MARYLAND CAPITAL ADVISORS INC

WEALTH MANAGEMENT • RISK-BALANCED PORTFOLIOS

INVESTMENT COMMENT **October 8, 2011**

Third Quarter Review and Strategy Update

There has been no shortage of fodder for alarming headlines during the past few months. Global political, economic, and financial problems continue to be at the forefront of our collective attention and the capital markets have adjusted accordingly. Setting aside the human impact of recent economic turmoil in Greece and elsewhere, the concern investors are now pondering is "Have capital market valuations adjusted enough for the increased possibility of a global recession?"

Our answer may disappoint[1]: *we cannot know with any certainty*. However, what follows is an update on two related questions made important by current market conditions:

- Since global stock markets have fallen significantly, when should we adjust portfolio investments back to targeted exposures (i.e. sell bonds, buy stocks)?
- With interest-rates so low should we consider extending the maturity or lowering the credit quality of our bonds in an attempt to reach for additional yield?

Before we delve into these issues, below is a review of this past quarter's market movements.

Selected Asset Classes September 30, 2011	Third Quarter	YTD Return
SELECTED RISK ASSET CLASSES		
US Large Cap	**-14.6%**	**-9.3%**
US Large Cap Value	**-16.2%**	**-11.4%**
US Small Cap	**-21.8%**	**-17.1%**
US Small Cap Value	**-21.5%**	**-18.7%**
Intl Large Cap	**-20.6%**	**-16.3%**
Emerging Markets	**-26.3%**	**-25.6%**
International Real Estate	**-19.9%**	**-15.6%**
US Real Estate Investment Trusts	**-15.2%**	**-7.0%**
SELECTED LOW RISK ASSET CLASSES		
US Treasury 1-3yr Notes	**+0.5%**	**+1.3%**
US Treasury 7-10yr Notes	**+10.4%**	**+14.2%**
US Treasury 20-30yr Bonds	**+29.6%**	**+32.1%**
US Treasury Inflation-Protected	**+4.8%**	**+10.4%**
Inv Grade Short Duration	**-0.2%**	**+1.4%**
Inv Grade Intermediate Duration	**+2.2%**	**+5.4%**
Inv Grade Long Duration	**+11.1%**	**+14.6%**
Mortgage-Backed Securities	**+3.1%**	**+6.4%**
International (Non-US Dollar)	**-2.9%**	**+2.5%**
EQUITY INDICES		
MSCI All-Country World Index	**-17.3%**	**-13.2%**
S&P 500 Index	**-13.9%**	**-8.6%**
BALANCED PORTFOLIOS		
Vanguard 60/40 Fund	**-7.8%**	**-3.3%**
DFA 60/40 Fund	**-12.0%**	**-7.9%**
DFA 25/75 Fund	**-4.2%**	**-1.2%**

Source: Bloomberg Professional

Note: Returns include reinvested dividends.

THIRD QUARTER CAPITAL MARKETS UPDATE

"Stocks end rotten quarter in a sour mood"[2] was one headline that summarized the just-ended quarter and captured current sentiment. The adjacent table highlights the significant movement out of Risk investments into bonds. The best-performing investment class during Q3 and YTD, by far, was long-dated US Treasury bonds, with Investment Grade corporate bond returns lagging significantly behind.

Within Risk assets, note that the riskiest elements generated the most negative returns in Q3:

[1] A classic book on the perils of taking advice from Wall Street brokers explains it this way: "…customers have an unfortunate habit of asking about the financial future. Now if you do someone the signal honor of asking him a difficult question, you may be assured that you will get a detailed answer. Rarely will it be the most difficult of all answers – "I don't know"." *Where Are the Customers' Yachts? or A Good Hard Look at Wall Street* by Fred Schwed, 1940, 1955, Pg 38

[2] ft.com on September 30, 2011 at 9:20pm

Emerging Markets, Small Company stocks, Value stocks – and this makes perfect sense as active investors attempt to move to safety. In contrast, as investors with risk-balanced strategies, we construct portfolios to have pre-determined exposures to such factors and, periodically, rebalance to these targeted percentages. The initial asset allocation decision is the most critical element of our portfolio construction process, since it establishes the risk-and-return characteristics that are prudent for each client. Over time, portfolios will drift from targets as investment returns vary, thereby changing the level of risk-taking and requiring a rebalancing.

