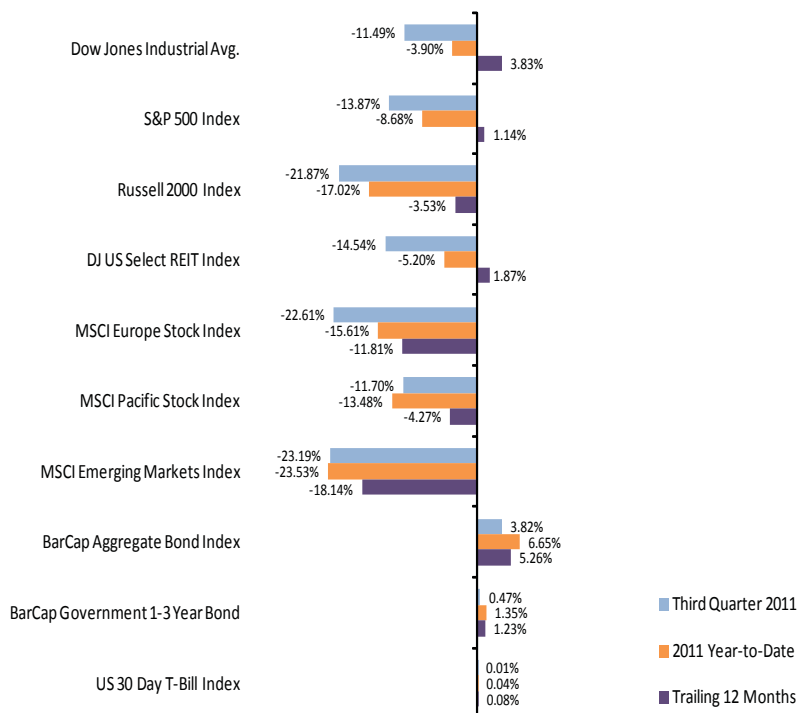


WORLD MARKET SURVEY

In some ways, the third quarter of 2011 felt like “*déjà vu* all over again.” A sudden spike in stock market volatility accompanied by a rapid decline in asset values was all too reminiscent of early days in the market collapse of late 2008. With the Dow Jones Industrials falling 1,500 points for a loss of 12%, and the S&P 500 down 14%, nervous investors withdrew \$71 billion from U.S. stock funds during the quarter. Whereas the market downturn during the financial crisis was triggered by an exploding real estate bubble and a meltdown in derivative investments, last quarter’s plunge had more to do with political issues: the fractious budget debate in Congress and the boiling sovereign debt crisis in Europe. The relatively high risk premiums associated with stocks at quarter end (implying potentially higher returns in the future) seem to indicate that the equity markets have adjusted to a negative outlook concerning the direction of the global economy.

(continued on page 8)

Index Returns: Third Quarter 2011, Year-to-Date, & Trailing 12 Months



REVISITING TIPS

Preface: TIPS Basics

INVESTMENT QUARTERLY for the Second Quarter of 2005 [available at schultzcollins.com/files/IQ2005Q2.PDF] featured an article on U.S. Treasury Inflation Protected Securities, or TIPS. The article states: “Each year, the Treasury adjusts the bond’s principal amount to reflect changes in inflation. Since the bond’s coupon payments are a fixed percentage of the accreted principal, they, too, are inflation adjusted. At maturity, a TIPS bond is redeemed for the greater of the inflation-adjusted principal or the original issue ‘par’ value.”

The U.S. Treasury began to issue TIPS in January, 1997. Commentators suggested that TIPS might be a valuable addition to many portfolios because the inflation-adjustment feature offered a unique opportunity to

protect purchasing power from erosion by inflation.

To understand TIPS, investors must first grasp the distinction between real and nominal interest rates. The nominal rate of interest is the current yield payable on the purchase price of a financial instrument. A simplified definition of the real interest rate is current yield minus inflation. A change in inflation will not be an important driver of change in real return of a TIPS bond, because the bond principal and coupon amounts adjust accordingly. By contrast, increasing inflation has a negative effect on the real returns of nominal Treasury bonds.

