



Institute Market Commentary

October 2011



T H E I N S T I T U T E

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The markets have changed color along with the leaves

After a truly rocky and dismal third quarter of this year, October took off like a shot due to better than expected economic growth, a strong start to earnings season, improving unemployment, and hope for a resolution regarding Greek sovereign debt. As the month progressed, these sentiments improved as reflected in the market, with the S&P 500 now up more than 13% over just the past three weeks. Even as I write this on Thursday, the markets are up over 3% for the day, on news that the EU has found a solution to the Greek sovereign debt crisis. Although the markets have recovered much of their summer loss, wild swings in both directions have become common place.

We are happy to see some overall improvement in market indicators but we also feel as though there are still issues to work through, such as the remainder of the EU agreement, as well as renewed focus on debt ceiling talks. Even during times of exuberance regarding economic progress, volatility and unknowns persist.

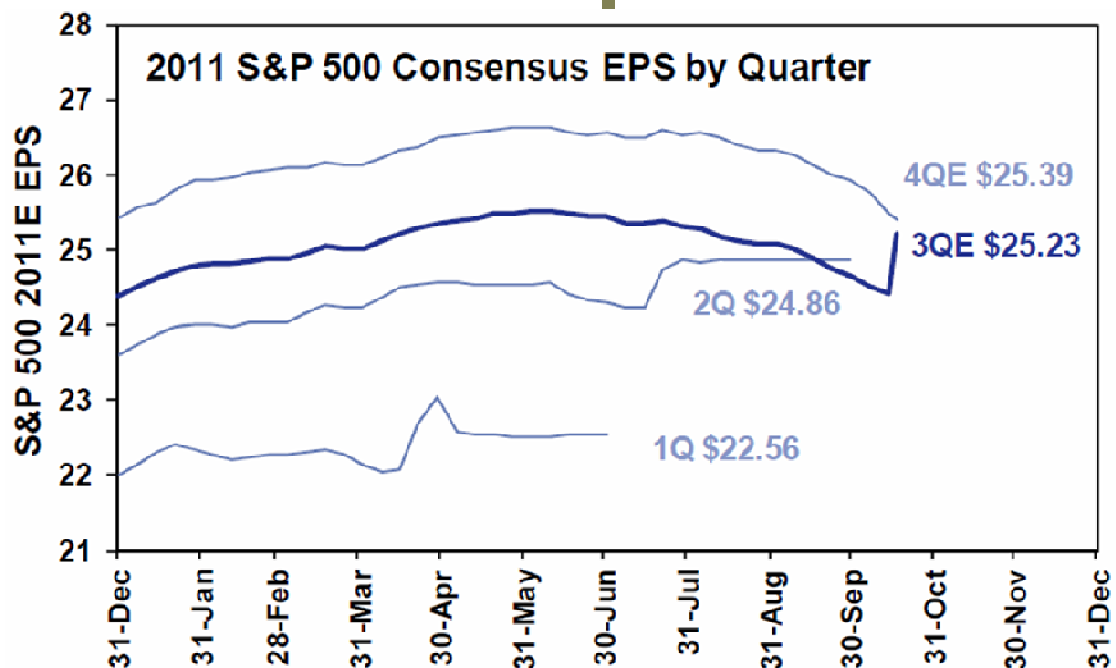
As an example of the new investing world we live in, the sustained Occupy Wall Street demonstrations represent the fact that political extremes, periods of fear, and the existence of the unknown have become somewhat permanent realities. For this reason, effectively managing portfolios has become a balancing act of optimizing growth potential while protecting portfolios during periods of sustained volatility. For these reasons, we have made several tactical changes within our portfolios in an attempt to help grow their value while maintaining the levity we are best known for.

This Month's Highlights:

- World economic update
- Our use of volatility as it has evolved
- Looking for opportunities in a fragile world

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S&P 500 2011 Earnings per Quarter



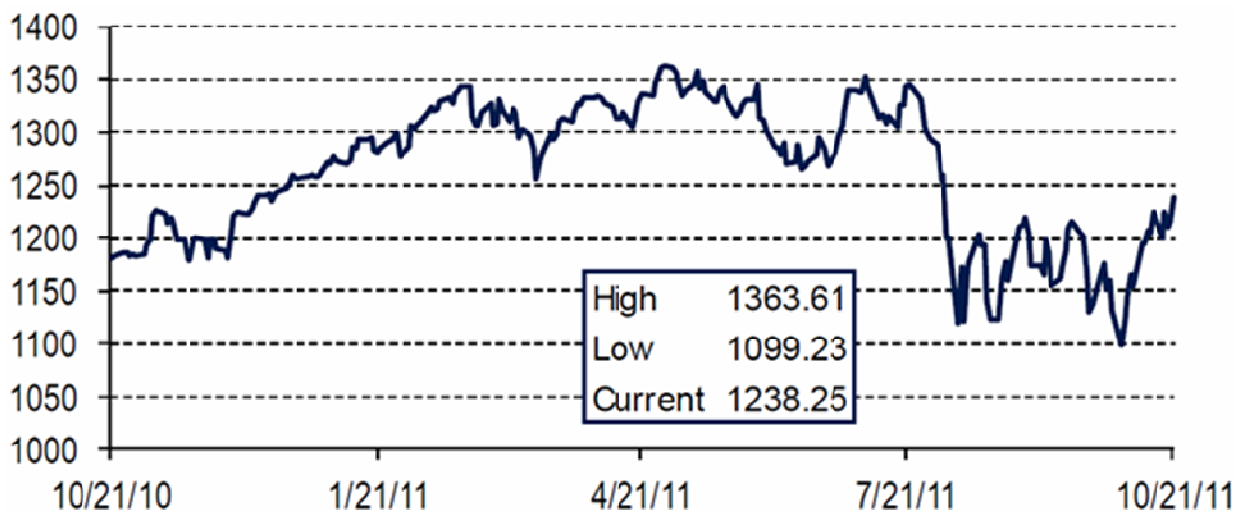
Source: Compustat, FirstCall, Bloomberg, and Goldman Sachs Global ECS Research



