

the Whitepaper

December 2008 | Vol. 2



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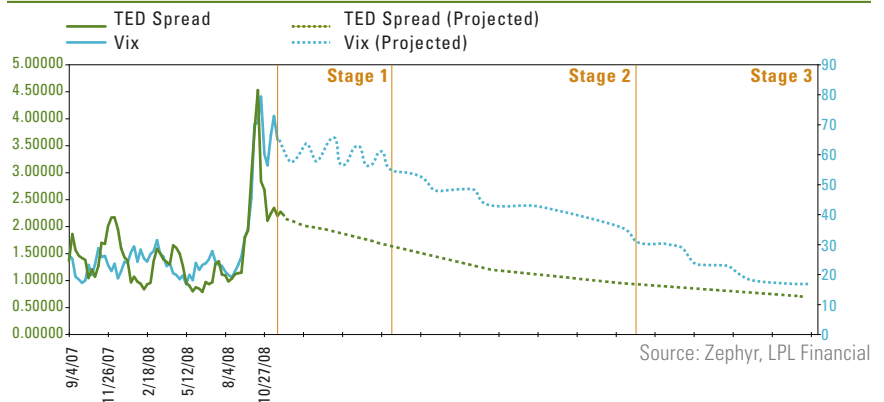
In this latest edition of *The Whitepaper*, we outline LPL Financial Research's view on the possible path that the markets may take on their Road to Recovery.

Specifically, we feel that there are three distinct periods of "healing" that need to take place, with each offering distinct opportunities and challenges for investing. Most importantly, we outline our reasons for our current portfolio positioning and how we will transition our asset allocation models throughout the market's recovery process.

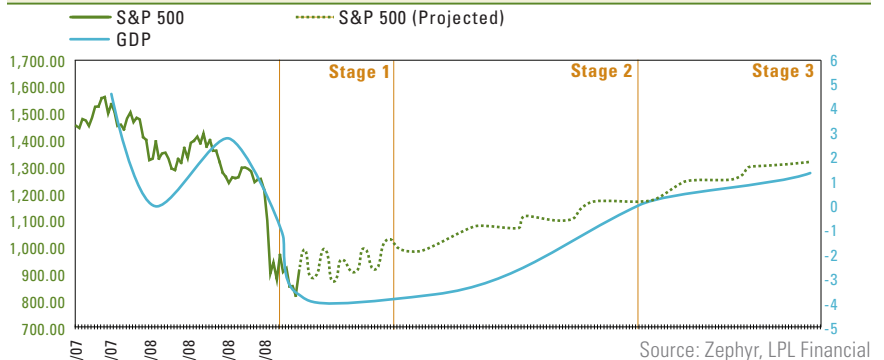
A Road to Recovery

The two charts below outline the current levels and likely future behavior of four key mile markers to watch throughout a Road to Recovery. The first chart shows two market gauges while the second illustrates two measures of market recovery. The TED spread, which is the difference between the 3-month LIBOR and the 3-month Treasury Bill, helps to illustrate overall liquidity in the market; a high reading indicates increased levels of illiquidity. Also on the chart is the VIX, the CBOE Volatility Index, which indicates the level of volatility in the market. Its recent spike represents an increase in overall market volatility. The second chart shows the S&P 500 Index, used as a proxy for the stock market, and the economic growth through a graphical depiction of GDP. Notice that the current environment is plagued with rising illiquidity (high TED Spread), a declining stock market, heightened volatility and an economy that has slipped into negative growth (a recession).

Weekly TED Spread & VIX Levels

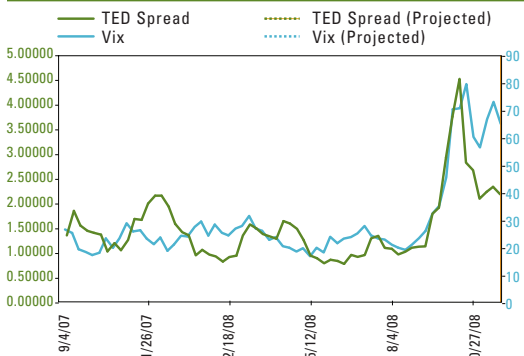


Weekly Returns of the S&P 500 & Quarterly Changes in GDP

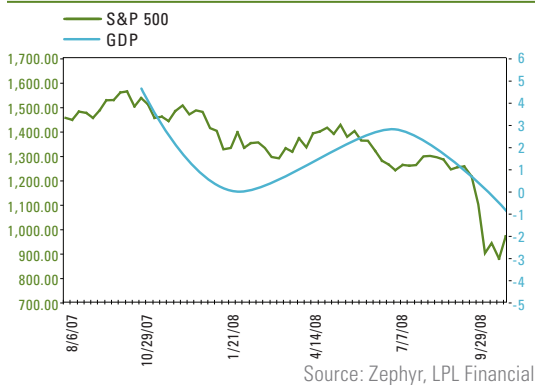


2008 Year-to-Date

Weekly TED Spread & VIX Levels



Weekly Returns of the S&P 500



The Current Environment

Bumper Sticker: Illiquidity, Volatility and Recession

Scenario: The current environment has been represented by the freezing up of liquidity as banks either failed or refused to lend to each other. Without credit available to fuel economic growth, the economy stalls, stock markets sell off and eventually consumer led growth suffers a significant retraction. The result is a full fledged, severe recession. However, we are about to enter stage 1 of the recovery.