A change in the underlying real interest rate, however, can strongly influence TIPS prices. TIPS bond holders are sometimes surprised when their bonds decrease in value when

inflation is positive and increasing. This happens because increasing prices for goods and services may indicate excess supply of money, or higher expected economic growth, or both. In a growing economy, the increased demand for capital to finance growth opportunities tends to push up the cost of money – i.e., the real interest rate. Increases in both inflation and real interest rates make it possible for TIPS bonds to drop in value during a period of rising inflation despite the fact that the bond has inflation protection. Just as a fire insurance policy does not compensate you for earthquake damage, a TIPS bond with inflation protection does not protect you against adverse price changes caused by increases in the real interest rate. Nevertheless, if held to maturity, a TIPS bond will deliver a constant inflation-adjusted – i.e., real – unit of consumption over time.

REVISITING TIPS

“An inflation-index bond is the safe asset for a long-term investor, because it supports a stable standard of living in the long term.”

Academic Commentary

In 2002, Harvard economists John Y. Campbell and Luis M. Viceira summarized the key benefits of TIPS in the portfolio context: “An inflation-index bond is the safe asset for a long-term investor, because it supports a stable standard of living in the long term. Aggressive investors benefit because inflation-indexed bonds have considerably higher return per unit of risk than nominal bonds, while conservative investors benefit from the elimination of inflation risk.”

Theory and Reality

In the real world, we know that the inflation rate was well below its long term average between 1997 and June 2011. This observation raises several questions:

- How have TIPS performed during a period of unusually low inflation?
- Are TIPS a good predictor of future inflation?
- What investment funds are available to capture the risk and return of TIPS?

The following graph helps frame the discussion by providing information on historical risk and return from several indexes over the period October 1997 – the first full month of TIPS index returns – to June 2011.

The cumulative results over the recent 165 months through June 2011 are noteworthy in several respects. It is not surprising that bond indexes performed well over this period. Both nominal and real yields declined

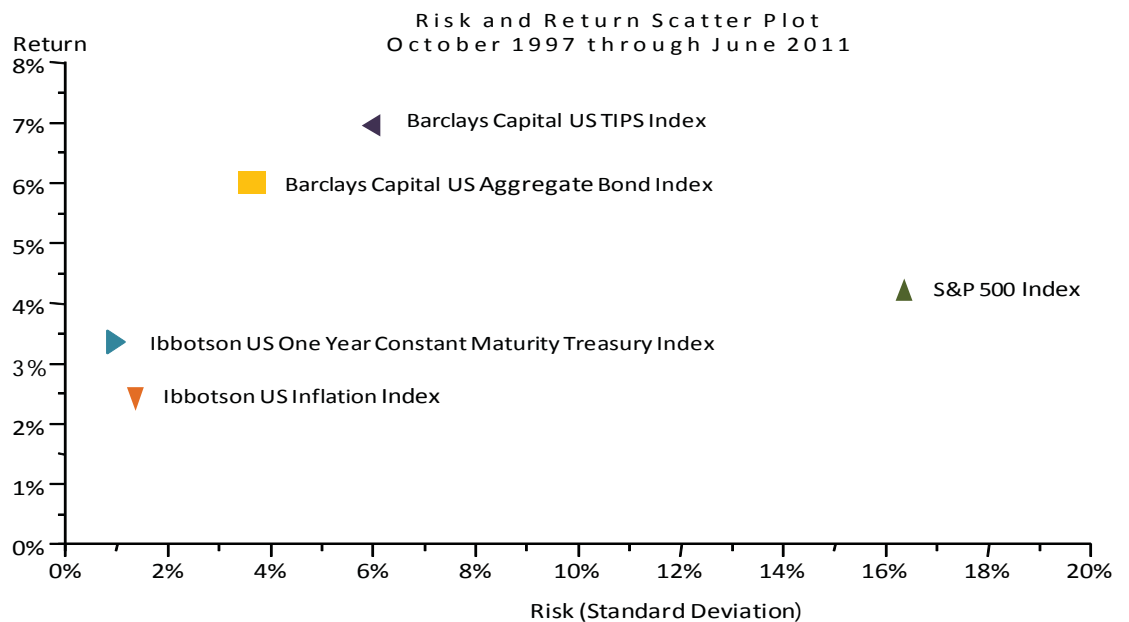
steadily from their peak early in the year 2000. All else equal, decreases in yields produce increases in bond prices. Inflation averaged less than three percent for the period. TIPS produced the highest return at a moderately low risk level. Short-term Treasuries, as expected, exhibit an extremely small standard deviation – i.e., they are the “safe” short-term asset – but produced only a miniscule return over inflation. US equity returns outpaced inflation, but at a high level of volatility.

Do Low Risk Assets Generate High Returns?

