to such an extent that market pundits have developed several new acronyms to reflect the current reality. The developed economies are now referred to as HIIC's, or "Heavily Indebted Industrialized Nations", due to systemic problems that resemble those of the former emerging markets. Concurrent with the weakening of the developed nations has been the rapid growth and sophistication of formerly emerging, but now relatively advanced, economies in countries such as Brazil, Russia, India and China – the "BRIC" nations. Although the recent financial crisis that seized up markets worldwide indicates how interdependent global economies have become, there are early indications of a "decoupling" of the BRIC's from the HIIC's. The emerging economies have resumed their upward trajectory as developed markets have stagnated. The MSCI Emerging Markets Index was up 18% for the quarter and 10.75% through the year-to-date.

How Low Can Interest Rates Go?

On the fixed income front, the demand for predictable income has driven bond prices up and their respective yields down to historic levels. Consider that Microsoft, one of the few triple-A-rated US firms, recently issued debt instruments for only the second time in its history. Its 3-year note sold with a yield of just 0.87% which, according to the Wall Street Journal, was the lowest interest rate for a corporate bond of that maturity in more than three decades. The quarter ended with the benchmark 10-year Treasury note yielding a miserly 2.51% and the 2-year Treasury note at just 0.43%. Meanwhile the yield on 10-year Treasury Inflation Protected Securities (TIPS) was 0.75%. The TIPS yield implied a forward looking annual inflation rate of 1.78%.

Commodities Prices Reflect Various Concerns – & Opportunities

Prices for agricultural commodities and precious metals rose during the quarter while oil and natural gas traded in a narrow range. Weather conditions contributed to a 45% surge in the price of wheat when Russia suspended exports due to a prolonged drought. Dry conditions in Brazil sent sugar up 40% and the floods in Pakistan pushed up cotton prices. Dry conditions in China also contributed to the demand as the Chinese have become net importers

Concurrent with the weakening of the developed nations has been the rapid growth and sophistication of formerly emerging, but now relatively advanced, economies in countries such as Brazil, Russia, India and China – the "BRIC" nations.

(continued on page 12)

SURVEY OF INDICES & FUND AVERAGES
PERIOD AND ANNUALIZED COMPOUND RETURNS IN PERCENT

	Third Quarter 2010	Trailing 12 Month 9/30/2010	3 Years Ending 9/30/2010	5 Years Ending 9/30/2010	10 Years Ending 9/30/2010
Inflation Index & Risk Free Rate					
Consumer Price Index	0.56%	1.04%	1.52%	1.88%	2.31%
US 3-Month Treasury Bills	0.04	0.12	1.01	2.48	2.41
US Stock Market (Large Companies)					
Standard & Poor's (S&P) 500 Index	11.29	10.16	-7.16	0.64	-0.43
S&P/Citigroup Large Cap Growth Index	12.63	11.67	-4.32	1.71	-2.86
S&P/Citigroup Large Cap Value Index	9.98	8.54	-10.13	-0.55	1.65
Average Large Cap Blend Fund ‡	11.13	8.88	-7.22	0.41	0.18
US Stock Market (Small Companies)					
Russell 2000 Index	11.29	13.35	-4.29	1.60	4.00
Dimensional US Micro Cap Fund	10.58	14.44	-5.59	0.26	6.02
Russell 2000 Growth Index	12.83	14.79	-3.75	2.35	-0.13
Russell 2000 Value Index	9.72	11.84	-4.99	0.73	7.72
Average Small Cap Blend Fund ‡	10.93	13.56	-4.61	1.11	5.56
Real Estate					
DJ Wilshire REIT Index	13.22	30.14	-6.98	1.36	10.12
Fixed Income (Bond) Markets					
BarCap Government Bond Index	2.52	6.97	7.20	6.10	6.19
Avg. Intermediate Gov't Bond Fund ‡	1.62	6.92	6.60	5.40	5.37
BarCap Municipal Bond Index	3.40	5.81	6.04	5.13	5.73
Average California Intermed/Short Muni Bond ‡	3.32	5.08	4.57	3.94	4.38
Credit Suisse High Yield Bond Index	5.96	17.85	7.72	7.85	8.21
Average High Yield Bond ‡	6.40	16.53	5.38	6.01	5.95
Citigroup World Gov't Bond Index	8.18	4.99	8.15	7.05	7.64
Average World Bond Fund ‡	7.33	8.30	7.40	6.31	7.18
International Stocks					
MSCI EAFE Foreign Stock Index	16.48	3.27	-9.51	1.97	2.56
Average Foreign Large Blend Stock Fund ‡	17.06	5.55	-9.43	2.22	1.98
MSCI Europe Stock Index	19.35	2.63	-10.37	2.35	3.01
MSCI Pacific Stock Index	11.49	4.85	-7.60	1.20	1.55
MSCI Emerging Mkt Index (excl. dividends)	17.16	17.67	-3.72	10.22	10.79
Average Emerging Markets Fund ‡	18.59	19.53	-3.23	11.09	12.73

‡ Source: Morningstar Principia 9/30/2010

WORLD MARKET SURVEY

(continued from page 10)

of corn and other foodstuffs, not to mention precious metals of all kinds. Toward the end of the quarter gold surged past \$1,300 an ounce on the expectation of further monetary easing by the Federal Reserve and efforts by other developed nations to devalue their currencies. Gold is still considered by some investors to be the ultimate store of value. On the energy front, demand in the emerging markets did not overcome a persistent oversupply in the US, along with pessimism regarding the growth prospects for the highly indebted industrialized countries. Overall, the Dow Jones-UBS Commodity Index rose 11.6% for the ninety days ending September 30.

Real Estate versus REIT's

What has been the top performing investment category thus far in 2010? That would be publicly traded Real Estate Investment Trusts (REIT's). Given that US home prices have declined more than 20% over the past three years, with only a slight recovery this year, how is it the Dow Jones US Select REIT Index has gained more than 13% for the quarter and 19% for the year-to-date? The answer is that the yield on these investments remains attractive relative to other income producing assets even after taking into account the default rate on the underlying properties. Even after the huge run up in REIT prices, the current yield on the index is 3.47%.

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Individual Country Returns Third Quarter 2010

	US Dollar	Local Currency
North America		
United States	11.0%	11.0%
Canada	13.7	9.8
Latin America		
Brazil	22.1	14.8
Chile	34.1	18.3
Mexico	11.3	8.3
Africa		
South Africa	22.8	11.7
Europe		
Austria	26.0	13.0
Belgium	20.2	7.9
Finland	27.4	14.3
Denmark	18.1	6.0
France	20.8	8.3
Germany	17.0	5.0
Great Britain	18.9	12.9
Greece	11.2	-0.2
Ireland	4.7	-6.1
Italy	18.5	6.3
Netherlands	16.3	4.4
Norway	27.5	14.9
Portugal	19.0	6.8
Russia	12.3	9.9
Spain	26.1	13.2
Sweden	26.8	9.6
Switzerland	14.1	3.3
Asia		
Australia	23.2	7.5
China	12.1	11.8
Hong Kong	18.4	18.0
India	16.1	12.3
Indonesia	18.6	16.7
Israel	13.4	6.2
Japan	4.4	-1.4
Malaysia	16.7	11.2
New Zealand	12.4	5.1
Philippines	31.4	24.4
Singapore	16.1	9.4
South Korea	17.9	10.0
Taiwan	15.9	12.7
Thailand	32.2	23.9
Turkey	31.5	20.1

Source: Dow Jones Global Indexes