Euro-zone fears dragged us down, and Euro-zone hope is lifting us up

As we touched on briefly, the Euro-zone continues to be mired in sovereign debt concerns and associated political unrest. This is having a profound effect on markets both here and abroad. When there is renewed fear of a Greek default we see asset prices plummet, as well as sharp rebounds during periods of optimism. Hoping for a permanent solution soon, we are currently waiting for a formal proposal from the EU, rather than reacting to rumors.

S&P 500 over the past year



Source: Source: Pertrac analytics, as of 10/21/11

Regarding economic progress in the U.S., several encouraging indicators are pointing to a period of positive momentum. We are excited to see growth here and abroad (we expect world growth in 2012 to top 3%) but also feel as though this will come with periods of dramatic uncertainty, not unlike what we have experienced for much of the past few years. Although this has been the story for quite some time, we must be prepared to manage through these sorts of periods. For years at The Institute we have preached managing risks as the highest priority and these sorts of periods are why.

Keeping in mind our long-term investment horizon, and in order to minimize the risks prevalent in volatile markets while still capturing growth, we have made a number of adjustments within our portfolios recently. Because we foresee the Euro-zone issues not only continuing but also having a detrimental effect on international earnings over the medium-term, we reduced our allocation to international equities dramatically. From a risk mitigation perspective, we feel as though the meek growth we expect to see internationally is not worth the fairly dramatic downside potential to prices given the concerns still present.

The second change we have made within our portfolios has been to increase our allocation to large-cap domestic equities. We feel as though growth in the third quarter of this year is likely to be robust. Further, given the continued economic expansion we are witnessing, we anticipate significant upside potential within the allocation. Over the past month, since we made this change, we have seen a strong move up in large-caps and we are very happy with the allocation. The final change we have made to our portfolios includes increasing our utilization of volatility as an asset class (which I'll cover momentarily).



An update regarding our use of volatility

As previously mentioned many times, our use of volatility has been a return-generator as well as beta-reducer during the past several weeks, months, and years. I would like to give everyone a little background on volatility, as the asset class has been evolving very quickly. As recently as a year ago, we were very limited in how we could own volatility. The choices that did exist had very high costs (both in terms of fees and roll cost) and relatively high tracking error as compared to the volatility index. At that time, it was worth owning volatility as a hedge only during times when volatility spiked but nevertheless the costs cut significantly into gains and the challenges related to timing spikes were ever-present.

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Since that time, several different exchange traded funds have been created, which we now utilize, that do a much better job at following volatility at a reduced cost. We made the decision early this summer to begin utilizing two of these new and improved funds and are pleased with the results. More specifically, in July 2011 we began utilizing a paired trade, meaning that we were utilizing both long and short volatility. To introduce the strategy, we took a conservative approach initially and started with a small position. Since that time, we have become more familiar and comfortable with the allocations and are now increasing the position within our portfolios. We’re happy to now be utilizing volatility, to those same ends, with a larger allocation. As can be seen in the chart illustrating levels of volatility over the past year, our increased utilization of volatility appears to us to be timely.

We understand the importance of weathering the type of storm we are experiencing. By drilling down on trends, risks, and opportunities, we hope to outperform the market while exposing our clients to a dramatically reduced level of risk. What we do know is that simple diversification rarely works alone. However, by combining traditional asset classes with alternatives such as emerging markets and commodities, along with our volatility strategy, we hope to expose our clients to growth while incurring the least amount of risk possible.

As a review, we do see a number of positive indications both domestic and abroad, hinting to positive market drivers, but also feel as though the path of growth will be a slow, and volatile one, as we’ve been experiencing. Put another way, because the markets tend to focus on

each fear as it arrives (examples include the Japan crisis, debt downgrade, debt ceiling debate, Greece, etc.), we foresee a level of continued volatility amidst more broad and long-term opportunities for growth. To that end, we believe our portfolios are positioned to excel while being buoyed by volatility.

Levels of S&P 500 Volatility over the last year



Source: Morningstar Direct



Socially responsible investing update

As an update regarding the progression of Socially Responsible Investing, according to The Forum for Sustainable and Responsible Investment (“SIF”), investment in S.R.I. platforms since the beginning of 2010 have jumped 15.9%. This growth trend is incredibly important because it represents a wider range of S.R.I. investment choices, more volume, and tighter trading spreads. According to US SIF CEO Lisa Woll this growth trend it because “Alternative investments in sustainable and responsible investing are attracting a wide range of investors – high-net-worth families and individual ‘angel’ investors, mission-driven institutional investors such as philanthropic foundations, hospitals and faith-based institutions, and some of the largest and most prominent pension funds and private equity firms.” At The Institute we hope to see this trend continue and we are certainly proud of the growth represented by our S.R.I. funds specifically.

Sources & Disclosures:

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TR denotes Total Return, which is a price-plus-gross cash dividend return. Gross cash dividends are applied on the ex-date of the dividend. It is not possible to invest directly in an index.