The brief review period argues for caution in interpreting the significance of the graph. During recent turbulent markets, bonds provided a valuable diversification benefit to investors and produced attractive risk-adjusted returns. However, in most twenty-year periods, stocks have outperformed bonds, but with a greater year-to-year volatility. But this is just another way of stating the basic proposition that long-term investors have the expectation of reaping a reward for taking market-related risk. Stock market investing entails greater risk than bond investing, so stocks should offer a correspondingly higher return.

Unfortunately, the expected reward for stock investors failed to materialize during this 165 month period because of two major equity market declines – the tech-stock plunge that began in 2000 and the 2008 global recession. In each decline, the price of stocks adjusted downwards – a painful event for stock owners – in response to the need to provide forward looking returns sufficiently high to attract new capital. It’s easier, on a go-forward basis, to earn a decent

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REVISITING TIPS

profit from stock dividends and appreciation when the stock is priced at \$50 per share than when it is priced at \$100.

It's the Journey, not the Destination

The chart below depicts the actual month-to-month path that each investment index took over the same period. It shows the growth of an initial \$1,000 investment starting in October 1997 and ending in June 2011. Note the wild ride taken by equity investors during this period. The plunge in prices during those two severe bear markets demonstrates the magnitude of short term stock market volatility. By contrast, both inflation and One Year Treasuries have a relatively smooth return pattern, despite their anemic upward slopes.

TIPS Performance During Low Inflation

Having looked at some background information, we can address the first of our three questions – how TIPS perform in a low inflation environment. The chart above shows that TIPS performed better than general bonds over the past 165 months, but it seems counterintuitive that an investment vehicle that sacrifices coupon yield in return for inflation protection can generate superior returns during a period of low inflation. Part of the puzzle can be explained in terms of classic bond mathematics. The duration of the TIPS index is greater than that of the Aggregate US Bond Market. Duration measures the sensitivity of a fixed income portfolio to changes in bond yields. As yields decreased, the longer duration TIPS index generated greater price appreciation than the shorter duration Aggregate index. Thus we see that TIPS can perform

well during periods of low inflation if interest rates are trending generally downward.

Can TIPS Predict Inflation?

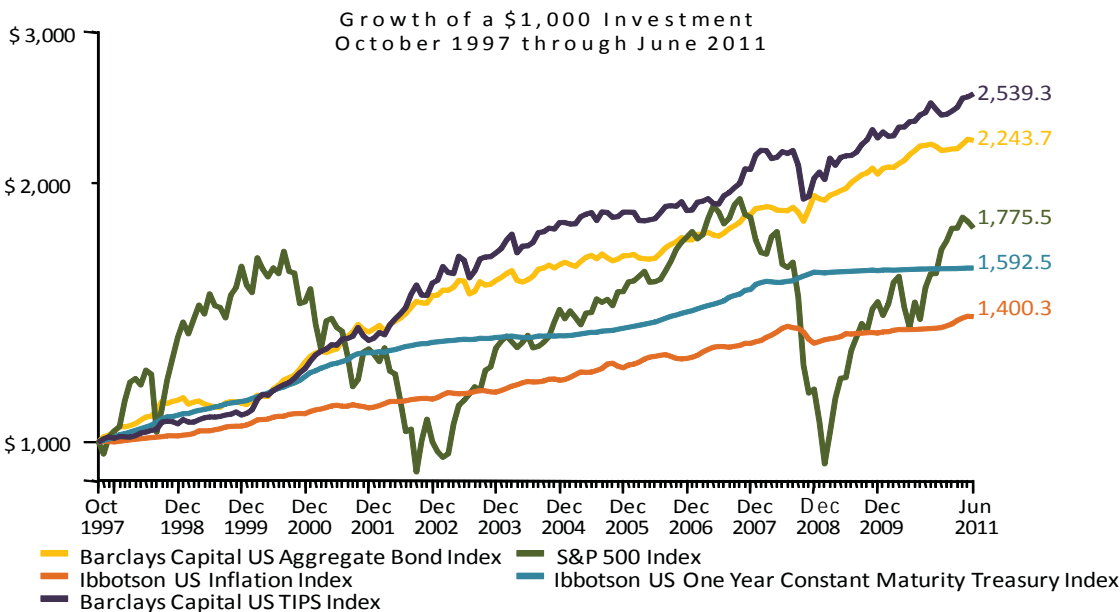
Our second question asked whether TIPS were a good predictor of future inflation. The answer depends on your definition of 'good.' A common way to achieve an estimated inflation forecast is to subtract the yield on TIPS from the yield of a comparable maturity-matched nominal coupon Treasury. Thus, for example, if a 10-Year US Treasury Note yield is 3.5% while a 10-Year inflation protected Treasury Note yields 1.5%, the difference can be attributed to the fact that market participants expect that inflation will average 2% over the 10-year period. Although this forecasting method is not precise enough for most economists, it remains popular because of its simplicity.

