



**STAR™ Asset Management**

**3<sup>rd</sup> Quarter Commentary**

October 1, 2011

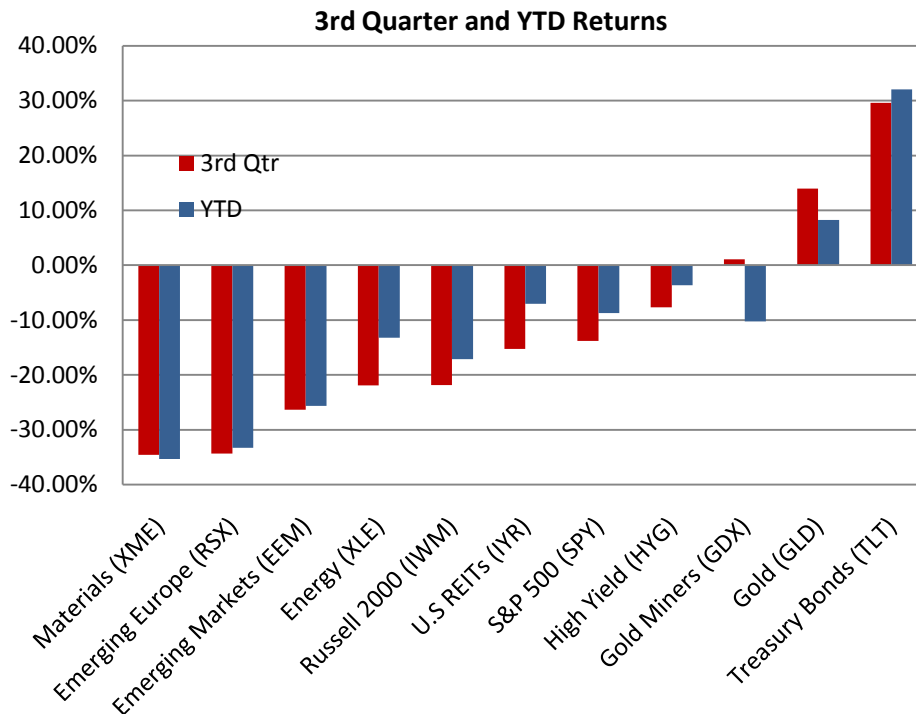
*“Not everything that can be counted counts, and not everything that counts can be counted.”*

Albert Einstein

Dear Investor,

Albert Einstein is famous for his general theory of relativity ( $E=MC^2$ ) which states that nothing can travel faster than the speed of light since at light speed its mass would become infinite. The corollary to this theory is that a lot of energy is contained in even the smallest objects. Applied to investing we might say a lot of change can happen in a very short period of time.

This was the case in the 3<sup>rd</sup> quarter, as concerns stemming from Greece turned into a full scale panic. As expected, Partnervest’s investment strategies did better for the most part than the broad market. Furthermore, October’s gains so far have eradicated a large portion of September’s losses.



It is difficult to avoid comparisons between the most recent quarter and the 4<sup>th</sup> quarter of 2008. Certainly the equity markets experienced their biggest quarterly decline since the Financial Crisis and the Lehman bankruptcy. Volatility, as measured by the VIX index, actually increased the most in percentage terms versus any other quarter since the index was first created in 1990. U.S. Treasury Bonds increased nearly 30%, also mirroring 2008. But here the similarities end.

Consider the following comparison of key economic indicators and valuation metrics for the 12 months leading up to December, 2008 versus the most recent 12 months.

<u>Indicator</u>	<u>12/31/08</u>	<u>9/30/11</u>	<u>Trend</u>
Unemployment Rate	9.9%	9.1%	Improving
Avg. Weekly Jobless Claims	550,000	404,000	Improving
Avg. Weekly Hours	39.5	41.3	Improving
Personal Consumption Change	-5.1	0.7	Flat
GDP Change from prior year	-3.3%	+1.6%	Improving
Industrial Production	-11.48%	+3.35%	Improving
Home Prices	-18.64%	-4.16%	Flat
S&P 500 Earnings	\$65.39	\$91.48*	Improving

\*Record High

In addition to its record earnings, the 12 month dividend on the S&P 500 is back to where it was in December 2006, nearly 5 years ago. As of September 30, 2011 however, the index was still 20% below its year-end 2006 closing prices. Back then the index was trading closer to its long-term average Price/Earnings (P/E) ratio of 16. Today it is trading at 12 times earnings. Earnings have been rising steadily since December 2009, and are higher today than any point in history. A return to a P/E ratio of 16 would represent a 25% increase from current levels.

