WOLF GROUP CAPITAL ADVISORS
GLOBAL WEALTH MANAGEMENT

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Stuff happens. Writing down and distributing one's opinion is fraught with danger. Consider this particularly ill-timed conclusion from our last quarterly letter, "We see nothing in the near-future that could change our generally positive views on the U.S. and global economies and the U.S. stock market…" Although one could argue that nearly no one foresaw the exact way concerns about Greece (yet again?) would affect the U.S. stock and bond markets, we still feel a bit blindsided by the events of the last three months and suspect that some of you may be wondering if we took our eye off the ball. To be fair, we also noted last time that "The world is often a scary place for those who only dwell on the big picture." We just didn't realize that it would get a whole lot scarier in the proceeding months. We once heard an old-timer on Wall Street quip that the market often does whatever it can to "discomfort" (not his actual word, but you get the gist) the maximum number of investors. This chestnut sounds a lot like the famous epigram "Anything that can go wrong, will go wrong," otherwise known as "Murphy's Law." In light of the events of the recent past, we thought it fitting to embrace this adage as this report's theme.

Third Quarter Review

For the quarter, the S&P 500 fell a whopping 14% as what might have been modest concerns about Greece's financial condition escalated into serious worry about the global economy. The Greek tragedy has become absolutely Sisyphean in nature as we find ourselves commenting on it yet again as a reason for U.S. stock market weakness.

Clearly, concern over Greece and the nation's possible default has rippled into all markets in the last three months. This concern triggered another "risk off" trade by hedge funds, traders, and other short-term investors who clearly favor the "sell first, ask questions later" tactic of investing whenever uncertainty looms. European markets were hit harder than the U.S. market, with the MSCI European Index falling almost 23%. Emerging markets too felt this ripple, down over 22% for the quarter. The All Country Index (which excludes the U.S. markets) declined 20%. So, despite the declines here, the U.S. market held up relatively well.

Yet, our stock market's action this quarter was puzzling. The direct link between a potential Greek default and the U.S. economy is extremely modest given the minimal exposure U.S. banks have to Greece's debt. The U.S. export exposure to the entire EU is almost modest; suggesting that a European slowdown (were it to happen) would also be unlikely to have a large impact on the U.S. economy. The real fear it seems is that U.S. banks have a meaningful exposure to European banks in general, and thus, to the extent that these banks would need to write down or write off a sizable amount of Greek debt, the U.S banking sector could be negatively impacted. Even this linkage seemed to be an unsatisfying reason for the U.S. stock market weakness this quarter, in our view.

Perhaps some investors were simply concluding that Greece's troubles could trigger a global financial crisis just like back in 2008. Valid or not, this opinion may have been the motivation for some of the selling. The political situation in the U.S., which started with an ugly fight about the debt ceiling and continues to this day on a number of issues, no doubt also contributed to the sour tone of the markets in the third quarter.

The bond market really liked all this bad news. If one looked only at the bond market for clues, one could conclude that the third quarter 2011 "crisis" was even worse than that of 2008-2009 as U.S. Treasury yields fell below those seen in early 2009. Concerns over the Euro currency no doubt enticed some investors to embrace the relative safety of the Greenback. The Fed pledging to keep rates low for an extended period may have also given cause to investors to buy the bonds or at least close out some of their short positions in bonds. Some commentary suggests that the Fed is out of ammo and has few tools remaining to spur the economy. This idea too has fueled the widespread pessimism evidenced in the third quarter.

Here's what the third quarter looked like by the numbers:

Index	3rd Qtr 2011	Year to Date	Trailing 12 Months
Dow Jones Industrial Average	-11.4%	-3.6%	4.0%
S&P 500	-13.7%	-8.1%	1.7%
NASDAQ	-12.9%	-9.0%	2.0%
Russell 2000	-21.6%	-16.3%	-2.7%
MSCI EAFE	-19.5%	-14.7%	-8.6%
MSCI EAFE Small Cap	-18.6%	-13.3%	-3.8%
MSCI Emerging Markets	-25.5%	-24.0%	-18.5%
Barclays Aggregate Bond	4.0%	6.5%	4.5%
Barclays Municipal Bond	4.1%	10.4%	2.3%
Dow Jones Commodities	-11.6%	-15.0%	-1.3%

The Perversity of the Universe

Everyone has experienced a Murphy's Law moment. If your wedding ring has ever made a perfect hole-in-one down the sink, or your piece of toast landed buttered-side down when you dropped it, you may think that the universe is conspiring against you. Murphy's Law is humankind's attempt to make some sense of these unfortunate events, and to try to find a bit of laughter through our tears. Some people seem prone to bad luck. We all know someone like this. Like the guy who gets two flat tires on the same day. The fellow in accounting who often has stains on his shirt from two separate meals. And so forth.