How SCLC Evaluates Investment Products

Our third question asks about investment funds that invest in TIPS. Each year, SCLC evaluates leading no-load TIPS mutual funds and exchange traded funds [ETF's]. Funds in this year's evaluation included:

- iShares Barclays TIPS Bond
- Vanguard Inflation-Protected Securities
- PIMCO Real Return

The iShares Barclays TIPS Bond Fund is an exchange traded index fund that tracks the Barclays Capital U.S. Treasury Inflation Protected Securities (TIPS) Index. The scatter chart on page 4 plots the monthly returns of the iShares fund (the fund has a 20 basis points expense ratio) against the monthly returns of



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REVISITING TIPS

its benchmark index. Visual inspection indicates that the fund tracks its index closely. It is worth taking note of the “outlier” point at the bottom left position on the line. The chart tells investors that the fund and the index suffered a month in which losses exceeded 8 percent.

The Vanguard Inflation-Protected Securities Fund is an actively managed fund. The fund typically invests at least 80% of its assets in inflation-indexed bonds issued by the U.S. government, agencies, instrumentalities, and by corporations.

The scatter chart at the top of page 5 plots the monthly returns of the Vanguard Inflation-Protected Fund (the fund has a 25 basis points expense ratio) against the monthly returns of the TIPS benchmark index. As you can see, the scatter plot suggests that the actively managed fund deviates a little more from the index than the iShares ETF.

The PIMCO Real Return Fund is also an actively managed fund. It invests at least 80% of its net assets in inflation-indexed bonds issued by U.S. and non-U.S. governments, agencies, instrumentalities, or corporations (including emerging market debt). The fund may invest up to 20% of net assets in fixed income securities rated ‘B’ or higher by Moody’s or S&P, up to 30% of its assets in securities denominated in foreign currencies, and up to 10% of its total assets in preferred stocks. Finally, the fund may invest all of its assets in derivative securities, and, under certain circumstances, may enter into short sales.

The scatter chart at the bottom of page 5 plots the monthly returns of the PIMCO Real Return Fund (the fund has a 45 basis points expense ratio) against the monthly returns of the TIPS benchmark index. The actively managed PIMCO fund deviates from the index far more than the actively managed Vanguard fund. However, over its history, the PIMCO fund has outperformed the index by an average of 72 basis points (0.72%) per year.

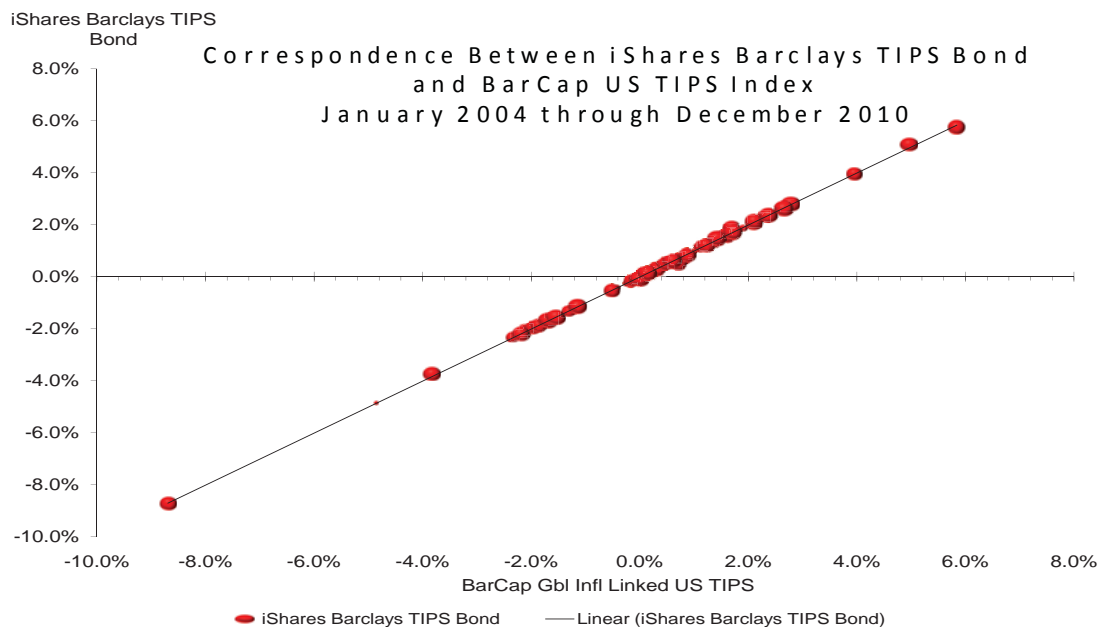
What Should I Buy?

