

Third Quarter
2011



LEAVELL
INVESTMENT MANAGEMENT

Investment Commentary

Following mostly positive returns for the first half of 2011, concerns about Europe's debt woes and negative global economic news sparked recession fears and drove stock markets down steeply in the third quarter. Stocks around the globe saw percentage losses from the mid-teens to the low twenties in the third quarter, while the U. S. Dollar and Treasuries climbed as investors fled to safety. Large-cap domestic stocks fell 13.9% during the third quarter and have lost 8.8% year to date. Smaller-cap stocks suffered larger losses, down 21.8% for the quarter, and 17% for the year through September. International stocks also suffered double-digit losses, with developed-market equities losing 20.9% for the quarter and 18% year to date. Emerging-markets stocks were hit hardest, losing 24% for the quarter and 23.4% year to date.

Domestic high-quality, intermediate-term bonds gained 4% in the third quarter and are up 6.6% year to date, driven by investors' flight to the relative safety of Treasuries. Developed-market international bonds were up 2.4% for the quarter and have gained 6.5% year to date. Local-currency emerging-markets bonds dropped significantly in September as capital flowed out of emerging-market currencies, and ended the quarter down 8.5% and are now in the red by 2.2% year to date.

Investment Outlook

It has been an eventful and highly volatile quarter and what seems to have changed from earlier this year is the perception that the likelihood of a global slowdown has increased and as such investors have reduced exposure to riskier assets. There are many signs suggesting a double-dip recession is possible, though it is certainly not a foregone conclusion at this point. A recent survey of economists by the Wall Street Journal suggests a 33% chance that the U.S. will slip into a recession in the next twelve months. The biggest market risk would seem to be an eventual default by Greece that led to further troubles for other Eurozone members and European banks. It is becoming more apparent that Greece cannot repay its debt without some kind of restructuring. The question becomes whether it is an "orderly default" which can be managed in a way that avoids bringing down other governments and/or banks, or a disorderly one which leads to chaotic conditions in Europe. Markets of course hate uncertainty and until there is some resolution on this front, volatility should be expected to continue.

In the event of a U.S. recession, American companies



September Benchmark Returns (Preliminary)			
Large-Cap Benchmarks	Sep	3Q	YTD
Vanguard 500 Index	-7.0%	-13.9%	-8.8%
Russell 1000 (iShares)	-7.5%	-14.7%	-9.3%
Russell 1000 Growth (iShares)	-7.4%	-13.2%	-7.3%
Russell 1000 Value (iShares)	-7.5%	-16.2%	-11.3%
Mid-Cap Benchmarks			
Russell Midcap (iShares)	-9.6%	-18.9%	-12.4%
Russell Midcap Growth (iShares)	-10.1%	-19.4%	-11.7%
Russell Midcap Value (iShares)	-9.2%	-18.5%	-13.1%
Small-Cap Benchmarks			
Russell 2000 (iShares)	-11.2%	-21.8%	-17.0%
Russell 2000 Growth (iShares)	-11.5%	-22.2%	-15.5%
Russell 2000 Value (iShares)	-10.9%	-21.5%	-18.6%
Other Benchmarks			
Vanguard Total Int'l Stock Index	-12.3%	-20.9%	-18.0%
MSCI World ex USA Index	-2.0%	-11.8%	-7.3%
Vanguard Emerging Mkt Stock Index	-16.2%	-24.0%	-23.4%
Vanguard REIT Index	-11.0%	-14.6%	-5.9%
Vanguard Total Bond Mkt Index	0.9%	4.0%	6.6%
Merrill U.S. High Yield Cash Pay	-3.5%	-6.2%	-1.6%
Barclays 7 Yr Muni Bond Index	0.1%	3.1%	7.2%
S&P/LSTA Leverage Loan Index	0.4%	-3.9%	-1.4%
Citigroup World Govt. Bond Index	-2.0%	2.4%	6.5%
JPMorgan GBI-EM Global Div. Index	-9.8%	-8.5%	-2.2%
DJ-UBSCI (Commodity Futures)	-14.7%	-11.3%	-13.6%

would appear to be extremely well positioned to weather the storm. Due to strong earnings, and in many cases record profits, U.S. companies have accumulated over \$2 trillion on their balance sheets since the recovery began. This cushion will enable companies to avoid slashing capital expenditures and reduce the necessity of more layoffs. Additionally, debt loads at many companies have been sharply reduced in the last two years and corporate cash flows continue at strong levels. While developing markets have suffered the most as a result of global slowdown fears, most emerging markets remain very healthy when gauged by debt levels and relative growth rates. According to Barclays, the forecast annual growth rates of emerging markets, while lower than previous years, remains approximately 4.68 percentage points above those of developed markets.

