



## Third Quarter 2011

### Market & Economic Conditions

Major Indices	3Q, '11 Returns	YTD 2011
S&P 500	-13.9%	-8.7%
Dow Jones	-11.5%	-3.9%
Russell 1000-Growth	-13.1%	-7.2%
Russell 1000-Value	-16.2%	-11.3%
Russell 2000	-21.9%	-17.0%
MSCI EAFE	-19.0%	-15.0%
BarCap Aggregate	3.8%	6.7%
BarCap 2% Issue Constrained High Yield	-6.1%	-1.4%

As the 3rd quarter commenced, the US Congress was embroiled in a bitter debate about the debt ceiling. The 11th hour resolution in early August averted a default on government obligations; however, much damage was done to credibility and confidence on both sides of the aisle. Following the resolution, Standard & Poor's downgraded the credit rating of US Treasury obligations from AAA to AA+ based on concerns surrounding the "effectiveness, stability, and predictability of American policymaking and political institutions." The market impact of the downgrade was rather interesting; while traditional expectations are that a downgrade would negatively impact bond prices, the flight to quality status of US Treasuries overrode the credit rating decline and pushed bond prices higher.

As attention on the US debt ceiling shifted to a focus on the ongoing debt crisis in Greece, global equity markets continued their slide. Greece remains on the brink of default and the country's finance minister announced that there is only enough money to fund the government through mid-November.

U.S. equity markets fell throughout the quarter as the S&P 500 posted its largest decline since the depths of the credit crisis in the 4th quarter of 2008. The 13.9% drop in the S&P was the 5th worst quarter in 25 years. Only in 4th Quarter 1987 (black Monday; -22.5%), 3rd Quarter 2001 (9/11 attacks; -14.7%), 3rd Quarter 2002 (bottoming of the internet bubble; -17.3%), and 4th Quarter 2008 (Lehman bankruptcy, credit bubble; -21.9%) did the S&P suffer more acutely.

Capitalization and performance were positively correlated as large caps suffered least (S&P 500: -13.9%) while results eroded notably through mid and small caps (Russell Midcap: -18.9%, Russell 2000: -21.9%). Growth outperformed value among large cap issues (Russell 1000 Growth: -13.1%, Russell 1000 Value: -16.2%) due in part to significant declines in large banks. Among mid and small caps the trend was reversed and value held up slightly better than growth (Russell Midcap Growth: -19.3%, Russell Midcap Value: -18.5%, Russell 2000 Growth: -22.3%, Russell 2000 Value: -21.5%). Within the GICS classification of the S&P 500, the traditionally defensive Utilities and Consumer Staples sectors were the best performers (+1.5% and -4.2%, respectively) while the economically sensitive Industrials and Materials sectors performed worst (-21.0% and -24.5%, respectively). Financials (-22.8%) also suffered as the European debt crisis rippled throughout the global banking system.

Developed foreign equity markets underperformed their large cap US counterparts while emerging market equities fell further (MSCI EAFE: -19.0%, MSCI Emerging Markets: -22.5%). The relative strength of the US dollar had much to do with the relative results. Unsurprisingly, Greece's ongoing debt saga continued to weigh on equities and again was the worst performing country in the EAFE Index (MSCI Greece -47%). Japan and New Zealand were the best performers among developed countries (MSCI Japan: -6.4%, MSCI New Zealand: -6.5%). In the developing world, Hungary is embroiled in a debt crisis of its own and led country decliners (MSCI Hungary: -44%) while Peru held up best (MSCI Peru: -5%).

Concerns of potential contagion from the Greek debt crisis and skepticism regarding the ability of the US Congress to overcome extreme partisanship to effectively run the government led to yet another quarter of declining interest rates in the US. The 10-year Treasury yield fell through the quarter with the debt ceiling debate and the Fed's announcement of "Operation Twist" accelerating the drop in yield. After commencing the quarter at 3.16%, the yield broke through the low set in 2008 (2.07% on 12/18/2008) and fell to a 50-year low of 1.72% on 9/22/2011 with the Twist announcement before inching up slightly to close the quarter at 1.92%. As a result of the drop in rates, the Barclays Capital Aggregate index (+3.8%) rose and long-dated government-related paper posted the strongest gains. Further down the credit quality spectrum, high yield bonds (Barclays Capital 2% Issue Constrained High Yield: -6.1%) suffered along with the equity markets and posted their worst quarter since 4th Quarter 2008.

## **Mutual of Omaha Retirement Program Product (0.00% Class as of 09/30/11)**

- For the quarter, Bond Index Fund (+4.59%) turned in the strongest performance.
- Domestic stocks of smaller companies underperformed their larger counterparts for the quarter, as evidenced by the Small Cap Stock Index Fund (-21.97%) relative to the Stock Market Index Fund (-13.88%).
- Consistent with the theme of long-term investing, for the actively managed stand-alone investment options that have at least a 10-year performance record, 82% have outperformed their benchmark over that time period.
- Although near-term returns on an absolute basis are disappointing, the Wells Fargo Advantage Emerging Markets Fund (-17.79%) continued to perform well relative to the MSCI Emerging Markets Index (-22.46%), outperforming the Index by 6.15% for the quarter. Longer-term, the Fund's 10 year average annual return of +18.50% has outpaced the Index (+16.41%) by 2.09%. However, as evidenced by the 3rd Quarter, the volatility of the returns that took place getting to this point was enough to make even the most seasoned investors uneasy.

- Mutual GlidePath, the series of eleven time-based asset allocation models, invest in a diversified mix of asset classes and styles and become increasingly conservative over time. The series continues along a glidepath for an additional 20 years beyond the target retirement date. For the quarter, the most aggressive Mutual GlidePath 2055 (-16.31%) underperformed the most conservative Mutual GlidePath 2005 (-6.83%) by 9.48%.
- Vanguard® Target Retirement Funds are a series of ten time-based asset allocation models that invest in a diversified mix of asset classes and styles and become increasingly conservative over time. The portfolio allocation should resemble that of the Vanguard Target Retirement Income Fund approximately seven years after the target retirement date. For the quarter, the most aggressive Vanguard Target Retirement 2055 Fund (-14.89%) underperformed the most conservative Vanguard Target Retirement Income Fund (-2.64%) by 12.25%.

Despite the political and economic turmoil that currently dominate the news cycle, corporations continue to perform well. Companies in the S&P 500 posted record profits for the 2nd Quarter of 2011, eclipsing the peak levels of 2nd Quarter 2007. Cash balances continue to amass on corporate balance sheets as firms remain reluctant to return capital to shareholders. Cash as a percentage of current assets is approaching 30% and has climbed steadily since the 2008 recession. However, dividends and stock buybacks dropped sharply during the recession and remain well below their 2007 peak. The strong earnings statements and balance sheets coupled with weak stock prices to give strong support to bullish equity valuations. The forward P/E on the S&P 500 has dropped to 10.6 times earnings, well below the 20-year average of about 16 times. Bearish investors counter the low valuations with observations about the risks that macroeconomic and geopolitical uncertainty place on the sustainability of the currently high profit margins. Margins are well above historical norms and appear unlikely to sustain those levels over the longer term. Acknowledging these risks, prudent asset allocation and risk assessment based on future capital needs should continue to be hallmarks of retirement plan investing. Due diligence reviews and an adherence to a well-developed investment plan remains a prudent long-term course for investors.

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