Suppose that an investor wishes to allocate 5 percent of wealth to a position in TIPS. Should the investor purchase the iShares ETF, the Vanguard mutual fund, the PIMCO mutual fund, or some combination thereof?

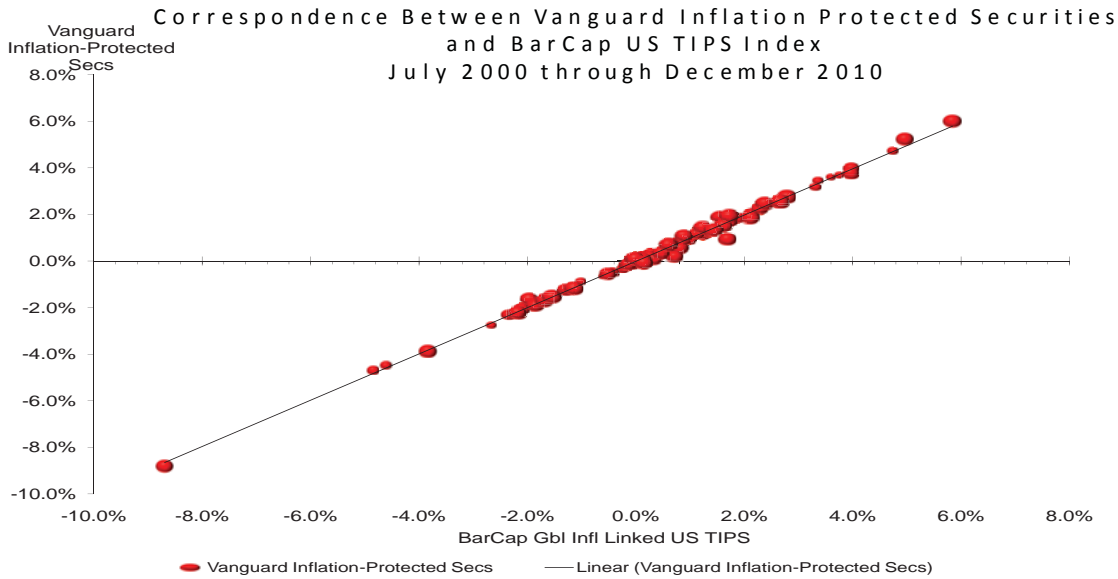
The simple answer is that each of the three funds is a prudent and suitable investment selection. Toss a coin, pick one, make life simple, and you’re done. For investors and fiduciaries who wish to dig deeper, we offer the following observations:

1. The first choice is between active and indexed management. The iShares fund explicitly states that its goal is to track an underlying index that follows the broad TIPS market. Purchasing the iShares fund provides TIPS market risk and reward exposure at a very low cost. The Vanguard and PIMCO funds represent a choice of active management. In addition to the risk factors present in the broad TIPS market, active managers are free

In addition to the risk factors present in the broad TIPS market, active managers are free to take investment positions which do not reflect market consensus.