Strategy: Avoid anything that has beta or requires liquidity. That leaves Treasuries and Cash as the only safe havens.

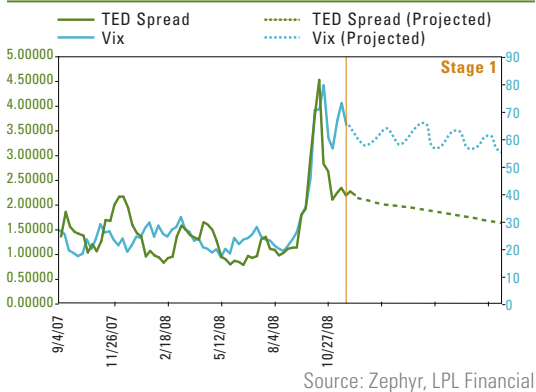
Investments to Use: Treasuries or Cash.

Investments to Avoid: Anything with beta.

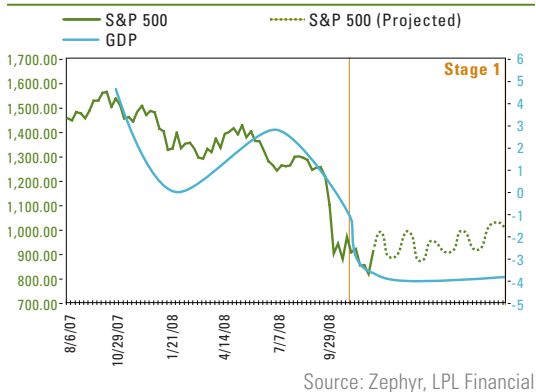
Danger Zone: Being overweight credit or equity beta. Unfortunately, many long term investors occupied this "danger zone" for much of 2008. While far from optimal, the real test is how investors will reposition going forward. Often investors spend too much time contemplating the impacts of investment mistakes (the past) and miss the market opportunities (the future). Like any good basketball coach will tell you, "keep your head up when dribbling" as it is by looking forward that the correct path to navigating this tricky market can be found. Remember, "often in err, never in doubt" means that market amnesia and respectful confidence make up the unique mix of character traits needed to turn a tough market position into a Road to Recovery.

Stage 1

Weekly TED Spread & VIX Levels



Weekly Returns of the S&P 500



Recovery Stage 1:

Bumper Sticker: Liquidity Returns, Bull Market for Volatility

Scenario: The first stage in the recovery, where we are now, is the return of liquidity but with the continued presence of high levels of volatility. Unprecedented policy actions, a flood of “easy money,” and the increased willingness of banks to lend to each other will eventually break the illiquidity freeze. Given that a significant percentage of the losses in fixed income are attributable to illiquidity, and not to credit related issues, any increase in trading should potentially result in some spread tightening and an increase in prices. The equity markets will continue to work on developing a bottom in stage 1 as they digest the news that the economy will likely be experiencing a much more severe recession than was thought just a few months ago. As a result, volatility will remain at elevated levels, demonstrated by powerful relief rallies when the markets hit oversold levels followed by re-tests of previous lows. Chart 1 above illustrates that liquidity has already begun to improve (lowering of the TED spread), but volatility remains at elevated levels. In stage 1 of the recovery, the return on stocks will likely be muted to a wide trading range, but volatility will be substantial.

Strategy: LPL Financial Research intends to tackle this stage of the recovery with two approaches. On the equity side, as strong rallies and down draft re-tests help to shape the market’s bottom, we intend to maintain beta slightly lower than the benchmark and utilize investment strategies that may benefit from volatility, such as Covered Calls, Global Macro, and the arbitrage characteristics of opportunistic balanced strategies. Keep in mind such mutual fund strategies are subject to increased risks due to the use of derivatives and futures. On the fixed income side, we look to position the models with significantly higher beta using allocations to those asset classes that will benefit most from an increase in liquidity. These include Municipal bonds, Investment Grade Corporates, High Yield, Mortgage-Backed Securities, Bank Loans and Preferred Stock.

