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Capital Management

3rd Quarter 2011 Market Review and Outlook

By Brian Bush

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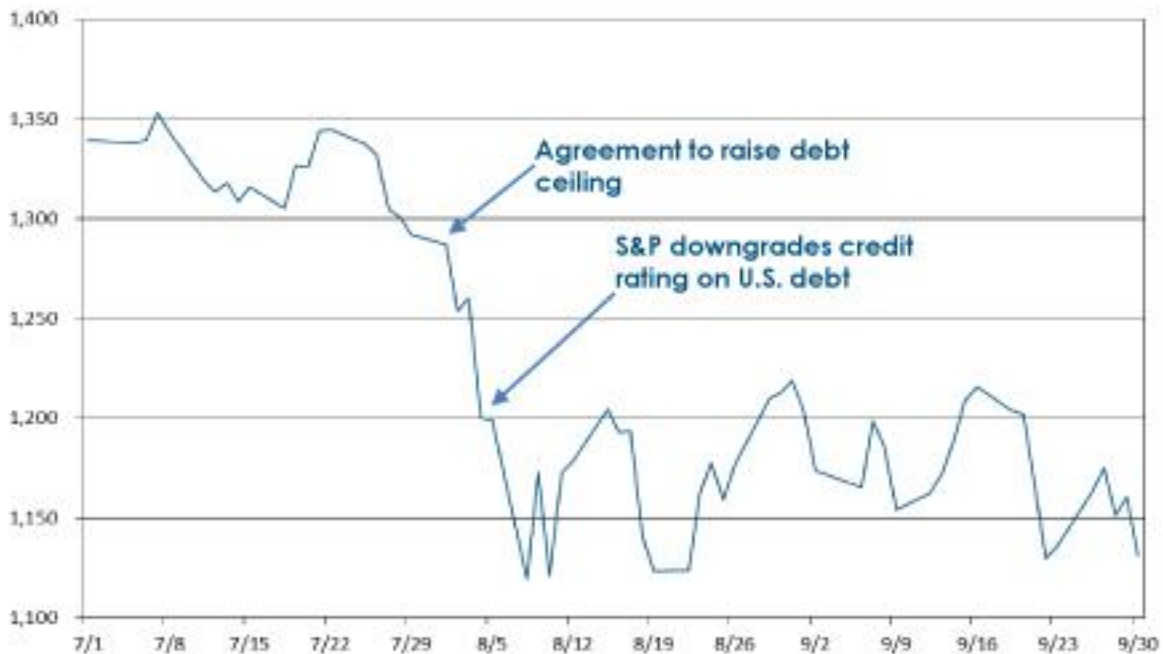
The third quarter of 2011 was the worst quarter for equities since the financial crisis of 2008. The Standard & Poor's 500 index suffered a 14% decline during the quarter and finished down 9% through the first nine months of the year. Foreign stocks dropped even further with emerging markets falling 23% and the MSCI EAFE (developed countries) index declining almost 20%. Even gold, which has been perceived as a safe haven for investors, plunged 11.25% during the month of September. Investors also had to endure extremely high levels of volatility throughout the quarter. In August and September, the Dow Jones Industrials Average rose or fell by more than 1% on 29 days and by more than 2% on 15 of those days. Domestic bonds were the best performing asset category with the Barclays U.S. Aggregate Bond Index closing the quarter up 3.82%.

What led to the decline in the stock market and volatility?

Political uncertainty was the major contributor to the poor performance of equities in the third quarter. The President and Congress finally reached an agreement to raise the debt ceiling of the United States on the evening of July 31; however, it was clear that no real progress had been made toward a long-term plan to reduce the growing Federal debt.

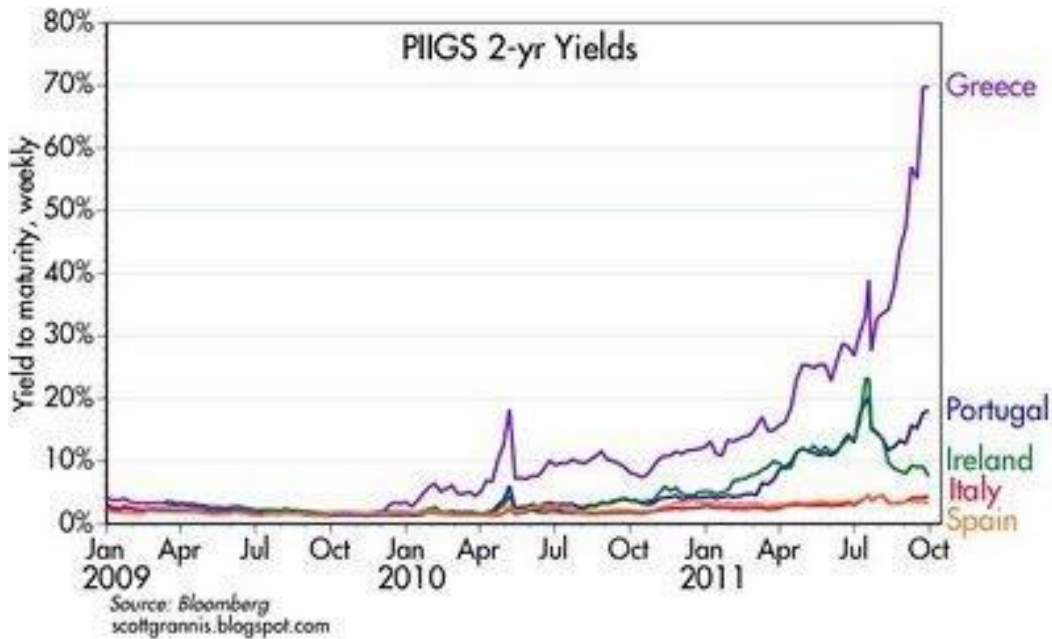
Instead, our political leaders agreed to appoint a “super committee” of 12 congressional leaders who are charged with finding a way to reduce the Federal budget deficit by \$1.5 trillion over the next ten years. The market responded by falling over 7% in the week following the announcement. On that Friday, August 5, in response to the announced agreement Standard and Poor’s lowered the long-term credit rating on U.S. Government securities from AAA to AA+ and the stock market fell another 6.5% over the next three trading sessions.