REVISITING TIPS



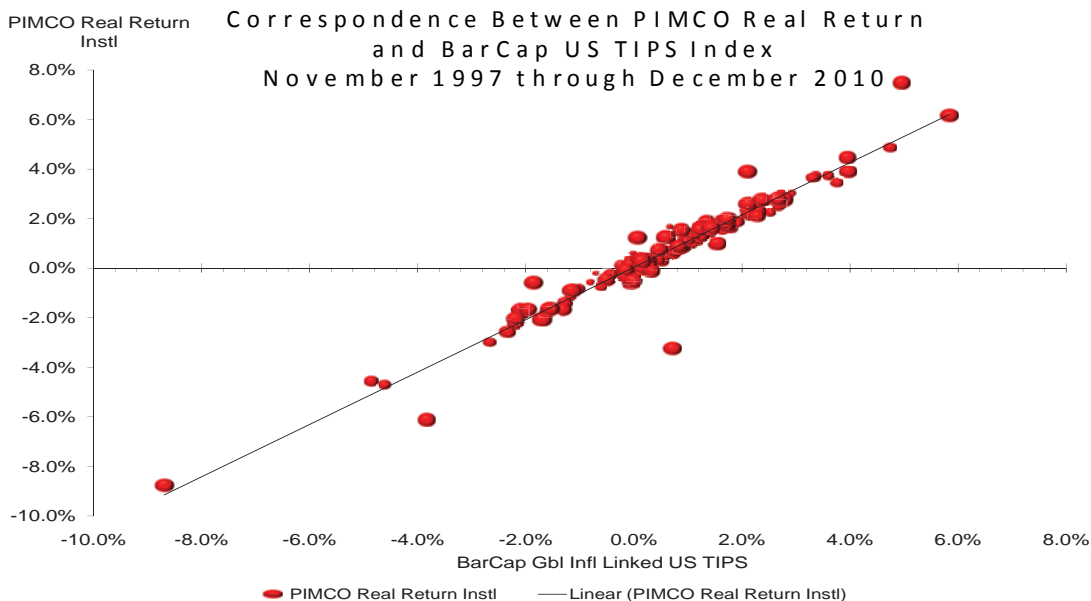
to take investment positions which do not reflect market consensus. Thus, for a higher cost, the Vanguard or PIMCO investor elects to assume both market risk and active manager risk — i.e., the risk that the manager’s deviation from the index will subtract rather than add value.

governments, corporations, and other entities. The fund can invest 100% of assets in derivatives, and may enter into short sales. This means that investors in the fund might conceivably experience periods in which they were not invested in TIPS at all.

2. The PIMCO fund’s prospectus indicates that fund management has broad latitude to pursue returns from inflation-protected fixed income through various potential strategies. The fund can invest in bonds that are not found within the TIPS index, such as bonds issued by foreign

3. The Vanguard fund occupies a position between iShares and PIMCO. Although it is nominally actively managed, the prospectus assures investors that there are constraints on the manager’s ability to deviate from index-related risk/reward exposures. For investors who are skittish about PIMCO’s free-wheeling strategies

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REVISITING TIPS

One fact should be obvious: it is important to read the fund's prospectus to understand fund management's investment strategies and objectives. As Yogi Berra said: "If you don't know where you are going, you may end up someplace else."

Our 2008 experience taught us that forced liquidation of assets during turbulent economic conditions can cause trades to become highly correlated – 'crowded trading' – and can send asset prices in a direction counter to economic theory.

but who wish to have an active fixed income manager, the Vanguard fund is a good choice. Alternately, an investor might wish to combine the iShares and PIMCO funds according to a weighting scheme that matches the investor's risk tolerance.

4. Although the PIMCO fund is the only one of the three that exhibits cumulative positive value added over the 165 month period, and performs similarly to or better than the index in most months, there are a couple of months when the PIMCO fund trails the index significantly. How much slack is an investor willing to cut PIMCO management in order to secure a contingent probability that, over the long run, the fund will add value? The answer to this question depends, in part, on (a) the investor's expectation that the investment will beat the market in the long run, and (b) on the investor's sensitivity to downside tracking risk.

Each year, we at SCLC supply our clients with a detailed quantitative analysis of funds owned within their portfolios under our supervision. Although quantitative analysis is an important evaluation tool, other qualitative factors also influence investor preferences. One fact should be obvious: it is important to read the fund's prospectus to understand fund management's investment strategies and objectives. As Yogi Berra said: "If you don't know where you are going, you may end up someplace else."

The 'Outlier' Month

An examination of the stock and bond returns for the last part of 2008, shown on the chart on page 3, reveals some interesting patterns. In September 2008 equity returns plunged as investors digested the implications of the Lehman bankruptcy, the continued crisis in the housing and subprime mortgage markets, and other negative economic news. By contrast, Treasuries rallied as investors executed a classic "flight to quality." Yields on new short-term Treasuries approached zero as investors focused less on the return on capital and more on the return of capital. Although Treasuries and TIPS are both generally considered to be default-free securities, the value of TIPS dropped suddenly at the same time that stocks plummeted. September 2008 was the 'outlier' month for TIPS – it was the month that TIPS index dropped precipitously while nominal Treasuries rallied. Why did investors flee to government guaranteed nominal Treasuries while avoiding government guaranteed TIPS? As interest rates fell, why did relatively long duration TIPS fail to

rally? Why did the negative correlation between TIPS and stocks suddenly turn positive at the very time it was needed most?