Politics and Policy

One of the challenges for investors today is that government policy is likely to determine the path taken by the global economy. This creates tremendous

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uncertainty because not only is it impossible to predict what will be decided by legislative bodies, it is also difficult to have confidence in what the ultimate effects of those decisions will be. Policymakers seem especially divided on how to approach the fiscal challenges in this particularly vulnerable global economy.

Along these lines, the past three months saw much debate and little progress on the U.S. fiscal deficit, as topics like tax policy continue to be very polarizing. The debt ceiling showdown earlier in the summer was the quarter's most dramatic example of politics contributing to general uncertainty. Many portfolio managers and strategists watched the debt ceiling debate in disbelief that politicians seemed to flirt openly with the possibility of a U.S. default. Despite an 11th hour agreement, the contentious process and lack of meaningful action seemed to drive down consumer confidence and were specifically cited as part of the reason for Standard & Poor's subsequent decision to downgrade the U.S. debt rating from AAA to AA. The downgrade didn't reflect any new information about the debt challenges we face as a country and so we don't view the actual decision as a highly material development, and in fact it had no impact on the perceived relative safety of U. S. Treasury debt.

Overall, we continue to view policy mistakes, or simply inaction, as a major unknown and a potential risk factor. Too much austerity too soon could prove counterproductive and reduce tax receipts by a greater amount than spending cuts, thereby worsening the deficit problem. But, failure to address the deficit and debt in a meaningful way runs the risk of markets forcing the issue: investors demanding higher returns for taking on the risk of owning U.S. debt, forcing interest rates higher and further choking off growth, not to mention raising the cost of servicing our debt.

Meanwhile, with fiscal policy stalled by politics, monetary policy has been more aggressive with the Federal Reserve deploying a range of experimental tactics for boosting the economy. The quarter began with the end of QE2, the Fed's second bond-buying campaign, and it ended with Operation Twist, by which the Fed will in effect exchange short-term debt on its balance sheet for long-term debt in an effort to reduce long-term interest rates and encourage lending and investing. The Fed has also made an unusually explicit commitment to keeping rates low until at least 2013. All of these efforts represent extraordinary measures intended to further the Fed's dual mandate of ensuring price stability (which today means fending off deflation and avoiding runaway inflation down the road), and fostering full employment.

Investment Time Horizon

As you know, we are not short-term investors. We have little confidence in forecasting (i.e., guessing) what will happen to interest rates or the stock market over the next few days, weeks, or months. And, we would certainly never base investment decisions on

such guesses. What we do have confidence in (tempered by a strong dose of humility and intellectual honesty) is our analysis of scenarios and potential asset class returns when we extend the time horizon out to several years *because we believe at some point, over that long of a time frame, economic fundamentals and valuations come to the fore*. This analytical framework forms the basis for our tactical portfolio allocation decisions.

Investors should never judge their decisions based on a moment in time. It is critical to successful long term investing to avoid the temptation to react to every headline and to daily market volatility. That type of short-term thinking is what leads most investors to get whipsawed, chasing the market (or asset classes or fund managers) on the way up and then riding them down before jumping into the next hot asset class or fund. In other words, buying high and selling low—the path to investment failure. Conversely, we believe sticking with a process that has been successful over time and using an appropriate time horizon to assess the success or failure of one's investment decisions is critical to winning the marathon of investing.

The point we want to emphasize is that when looking at the short-term performance of a fund, manager, or asset class, remember that it is just short-term performance. It is important to understand what is driving the performance and whether or not that is consistent with your reasons for investing in the fund in the first place and your expectations looking forward. For example, if you believe the dollar is likely to decline against emerging-markets currencies over the next five years, that belief is not invalidated by a several-month period in which the dollar gains due to a temporary flight to quality. And, given a flight to quality that boosts the dollar, you shouldn't be surprised by the performance of funds with significant exposure to nondollar currencies. The key question for us would be whether the magnitude of the decline is inconsistent with our original expectations and risk assumptions. *So, don't overreact to the short term*. And, when markets are volatile, as they certainly have been the past few months and years, the long-term cost of overreacting to short-term performance-swings is potentially even higher.

Speaking of Volatility . . .

The shorter-term market swings, brought on by daily news flows and binary risk on/risk off investment decisions, could well continue for some time. Matching your risk tolerance and portfolio objectives to your asset allocation is especially critical in such a volatile investment environment, as is your focus on an appropriate investment horizon. We appreciate your continued confidence in our firm and please do not hesitate to contact us if you have any questions.


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