S&P 500 from July 1 – September 30, 2011



Source: FactSet Research Systems

While investors in the United States were focused on events in Washington, interest rates and credit default swaps continued to rise in the European peripheral countries as doubts increased over Greece's ability to meet its upcoming funding needs.



The European Central Bank announced a second bailout package in July, but the increase in funding is not sufficient to prevent a similar crisis in Italy and/or Spain, and requires ratification by each of the 17 individual Eurozone governments.

The Greek government is in an impossible situation with government debt at 150% of GDP, a collapsing economy with GDP down 7% this year and an unemployment rate of 16%. It appears the only way out for Greece is through some form of default. We believe the markets are fully anticipating a Greek default which is why interest rates on Greek debt with 2 year maturities are currently at 69%. The more significant issue is the risk that a Greek default would induce sovereign defaults in other countries, particularly in Spain and Italy. Currently, the European Financial Stability Fund (EFSF) is not large enough to backstop Italy and Spain in the event of a run on their debt. European banks hold significant amounts of sovereign debt on their books.

A default by those countries could have disastrous implications for the European banks and would likely lead to a worldwide recession. Europe is the United States largest export market so their problems would quickly wash up onto our shores.

Scope of the Euro Rescue Fund and the Financial Needs of Crisis Countries

in billions of euros



In the PIIGS states, government bonds totalling €795 billion will come due by the end of 2013. For Spain, the volume of the fund may still be sufficient. But the addition of Italy, the third-largest economy in the euro zone, would overwhelm the EFSF.

Source: Thomson Reuters Datastream, Aug. 9 2011

Finally, the head-jerking level of volatility experienced during the third quarter was driven not only by political and economic news, but by the growth of electronic trading. Today, there are more than 50 different trading venues available for order execution. In order to access all those markets simultaneously, traders are relying on computers to execute their orders. It is estimated that 75% of all trading activity today is done by computer algorithms and high frequency trading. While computers are faster than human beings, they can accelerate the market's reaction to any news flow. Many people believe this was a major contributor to the "flash crash" in May of last year when the Dow plummeted almost 1,000 points in a matter of minutes. Regulators continue to examine the potential consequences of electronic trading, and some believe that the risks to market participants are still largely unknown.

What are investors to do?

The two questions heard most often are "is this going to be 2008 all over again?" and "when will we return to normal?" There are similarities between the European debt crisis and the financial crisis. In 2008, large amounts of mortgage debt and derivatives of dubious quality were being held by financial institutions. Once those institutions began realizing the losses on those securities they found themselves with insufficient capital. Today, many European banks hold sovereign debt of countries that are fiscally unsound. If forced to write down the value of those securities, many may find themselves insolvent. Unlike 2008, European policy makers have the tools to solve the ongoing debt crisis and have had two years to prepare, but the European Central Bank lacks the authority to use many of those tools. Some countries in the Eurozone, most notably Germany, are reluctant to support their profligate neighbors to the south. Until Europe's political leaders agree on how they wish to solve the ongoing debt crisis, the potential for an undesirable outcome exists. Compared with 2008, U.S. companies are in much better position to weather a potential downturn in the economy. Corporations are holding more cash on their balance sheets than at anytime since 1963. Financial companies are well capitalized and U.S. banks are holding record amounts of excess revenues.

The Super Committee in the United States has until November 23rd to propose ways to reduce the U.S. budget deficit and a plan must be voted on by December 23rd. Given the political climate in Washington we anticipate a contentious round of negotiations in the weeks ahead. In our opinion we are unlikely to experience the panic of 2008 again, but we are a long way from normal.

While our domestic problems and the European crisis are largely political in nature, the consequences have significant economic impact. The leaders of Germany and France have said they will present a comprehensive package of measures against the crisis in Europe by the end of this month, but have supplied no details. Even though stock valuations remain extremely attractive, we have assumed a defensive posture in our portfolios while these upcoming events unfold. The lack of political leadership to this point has created major uncertainty for investors. Volatility is likely to remain high until we get a policy response that reduces the risk of a recession.

We believe recent market action reaffirms the value of effective risk-appropriate asset allocation. During times like these, markets tend to trade on emotion instead of fundamentals. Our guidance is not to panic and stay focused on your long term investment objectives.

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