The global crisis of confidence has resulted in a flight to safety, particularly cash. As of August 31<sup>st</sup> the M2 money supply index, which includes currency in circulation, bank deposits and retail money market funds, leaped 10.3%, the third biggest jump since 1990. Prior to the most recent month, the biggest annual increase was 10.4% right after 9/11 and the second, the 10.4% gain in January 2009 in the wake of the Financial Crisis. This indicates there is ample cash waiting on the sidelines to fuel stock and commodity prices when the current uncertainty abates. The previous two instances were followed soon after by rising equity prices.

These signs indicate that the U.S. economy as a whole, while not going great guns, remains on a positive trajectory.



## STAR™ Asset Management

There's no ignoring that the recent bout of global uncertainty has resulted in elevated levels of volatility. However, with volatility comes opportunity, and I'd like to highlight a few that we're capitalizing on in the remainder of this letter.

### STAR II

We stated in last quarter's commentary that "a market decline of 20% or more in a given year actually occurs more frequently than the laws of probability suggest." While we didn't know then that we'd be proven correct in such short order, we were prepared. Our Alternative and Satellite investments<sup>1</sup> held up well considering the extent of the decline in equity and commodity prices. Collectively, they declined just 60% of the S&P 500 index's decline in the 3<sup>rd</sup> quarter.

Partnervest continues to actively assimilate new funds that adhere to our investment philosophy. In our STAR II™ models we are initiating a "tactical switch" and replacing the Goldman Sachs Absolute Return Tracker Fund (GARTX) with Goldman's Dynamic Allocation Fund (GDAFX). We like the fact that the replacement fund benefits from the collective expertise of Goldman's staff of 110 investment professionals. Analysis shows that it should be equally as effective as GARTX in a decline, but more responsive to a recovery.

### STAR III

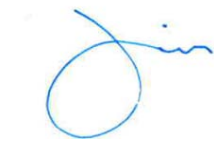
Our Alpha strategy was the shining star during the 3<sup>rd</sup> quarter, with the composite index up nearly 2%. One of the unique characteristics of the strategy is that it has the potential to achieve a positive return even in a declining market environment. This is due in part to the structure of the call spreads, which have a maximum initial downside equal to the net amount paid. Another protective feature is how we manage the Treasury Bond ETF (TLT) position. Simply put, when the price of the TLT rises above the upper band of its normal range, we exit the position, and re-enter via cash secured puts when the price comes back down. In doing so, we avoid what might otherwise be a large loss. The side effect of this approach is that the portion of an account that would otherwise be invested in TLT remains in cash until conditions are favorable for repurchasing the ETF. Similar spikes in price occurred in the 4<sup>th</sup> quarter of 2008, and again in 2010. As the chart below illustrates, it may take several months before prices once again approach \$100. In the meantime, we wait. So far this patience has proven to be a virtue, as TLT has declined 7 ½% since hitting a peak on October 3<sup>rd</sup>.

<sup>1</sup> Broadly speaking, "Alternative Assets" denotes those securities or investment strategies with little or no correlation to stocks or bonds. Examples include: real estate, precious metals, and commodities along with market neutral and long/ short funds, amongst others.

In our VEGA and VEGA Enhanced strategies the 3<sup>rd</sup> quarter provided a good example of how the protective features work to mitigate negative price performance in the underlying ETFs. At Partnervest, we refer to this as the “Three Lines of Defense.” While not all VEGA accounts are structured in this manner, this is our preferred method for managing the strategy<sup>2</sup>. Starting with volatility itself, we purchase the iPath S&P 500 VIX ETN (VXX) in VEGA accounts when volatility is on or below average. The VXX position is designed to help buffer the effects of normal market “potholes” i.e., declines of 5 -10% in the S&P 500. VXX rises as the market declines, and after a relatively routine correction, we exit the position and wait until volatility abates before repurchasing it. The second line of defense comprises the protective puts we purchase for certain VEGA Enhanced accounts when premiums are low. When the market drops by more than 10%, as was the case this last quarter, the puts rise in value at an exponential rate. We started selling the puts in early August, and sold the last of them by the first week of October. At that point the market had dropped over 20% from its 52 week high. The third and final bastion of defense comes in the form of higher than average premiums earned from selling calls when volatility is high. By quarter-end, volatility had risen to more than double its long-term average. In practical terms, clients invested in the strategy collected premiums that were twice as high as normal at that juncture.

In the words of the late Steve Jobs “*The only way to be truly satisfied is to do what you believe is great work. Don’t settle.*” At Partnervest we continue to work towards achieving greater efficiencies, improving returns and lowering downside volatility in our asset management programs. We truly appreciate your trust and support. As always, please feel free to contact your Advisor if you wish to discuss any of the topics mentioned in this letter in greater detail.

Sincerely,



James Herrell, CFA

<sup>2</sup> *For additional details regarding the VEGA and VEGA Enhanced strategies, please consult your Advisor.*

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