Most often these random acts of statistical malice occur to absolutely innocent victims. Often all seems to be going fine, then – Wham! – Murphy's Law raises its ugly head. We then look heavenward and with a mournful cry or submissive shrug, ask "Why me?" Perhaps investors looking at third quarter returns for their portfolios will be asking the same question. Fear not, intrepid reader, and know that there is no conspiracy against your investments. There are no malicious gods on Mount Olympus tugging on the S&P 500. The market is not "broken." It's just that sometimes stuff happens…

Murphy's Laws for the Masses

The ubiquity of Murphy-esque experiences has created a cottage industry of sorts – people (who no doubt have too much time on their hands) love to come up with corollaries which better describe Murphy's Law as applied to a specific discipline, industry or group of people. Space does not allow us to list all that we would like to share, but here is a smattering of our favorites:

"If the possibility exists of several things gong wrong, the one that will go wrong is the one that will do the most damage." This is how we view the Greek problem. Not only should the market have discounted the nation's challenges when they first appeared, the market certainty should have not reacted to the same event numerous times.

"Dimensions will always be expressed in the least usual terms. For example, velocity will be expressed in furlongs per fortnight." Sometimes when we listen to the "experts" in the media, we feel like they are speaking a foreign language. Is the "economy" really the best way to measure the prospects for the stock market? Despite the intuitive feels of this notion, academic studies suggest the linkage is much less rigorous than the average person might think.

Sometimes inspired thinkers will actually name their corollary:

Gunnerson's Law – "The probability of a given event is inversely proportional to its desirability." If everyone is long stocks, the market falls. When we go to cash, the market rallies.

Meskimen's Law – "There's never time to do it right, but always time to do it over." Isn't this why he have deadlines? And why we call them ***dead***lines?

Gummidge's Law – "The amount of expertise varies in inverse proportion to the number of statements understood by the general public." We addressed this topic in our quarter letter in the summer of 2010 as we reviewed David Freedman's work in his book *Wrong*.

Osborn's Law – "Variable won't, constants aren't." Despite one's portfolio being well-diversified and chock full of inexpensive "value" stocks, it nonetheless underperforms sometimes.

Sproles' Correlary – "If there is an opinion, facts will be found to support it." This may be the secret motto of all politicians!

Murphy was an Optimist

In any collection of Murphy's Laws, one will generally find "Murphy was an optimist," effectively raising the stakes of pessimism to the nth degree. Maybe it's the economy, the high unemployment rate, the ubiquity of 24/7 news, the political rancor of the times, but wow! It's easy to get discouraged hearing all the gloom and doom out there. In times like these, it may be important to cut through the chatter and try to find out what's really going on.

According to the credible economists we closely follow, the U.S. economy is not likely to fall into recession. The underlying data, in general, supports the notion that the economy is somewhere between "recovery" and "expansion." Granted, higher employment growth would be nice and could move the economy solidly into "expansion" phase, but many data points indicate that the economy is still growing. Rail traffic, consumer consumption, retail sales, trade data, corporate profits, etc. all indicate that the economy is better off than the headlines we see every day would suggest.

What *is* decidedly bad right now is sentiment. Consumer sentiment surveys are nearly as negative as they were in late 2008 (really? Check this). Investor sentiment is as bearish as it has been since the worst days during the "Great Recession." The funny thing about sentiment is that its ability to predict future events is quite poor. Also, swings in sentiment occur much faster than do real changes in the economy or other macro systems. So as the economy continues to chug along at its current modest pace, the fear of a massive slowdown will likely abate.

The stock market too, which ultimately dislikes uncertainty most of all, can be driven by the changeable winds of sentiment. We have already seen in October, the market rally sharply as fears of the worst have faded and a realization that fundamentals (the economy, earnings, etc.) are probably better than the sentiment measures indicate.