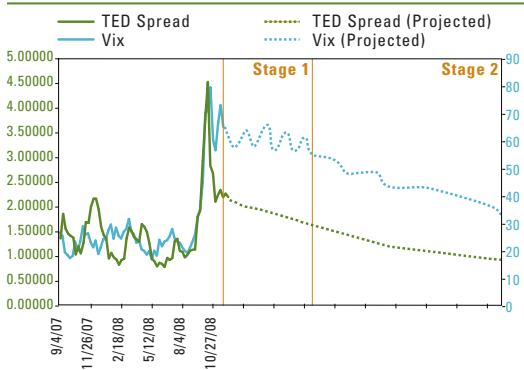
Investments to Use: Fixed Income vehicles that potentially benefit from increased liquidity (Municipals, Investment grade corporates, High Yield, Bank Loans, Mortgages, Preferreds); Volatility thriving mutual funds (Covered Calls, Long/Short, Global Macro, Opportunistic Balanced)

Investments to Avoid: Economically sensitive investments such as Real estate, Commodities, Emerging Markets investments and Managed Futures.

Danger Zone: Do not be lulled into excitement by “fake rallies” or panic on re-tests. The market will not be directional in nature (up or down) but rather will be saw-toothed (up and down). If overweight equities, have a plan to move to slightly lower beta than the benchmark. Since it appears that the S&P 500 is maintaining a trading range of 800 to 1000, remain patient and look at re-positioning the portfolio around 900 or the 50-day moving average (currently about 925), whichever is first. If underweight, do the opposite, look at adding opportunistically to get to a slight underweight at the low end of the range, which is between 800-875. Look for the stage 1 of the recovery to end sometime in the first half of 2009.

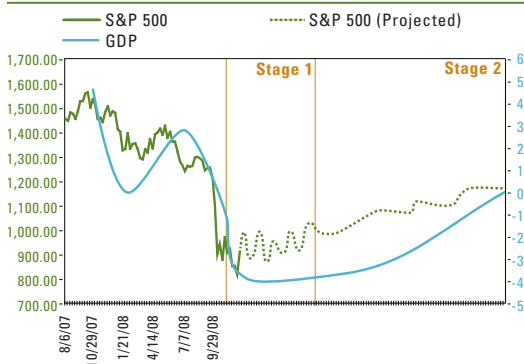
Stage 2

Weekly TED Spread & VIX Levels



Source: Zephyr, LPL Financial

Weekly Returns of the S&P 500



Source: Zephyr, LPL Financial

Recovery Stage 2:

Bumper Sticker: Light at the End of the Tunnel

Scenario: Examining every recession and bear market since WWII reveals that stocks have always bottomed before the recession was over and delivered on average powerful 25% gains as measured by the S&P 500 Index, recouping nearly all losses by the end of each recession. In other words, the markets can see the “economic growth” light at the end of the “recession” tunnel. Therefore, waiting until the end of the recession for the return of economic growth is not necessary to reap rewards from the market’s forward looking view.

Strategy: LPL Financial Research intends to confront this second stage of the recovery with an increase in equity beta as the market begins to anticipate the end of the recession. Likely, the aggressive fixed income exposure will continue to be paying off in this stage, so allocating out of some of the volatility thriving, lower beta strategies that benefitted in stage 1 and into higher beta stock exposure will be the core of the strategy.

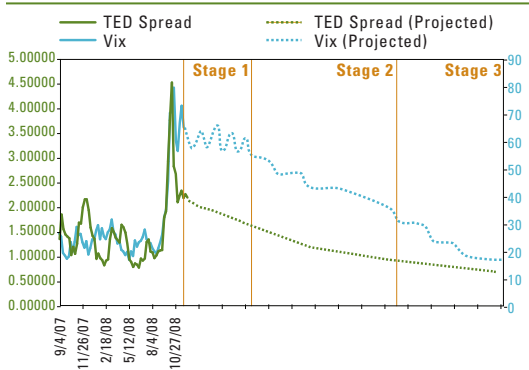
Investments to Use: Beta, beta, beta. Work toward a broadly diversified equity overweight. On the fixed income side, maintain exposure to aggressive credit sectors such as Investment Grade Corporates, High Yield, Bank Loans, and Preferreds.

Investments to Avoid: Low beta options, such as Cash, Treasuries and some types of Alternative Investment mutual fund strategies like Absolute return and Market Neutral. Economically sensitive investments such as Real Estate, Commodities and Emerging Markets also will experience a headwind.

Danger Zone: Be careful not to declare the end of the first stage and the start of the second stage too early. Validation of the market’s breakout will be the key. Likely, a strong push-through and strong support at the 50-day moving average will be the signal that the second stage has begun. Look for this signal to probably occur sometime between Groundhog’s Day and the middle of 2009.