One widely held theory focuses on the Lehman bankruptcy. Lehman owned substantial TIPS positions, and had posted TIPS as collateral for various counterparty transactions. Following the bankruptcy, counterparties raced the bankruptcy court to raise cash by dumping a large volume of TIPS into the market. Concurrently, several major hedge funds with TIPS positions came under pressure because they were desperate to de-lever their investment portfolios. As loan collateral in the form of stocks became more problematic, they began to sell the assets that had held their value best – i.e., TIPS. As TIPS sellers flooded the market, market makers became reluctant to purchase TIPS because the recession was increasing risk aversion across the board. Arbitrage mechanisms broke down because arbitrage itself was becoming too risky. Finally, some mutual funds that combined TIPS positions with commodity futures were forced to sell TIPS as commodity prices plunged. The typically thin market for TIPS froze due to an absence of buyers, and a full blown liquidity crisis developed. The view of TIPS as a secure long-term investment but a highly variable short term investment was confirmed by the events of late 2008.

Implications for Investors

Our 2008 experience taught us that forced liquidation of assets during turbulent economic conditions can cause trades to become highly correlated – 'crowded trading' – and can send asset prices in a direction counter to economic theory. Practical implications for investors include:

1. Don't leverage your investment positions unless you can afford to lose a lot of money very quickly.
2. Don't fall in love with any investment idea or strategy – maintain a well diversified portfolio unless there are compelling reasons not to do so.
3. Don't market time – you can't predict the effects of anomalous events on market liquidity.
4. Pay attention to the prospectus.

A longer version of this article may be found at schultzcollins.com/files/Revisiting_TIPS.pdf.

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

	Third Quarter 2011	Trailing 12 Month 9/30/2011	3 Years Ending 9/30/2011	5 Years Ending 9/30/2011	10 Years Ending 9/30/2011
Inflation Index & Risk Free Rate					
Consumer Price Index	0.65%	3.76%	1.13%	2.11%	2.46%
U.S. 3-Month Treasury Bills	0.01	0.11	0.21	1.62	1.92
U.S. Stock Market (Large Companies)					
Standard & Poor's (S&P) 500 Index	-13.87	1.14	1.23	-1.18	2.82
S&P/Citigroup Large Cap Growth Index	-11.56	4.85	4.47	1.41	3.05
S&P/Citigroup Large Cap Value Index	-16.30	-2.66	-2.19	-3.88	2.41
Average Large Cap Blend Fund ‡	-15.84	-1.79	0.29	-1.81	2.56
U.S. Stock Market (Small Companies)					
Russell 2000 Index	-21.87	-3.53	-0.37	-1.02	6.12
Dimensional U.S. Micro Cap Fund	-20.75	-1.61	0.87	-1.58	7.55
Russell 2000 Growth Index	-22.25	-1.12	2.07	0.96	5.45
Russell 2000 Value Index	-21.48	-5.99	-2.78	-3.08	6.47
Average Small Cap Blend Fund ‡	-21.77	-3.70	0.61	-1.12	6.18
Real Estate					
DJ Wilshire REIT Index	-14.54	1.87	-2.16	-3.18	9.08
Fixed Income (Bond) Markets					
BarCap Government Bond Index	5.85	5.58	6.43	6.56	5.44
Avg. Intermediate Gov't Bond Fund ‡	3.35	4.92	6.72	5.84	4.70
BarCap Municipal Bond Index	3.81	3.88	8.08	5.01	5.09
Average California Intermed/Short Muni Bond ‡	2.58	2.55	6.01	3.84	3.81
Credit Suisse High Yield Bond Index	-5.12	2.61	12.54	6.80	9.04
Average High Yield Bond ‡	-6.64	0.77	9.70	4.74	6.93
Citigroup World Gov't Bond Index	2.38	4.61	7.71	7.54	7.43
Average World Bond Fund ‡	-1.19	1.45	8.13	6.32	6.63
International Stocks					
MSCI EAFE Foreign Stock Index	-19.01	-9.36	-1.13	-3.46	5.03
Average Foreign Large Blend Stock Fund ‡	-20.90	-11.64	-1.79	-3.65	4.42
MSCI Europe Stock Index	-22.61	-11.81	-2.76	-4.13	4.81
MSCI Pacific Stock Index	-11.70	-4.27	2.37	-2.09	5.47
MSCI Emerging Mkt Index (excl. dividends)	-23.19	-18.14	3.81	2.50	13.35
Average Emerging Markets Fund ‡	-22.81	-17.72	3.93	2.85	14.71