The Light Side of Pessimism

The events of recent weeks have underscored the notion that the average person is pretty clueless about "Wall Street." I suspect the same person targeting "Wall Street" for some perceived malfeasance, would be equally misinformed about the fundamentals of investing. One of the perverse features of investing is the "good news is bad news" syndrome evidenced during earnings season. For example, the aluminum company Alcoa (AA, NYSE) reported that its third quarter earnings rose 182% year over year. One might expect dancing in the street with amazing growth like that. The stock actually fell 5% in the aftermarket following the release. Why? The company's earnings were actually a bit light versus expectations and the future guidance was not encouraging. So, on Wall Street, the news is rarely "good" or "bad" in any kind of absolute terms, but rather is always "good" or "bad" relative to expectations. This perverse calculus is one reason that non-investors struggle with the basics of the stock market.

Which leads us back to sentiment. On Wall Street negative sentiment is generally considered a good thing. Why? For one, sentiment changes faster than any other market-impacting fundamental. Thus, when negative sentiment is weighing on the market, it may take only a very small bit of good news to turn around both sentiment and the market. We have seen this happen so far in October. The Greek crisis has not yet been fully resolved, but the promise by France and Germany to not let Greece default has proved to be enough for sentiment and the stock markets to improve.

The second reason that negative sentiment can be viewed as a positive is that it often accompanies a selling climax. As pessimism builds, selling pressure tends to also escalate. Often, the peak in pessimism will match the maximum amount of selling pressure. When no one is left to sell, the market will often rebound.

So while it's difficult sometimes to endure these market corrections and remain optimistic in the face of so much negativity, we can find some comfort in knowing that in many cases, the fear of the unknown is the only reason for the market's movement. Once investors regain a bit of clarity, the markets generally return to a more normal state. In this sense, we can view pessimism and negativity as the seeds of new market rebounds and recoveries. Indeed, bad news is good news…

The Outlook

Murphy might have been a market forecaster or even an economist. The gloom and doom folks (like Murphy?) are masters of the "what if" forecast. These forecasts are compelling exactly because they are presented by experienced and intelligent people and they appeal strongly to our intuitive selves. Although these forecasts may be pure fantasy, they always sound "reasonable," start with the word "if," usually contain some kind of number (precision without accuracy?), and, of course, are punctuated with inflammatory language to underscore the seriousness of the danger being forecast. For example, "**If** Greece defaults, U.S. banks may see **35%** of their capital **wiped out**."

This is why we don't generally make forecasts and rarely give serious heed to any single forecast we happen to see. We find greater comfort in watching the consensus estimates and forecasts because they represent to us the broadest "guess" of what might happen to the economy or the markets. We also look to history in search of clues to the future. The past is not always the prologue, but reversion to the mean carries substantial weight on Wall Street and the investment industry. Complex series (such as the stock market) tend to oscillate within known bands. We can measure when something, be it sentiment, valuation, technical measures, etc. is at the low or high end of its range, and thus, be somewhat certain as to what the most likely direction for that measure will be (the opposite).

So, we see the U.S. economy continuing its slow growth slog. Maybe the government can help improve things, but we think the stock market is not counting on that. Improvement in the housing sector and on the jobs front would be welcome news, but again, the stock market is unlikely to need either of these to move higher. If a recession were to occur (something we think is very unlikely given the lack of excesses anywhere in the economy), U.S. corporations are absolutely prepared for it. They have low debt, high levels of cash, solid cash flow and have been operating in an uncertain environment for nearly three years.

Unit labor costs in the U.S. are still very tame, suggesting that U.S. corporate profits are likely to continue growing as they have. Growing profits and low interest rates (something the Federal Reserve has all but guaranteed for the foreseeable future) are a powerful combination for the stock market. The market's valuation remains at the low end of historical ranges. All of these elements suggest to us that the bull market in equities could continue.

When all is said and done, much of the discussion about bear market versus bull market or recession versus slow growth or recovery has very little impact on how we manage our client portfolios day to day. We continue to focus our efforts on identifying excellent mutual funds which we think will beat the market over time, and finding stocks of great companies trading well below their fair value. So what if the U.S. slips into recession and we experience another bear market here? Well, we will continue to buy cheap stocks and adjust portfolios to benefit from the rebound when it comes, and so far, they have always come. It may take a bit longer for our stocks to reach our estimate of fair value, but we are confident that these returns will ultimately be much larger than anything the cash or bond market can offer. As the great investor Shelby Cullom Davis once said, "You make most of your money in a bear market, you just don't realize it at the time."

Sincerely,

Wolf Group Capital Advisors