IS NOW THE OPTIMAL TIME TO PURCHASE RISK AND SELL LOW-RISK INVESTMENTS?
There are essentially two decision-making approaches to portfolio risk rebalancing: Calendar and Market. The first method simply establishes a specific frequency to measure portfolio exposures and rebalance. Some investors advocate for monthly or quarterly rebalancing, while some rebalance at the end of each year. More frequent rebalancing can result in higher transaction costs and taxable events and offers no material difference in returns when compared with annually rebalanced portfolios[3]. *The second method – which we use at MCA – relies on constant monitoring of portfolio exposures versus target and, when significant variations from a target exists, we select a time to restore the original balance.*

Based on our discipline, we rebalanced client portfolios at quarter-end. As we noted in our mid-quarter Investment Comment on August 7, "The extent of this recent adjustment was not sufficient to cause us to consider rebalancing client portfolios by selling Low Risk and purchasing Risk investments. However, as always, we are continually monitoring each client's portfolio actual vs. targeted exposures and may find an opportunity to rebalance as markets find their equilibrium level."[4] *By the end of the 3rd Quarter this opportunity arose as various elements of Risk declined even further, causing our rebalancing action.* Although our decision-making process involves judgment and some subjectivity, such actions are triggered by disciplined monitoring of variation from targets coupled with patience. Of course, we cannot be certain of the optimal time to rebalance, but the Market approach is inherently more appealing to us than a strictly calendar-based rebalancing strategy.

DO CURRENT BOND MARKET CONDITIONS WARRANT A CHANGE IN OUR LOW-RISK STRATEGY?
The short answer is "no. The two primary dimensions of risk-and-return in the bond market are interest-rate risk (bonds that mature farther in the future are subject to greater risk of interest-rate changes) and credit risk (bonds with lower credit quality are subject to risk of default). We intentionally constrain the Low Risk portion of our portfolios to shorter average maturities and high credit quality, while enhancing yield prospects by including other elements of bond risk (ex. inflation-linked, non-Dollar, mortgage-backed, etc).

As the table (right) shows, long-dated US Treasuries generated incredible returns in Q3. As a former bond trader, I can confirm that trading bonds with significant interest-rate risk (long maturities) can be exciting. However, as portfolio managers, our primary objective is to accumulate bonds that offer attractive yield compensation for the inherent risks of each investment.

US Bond Market Risk Factors
Q3 Total return, select Barclays Capital Indices

	US Treasury	Blend	Investment Grade
Long	+29.2%	+15.2%	+9.1%
Intermediate	+6.0%	+2.3%	+0.9%
Short	+0.5%	+0.3%	-0.3%

Source: MCA, Bloomberg

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3 See "Best practices for portfolio rebalancing", Vanguard Research, July 2010
4 Investment Comment "Recent Events", Maryland Capital Advisors, August 7, 2011

Investors brave enough to have purchased the US Treasury 30yr bond on June 30, 2011 at a price to yield 4.37% could have sold it at quarter-end at a price to yield 2.89%, for a total return of +30.2%. *This is the second largest quarterly gain in my 25 year career. Current conditions have made bond market investing very challenging.* In fact, Bill Gross, manager of PIMCO Total Return, the World's largest bond fund, avoided US Treasury bonds during Q3 and experienced a relatively difficult quarter (see table below). Since the Federal Reserve is holding short-term rates extremely low, yields on high quality short-term bonds are essentially unable to move lower in yield (higher in price). That translates to little hope of generating positive quarterly returns and has caused further risk-taking in longer maturities or riskier (higher yielding) corporate bonds.

Selected Bond Funds September 30, 2011	Third Quarter
PIMCO Total Return	**-1.06%**
Vanguard Short Term Inv Grade	**-0.16%**
DFA Short Term Ext Quality	**+0.73%**

Source: Bloomberg Professional
Note: Returns include reinvested dividends

Historically, high-quality bond portfolios with relatively low interest-rate sensitivity generated modest returns that were negatively correlated with stock market returns – meaning that stock market declines would generally translate to more positive returns for bond investments. In our current interest-rate environment, this beneficial negative correlation may no longer hold as short-term bonds have little room to rise in value.

As the Federal Reserve's monetary policy efforts to revive economic activity continue, investors fatigued by holding assets with near-zero returns may begin questioning this strategy. The allure of seeking incremental yield by taking greater interest-rate or credit risk can be a strong temptation. We would strongly advise against this approach and remain focused on the purpose of the Low Risk portion of our portfolio – capital preservation.

Michael Damas