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THE BIG PICTURE

While most asset prices (except higher quality bonds) declined in the third quarter, very little has actually changed since our last quarterly communication. Principally, the European sovereign debt crisis remains at the forefront of investors' minds, sparking memories of our own financial crisis in 2008/09 and causing an immense amount of market volatility. Our big picture analysis is focused on applying ourselves to understanding the overall environment and assessing the ways it might affect financial markets and the investments we have made on behalf of our clients. In this context, and for the reasons cited below, our base case view remains that the global economy is not on the verge of another 2008 (i.e. widespread global economic recession).

- * Corporate profits and balance sheets are in much better shape than they were three years ago. We expect profitability to hold up reasonably well at multinationals, even in a slower growth environment, due to efficient operations and better growth in emerging economies.
- * Recent economic data continue to support our view that we will not have a double dip recession; however, GDP growth will remain sluggish in the quarters ahead.
- * Overall, stocks are trading at valuation levels (based on forward P/E ratios) typically seen near market lows.

Although our current view of the economic landscape is not nearly as negative as the major headlines of the day (i.e. we are contrarily optimistic), we are not at all discounting the concerns related to the EU/Greece problems. Our base case relating to Europe, in part due to the immense focus of global policy makers on this issue, is that a solution will develop (either through greater Euro zone fiscal integration or via a planned default) that will allow the EU to avoid a worst case scenario. In our opinion, the worst case scenario would be the equivalent of a global economic depression. We continue to monitor events in the Euro zone closely for signs of a more negative outcome and will adjust our portfolio strategies accordingly if we feel that the evolving situation warrants a change. See *Where We Are Investing Capital Now* for more on our current portfolio positioning.

7.7% ANNUALIZED OVER THE LONG RUN

Unsettling as the recent stock market correction has been over the short-run, our decision making process continues to focus on generating solid results for our clients over the long-term. Over a 20 year time span (1991 – 2010) the S&P 500 annualized at 7.7%, providing investors with a very nice return. Even more impressive, 7.7% includes the “lost decade” where stocks did not perform well from 2000 – 2010. So, how did the Average Investor make out over that same 20 year period? According to research from Dalbar and JPMorgan Asset Management, the Average Investor generated only 2.6% annualized, which is well below average when compared with 7.7%. What went wrong? Our hunch is that investors sold after big declines, succumbing to the fear that is accompanied by extreme volatility, and then bought back into the market after watching large advances.

(7.7% Annualized Over the Long Run continued)



Above is a chart of the S&P 500 Index over the CBOE Volatility Index (green). Periods of extreme volatility (VIX readings over 40) tend to coincide with market bottoms (circled in blue). Viewing volatility through this lens informs us that short-run volatility ultimately translates to long-term opportunity.

INCREASING YOUR RETIREMENT INCOME

U.S. Treasury yields remain at historic lows as the Fed has continued to follow an “easy money” policy to help spark economic activity. Unfortunately, this has created a cash flow problem for income oriented investors. Those who estimated that they would earn 5-6% in risk free treasuries in retirement are now finding themselves with a cash flow problem. As a result, investors looking to realize a decent return on their retirement income are being forced to look outside the “safe” investment grade bond asset class. This includes adding exposure to investments like high yield bonds, dividend paying stocks and real-estate investment trusts. While these assets are more volatile than investment grade bonds, they do offer significantly higher cash flows in the current environment.

ENHANCED INCOME STRATEGY—MORE CASH FLOW

In addition to these assets, we have also periodically used a covered call option strategy to enhance client portfolio income. Buying a call option gives the investor the right to purchase a stock at a predetermined price (strike price) prior to the expiration date of the option. When a stock holder sells a call option on a stock that they currently own, this is referred to as “writing a covered call”. Selling the option allows the stock holder to take in additional income via the price or “premium” at which the option is sold. We have used this strategy as an overlay to a dividend paying stock portion of a client’s portfolio. *Please call us if you are interested in learning more about this strategy and whether or not it is appropriate for your specific situation.*

WHERE WE ARE INVESTING CAPITAL NOW

Alternative Assets: We continue to overweight alternative assets across our asset allocation portfolios. While we still favor Merger Arbitrage strategies due to their low overall correlation to the stock and bond markets, we recently reduced our holdings here to make room for a position in Gold and Silver Bullion via the Central Fund of Canada (CEF). CEF is an Alberta based Canadian company that passively holds gold and silver bullion which are both priced worldwide in U.S. dollars. Recent price weakness has created a reasonable entry point to these commodities. Gold specifically has endured as a store of value and protection against risk for thousands of years; however, the asset class will remain volatile and should be seen as a store of value only over the long run. In addition to merger arbitrage strategies and Gold/Silver, we continue to hold exposure to high yielding Real Estate Investment Trusts, and a broad based basket of commodities.

Bonds: In the third quarter, we eliminated our floating rate note exposure across the majority of client portfolios. Given the increased uncertainty related to the European crisis, we felt it was prudent to sell these riskier fixed income assets. High yield bonds, which we eliminated towards the end of Q2 for similar reasons, have dropped to levels that now appear attractive with some broadly invested funds now offering yields in the high single digits. We are watching this market closely and may add exposure to this asset where appropriate. In Q3, our fixed income focus tilted towards adding quality, investment grade holdings via the Pimco Total Return Fund and the Templeton Global Bond Fund. We have periodically invested in these funds in the past, and the managers of both funds have excellent long-term track records. In addition to these funds, we continue to maintain exposure to inflation hedged bonds, emerging market bonds, and unconstrained (“go anywhere”) funds.

Stocks: After reducing exposure to international and domestic stocks in the 2nd quarter, we began to reinvest in these markets amidst the heightened market volatility in August and September. Our primary stock focus is on large-cap, high quality and/or dividend paying stocks domestically, mixed with exposure to emerging market (EM) equities internationally. The EM story is one of rapid industrialization and productivity growth. These two components have historically acted as major factors in economic expansion. While EM stocks have performed well over the last decade, we continue to view them as one of the more sound *growth* opportunities across the investment landscape.

3RD QUARTER IN REVIEW

Year to date through September 30th, the S&P 500 declined 8.7%, International stocks (EAFE) declined 15%, and bonds (BarCap US Aggregate Index) gained 6.7%. Should you have any questions regarding your investment accounts, or if there have been any changes to your investment and/or retirement objectives, please do not hesitate to contact our office.

As always, we thank you for entrusting AMM to help you achieve your investment and retirement objectives.

AMERICAN MONEY MANAGEMENT, LLC

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