‡ Source: Morningstar Principia 9/30/2011

WORLD MARKET SURVEY

(continued from page 1)

The difficulties facing the Euro Zone precipitated a steep sell-off: the German and French stock markets, the largest in Europe, were off by more than 24% last quarter. The ongoing crisis has also undermined the Euro, which declined roughly 8% relative to the dollar. The combined market and currency return pushed returns on French and German stocks down by more than 30%. The U.K. saw its markets decline 14.1%, but Britain is not a member of the European Monetary Union: the pound sterling weathered the storm with only a slight adjustment, with a return on U.K. stocks in dollar terms of -16.7%. Japan, still struggling to recover its full production following the tsunami and nuclear meltdown, saw its markets decline 10.2% for the quarter. However, investors have perceived the yen as a relative safe haven: it appreciated by about 4%, reducing the loss on Japanese shares for U.S. investors to just 5.9%.

Results from the emerging markets were also negative last quarter. Stock markets in the BRIC nations (Brazil, Russia, India and China) were hit first by falling share prices and then by a stiff penalty from a decline in their respective currencies relative to the dollar. For U.S. investors, Brazil was off 27.2%, Russia fell 28.5%, India finished down 19.6%, and China ended the quarter with a 26.1% loss.

U.S. Treasuries with maturities of ten years or more surged, reducing their yields to historic lows. The interest rate on the 10-year Treasury note dropped below 2%, and the 30-year Treasury bond yield hovered around 3%. In an unusual turn of events, returns from bonds have trumped those from stocks over the past ten years. The cumulative total return on the S&P 500 for the period was 32%, versus a 73% total cumulative return on the BarCap U.S. Aggregate Bond Index.

Commodity prices held firm through most of the third quarter, but finally succumbed to the prevailing concern about a slowdown in the global economy. The Dow-Jones UBS Index of nineteen widely consumed commodities ended the quarter down 11.3%. Even gold prices, which had been soaring on fears of a deteriorating global financial system, took a hit last quarter, with the price of bullion off 14%. Despite their relatively generous yields, equity REIT's also dropped in price last quarter, with the Dow Jones US Select REIT Index generating a total return of -14.54%.

Overall, the equity and commodity markets seemed to have girded for a global recession. Any substantive news to the contrary could cause markets to change direction in a hurry.

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QUALIFIED RETIREMENT PLANS
PRIVATE INVESTORS
TRUSTS, ENDOWMENTS & FOUNDATIONS

Individual Country Returns Third Quarter 2011

	U.S. Dollar	Local Currency
North America		
United States	-15.7%	-15.7%
Canada	-19.6	-13.2
Latin America		
Brazil	-27.2	-13.5
Chile	-27.0	-18.4
Mexico	-21.4	-7.0
Africa		
South Africa	-17.6	-2.3
Europe		
Austria	-34.3	-29.0
Belgium	-19.6	-13.1
Finland	-28.0	-22.2
Denmark	-24.7	-18.9
France	-30.0	-24.4
Germany	-30.9	-25.3
Great Britain	-16.7	-14.1
Greece	-45.3	-40.9
Ireland	-21.2	-14.8
Italy	-31.2	-25.6
Netherlands	-23.5	-17.4
Norway	-24.6	-17.5
Portugal	-25.2	-19.2
Russia	-28.5	-17.4
Spain	-23.7	-17.6
Sweden	-27.0	-20.5
Switzerland	-18.0	-11.5
Asia		
Australia	-21.6	-13.6
China	-26.1	-26.0
Hong Kong	-25.5	-25.4
India	-19.6	-12.0
Indonesia	-12.5	-10.4
Israel	-25.5	-17.8
Japan	-5.9	-10.2
Malaysia	-18.6	-13.9
New Zealand	-10.0	-2.8
Philippines	-8.3	-7.5
Singapore	-20.2	-15.2
South Korea	-22.7	-14.7
Taiwan	-21.3	-16.5
Thailand	-13.6	-12.6
Turkey	-18.2	-6.4

Source: Dow Jones Global Indexes