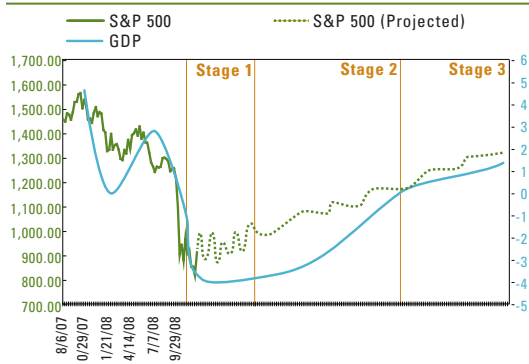
Stage 3

Weekly TED Spread & VIX Levels



Source: Zephyr, LPL Financial

Weekly Returns of the S&P 500



Source: Zephyr, LPL Financial

Recovery Stage 3

Bumper Sticker: The Next Bull Market

Scenario: The last and final stage of the recovery. Stage 1 saw liquidity improve, and stage 2 saw the stock market improve. Stage 3 will be marked by the economy improving.

Strategy: Investments can be broadly classified into two camps: “motorboats” and “sailboats.” Motorboats are companies and sectors that do not rely on economic expansion to drive sales and earnings. Motorboats are often the “recession-proof” sectors, like Healthcare and Consumer staples. Sailboats, on the other hand, depend on economic expansion to fill their sails. Sailboats include cyclical sectors like Energy, and Industrials, as well as Real Estate, Commodities and Emerging Markets. LPL Financial Research will use stage 3 to shift our focus from the “motorboats” used in stage 2 to “sailboats” in stage 3.

Investments to Use: The market is still likely to maintain an upwards slope, and with the improvement of economic conditions, the move from motorboats to sailboats is prudent. Economically sensitive investments such as Real Estate, Commodities, Emerging Markets and Managed Futures mutual funds should be among market leaders.

Investments to Avoid: Cash, Treasuries.

Danger Zone: Depending on to what extent and for how long global central banks have to maintain easy monetary policy could determine the level of inflation within stage 3. An improving economy flush with loose monetary policy is the recipe for high and potentially hyper inflation. However, timely contraction in available monetary supply can quickly defuse inflationary pressures. Therefore, be careful to understand the economic backdrop with regard to inflation and global monetary policy before jumping two-feet into Commodities, Emerging Markets and Managed futures, as fighting the Fed is rarely a battle investors win.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Investors should consider the investment objectives, risks, charges and expenses of the investment company carefully before investing. The prospectus contains this and other information about the investment company. You can obtain a prospectus from your financial representative. Read carefully before investing.

Neither LPL Financial nor any of its affiliates make a market in the investment being discussed nor does LPL Financial or its affiliates or its officers have a financial interest in any securities of the issuer whose investment is being recommended neither LPL Financial nor its affiliates have managed or co-managed a public offering of any securities of the issuer in the past 12 months.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise and are subject to availability and change in price.

Investing in alternative investment may not be suitable for all investors and involve special risks such as risk associated with leveraging the investment, potential adverse market forces, regulatory changes, potentially illiquidity. There is no assurance that the investment objective will be attained.

IMPORTANT DISCLOSURES (continued)

High yield/jund bonds are not investment grade securities, involve substantial risks and generally should be part of the diversified portfolio of sophisticated investors.

Investing in Mutual Funds involve risk, including possible loss of principal. Investments in specialized industry sectors have additional risks, which are outlines in the prospectus.

Government bonds and Treasury Bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

The market value of corporate bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield.

Beta measures a portfolio's volatility relative to its benchmark. A Beta greater than 1 suggests the portfolio has historically been more volatile that its benchmark. A Beta less than 1 suggests the portfolio has historically been less volatile than its benchmark.

ASSET CLASS DESCRIPTIONS

Covered Call Strategies: Covered call mutual fund strategies typically hold a long portfolio of stocks and then sell covered calls. Some covered call strategies then buy puts to further protect against downside risk. The net result is a portfolio that is correlated to the broader markets, but with significantly less volatility and increased risk due to the use of derivatives.

Absolute Return: Absolute Return funds have the goal of providing a positive return in all market conditions and tend to have low volatility and provide bond-like returns. They also tend to have a very low correlation to bonds and low correlation to stocks. Because of their goal of low to moderate volatility, these securities are more suited for accounts with more moderate risk/return goals.

Long/Short: Long/short funds focus on managers who go long and hedge against the market through options or shorting equity securities with the goal of outperforming the market while limiting volatility. These funds tend to have a higher correlation to equities than other alternative strategies and, therefore, are most appropriate for more aggressive portfolios.

Managed Futures and Global Macro: Managed futures funds use systematic quantitative programs to find and invest in positive and negative trends in the futures markets for financials and commodities. Global Macro funds are similar but use fundamental inputs (focused on broad global economic themes) in their models as well as technical (or price related) inputs. Global Macro funds may also be less systematic than the typical managed futures fund. Historically, the benefit of managed futures and global macro has been solid long-term returns with very low correlation to equities and fixed income securities.

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