

Client Review

Preservation Strategy

Third Quarter 2011

Asset prices experienced very high volatility and significant weakness during the third quarter. Markets overall took their cue from uncertain economic fundamentals as investors, many having taken on added risk in the face of negative real interest rates, ultimately sought refuge in Treasury securities and the US dollar. The Dow Jones Industrials Index, which began a damaging descent the last week of July, experienced a level of volatility over the remaining quarter that was twice that seen over the prior decade (*Source: WSJ Market Data Group*).

Equity investors have fresh memories of prior market sell-offs, and stocks were further pushed about by the transient intra-day liquidity that is characteristic of computer-driven trading strategies. This source of equity trading activity, often referred to as high frequency trading (HFT), can provide markets with the appearance of reasonable liquidity; however, the growth of HFT has relegated many traditional investors to transact at the open and close in order to avoid the unpredictable intra-day impact of HFT flows. This is but another reason to question the periodic bouts of strength exhibited by the stock market in the face of no real "news."

Stocks responded positively in late September on the hope that a political solution, in the form of an expanded European Financial Stability Fund (EFSF), was finally at hand for Europe's convoluted debt problem. But this belief in European progress had a limited shelf life, and broader market averages sold off sharply by the end of the month.

September's deterioration in risk appetite accounted for a large portion of the latest quarter's equity index losses. Of particular note, in US dollar terms, per MSCI data, every single developed and emerging stock market (except for Turkey) was down for both the one and three-month periods ending September 30, 2011. The MSCI EAFE Index of developed markets was down -19% for the third quarter, with half of that loss occurring during September. Emerging market stocks proved vulnerable to investor risk aversion on two fronts: In equities, the MSCI Emerging Market Index depreciated -22.5% during the third quarter, however fully one third of the loss was due to local currency weakness versus the US dollar.

Commodities also sold off, with more cyclical sectors such as energy and industrial metals leading the fall, and a few agriculturals bucking the trend. Gold experienced pronounced volatility with safe haven bullion demand thrown off course by the troika of margin increases, profit taking, and funding-induced liquidations from leveraged investors.

Investment grade bonds (Barclays Capital US Aggregate Index) gained 3.8% for the quarter and benefitted from a bullish interest rate environment that aided US government securities and offset downward pressure on corporate bonds. The bellwether Barclays 7-10-year US Treasury Bond Index returned 10.1%, in sharp contrast to the -6.3% loss turned in by the Merrill Lynch High Yield Bond Index.

In addition to the disruption visited upon secondary markets (trading between investors), market volatility also impacted primary markets, as corporations struggled to raise capital in a moribund environment for US initial public offerings and new debt issuance. With equity volatility spiking to levels last seen in March 2009, the risk appetite of investors and investment banks was clearly low. Time will tell whether domestic capital raising activity rebounds to the robust levels seen earlier this year, but a developing concern is the relative health of funding activity in emerging markets where new issuance tends to be weighted toward energy, mining and financial companies. These economically sensitive sectors are key drivers of continued growth across emerging markets and the secular expansion of global consumer demand.

Third Quarter Strategy Positioning

The primary allocation changes implemented during the second quarter benefitted the Preservation Strategy during the third quarter. To recap, the largest shift in the second quarter was the move out of short duration high grade bonds into intermediate duration high grade bonds in June. This move was timely as US Treasuries rallied on fears of a global growth slowdown and further deterioration of Europe's sovereign debt story.

Our flight-to-quality second quarter trades continued in the third quarter as we eliminated exposures to high yield bonds and bank loans and reduced our allocation to fixed income market neutral. The remaining fixed income market neutral allocation negatively impacted performance during the third quarter as long positions in credit strategies and short positions in US Treasuries both experienced losses. We also made a tactical allocation to an inverse financial sector exposure in September, as this sector was seen as vulnerable to European banking issues, which added value to the strategy.

Beginning in June, we initiated an allocation to gold bullion as a hedge against US dollar weakness and a potential escalation of broader currency risk. Having tactically increased exposures to US Treasuries, gold was also judged to be an effective counterbalance to the risk of government securities losing their safe-haven status. This trade worked well in July and August, but suffered during the last weeks of the quarter. It is believed that many investors and trading desks used profitable gold positions as a funding source to cover margin calls on losing portions of their trading books.

We exited the allocation to gold bullion in September as we saw a change in the behavior of gold that caused the allocation to lose its integrity as a hedge. While the allocation to gold bullion increased in value over the timeframe held, the fact that gold did not hedge risk-on positions in September resulted in a modestly higher exposure to general risk-on market factors during a volatile time period.

Look Ahead

We view global policy risk as a significant source of ongoing uncertainty and unintended consequences. It is the nature of most governments to intervene in an attempt to shield their populace from economic discomfort and to protect a cohort of vested interests (all the better if the two overlap). One of many unfortunate consequences of policy-induced solutions is the hindrance of natural economic entropy and the resulting build up of accumulated stress. The current landscape of macro distress is tailor-made to motivate additional political initiatives that we believe will stoke further volatility of asset prices. The behavior of investment assets will remain heavily influenced by either the promise or lack of resolution with respect to global economic challenges that defy a painless fix. Given this reality, fundamental values that represent potentially compelling opportunities must be weighed against the considerable risk of further market weakness.

	3RD QUARTER 2011
Preservation	-2.92
MARKET INDICES	3RD QUARTER 2011
Russell 2000®	-21.9
S&P 500®	-13.9
MSCI EAFE	-19

DISCLOSURES

The performance data are for the Preservation Strategy for the third quarter of 2011 and are shown on a net-of-fees basis. This short-term performance should be considered in conjunction with the longer term performance shown on the quarterly performance sheets, which may be found on Genworth Financial Wealth Management’s website, www.ewealthmanager.com. An investment account’s performance may be subject to substantial short-term changes, particularly during periods of market or interest rate volatility.

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