



INVEST WITH A STAR

Dear Advisor,

What a week! All in all not a bad start to the 4th quarter, just a volatile one.

We're going to cover a lot of ground during Tuesday's webinar, including 3rd quarter performance and attribution, but I wanted to take a minute to discuss a few items I feel are relevant at the moment. I hope they prove useful in current conversations with your clients as well.

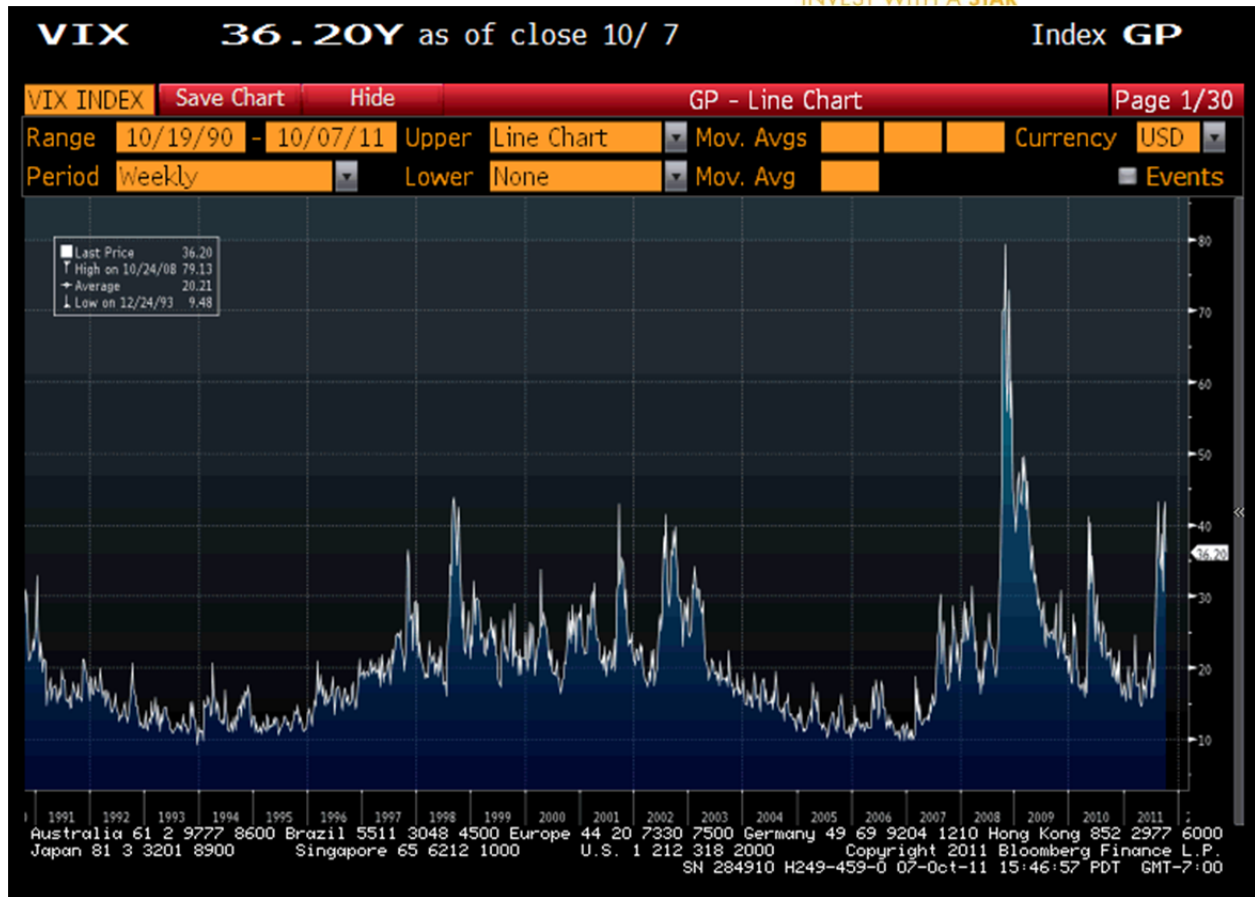
First, the markets remain volatile, but volatility is decreasing. This is a good thing for us as we have been able to cover many October options as 3 -4 weeks ahead of schedule. In practical terms this means that instead of waiting three more weeks to earn about a nickel in VEGA, we are able to sell new calls at the still elevated levels of volatility. High volatility can directly translates into higher option premium income.

High volatility helps clients in Alpha as well. In a nutshell, high volatility helps prop up the premiums on longer-dated options, while simultaneously providing higher short-term premium income.

Turning to the bigger picture, the uncertainty surrounding Greece and the European Union remains unresolved. There is no guarantee that European's debt crisis will end any time soon. Furthermore, in the U.S., despite better than forecast job growth in September, the economy is still bumping along at 1.3% GDP growth – scarcely positive. This goes a long way to explaining why yields on U.S. government bonds remain historically low – despite the fact that Standard & Poor's stripped them of their AAA credit rating for the first time in history. That being said, yields have started to move higher. The price of the iShares Barclay's 20+ year ETF (symbol: TLT) has dropped 4 ½ % since Monday.

There is a good case to be made then that we can reasonably expect volatility to remain elevated for some time, at least until there is a clearer resolution to the uncertainty. This does not mean that we should expect stock prices to continue falling at such a drastic rate, or even that they will drop further at all. The simple answer is we don't know. But I'd like to highlight a few contrarian indicators that seem to indicate that perhaps the worst of it is over for now. One of these is the CBOE volatility index itself (VIX for short). The 3rd quarter marked the largest single quarter increase in volatility since the index was created. As the chart below illustrates, we started the quarter at below average levels, and ended at levels that are extremely high by historical standards.

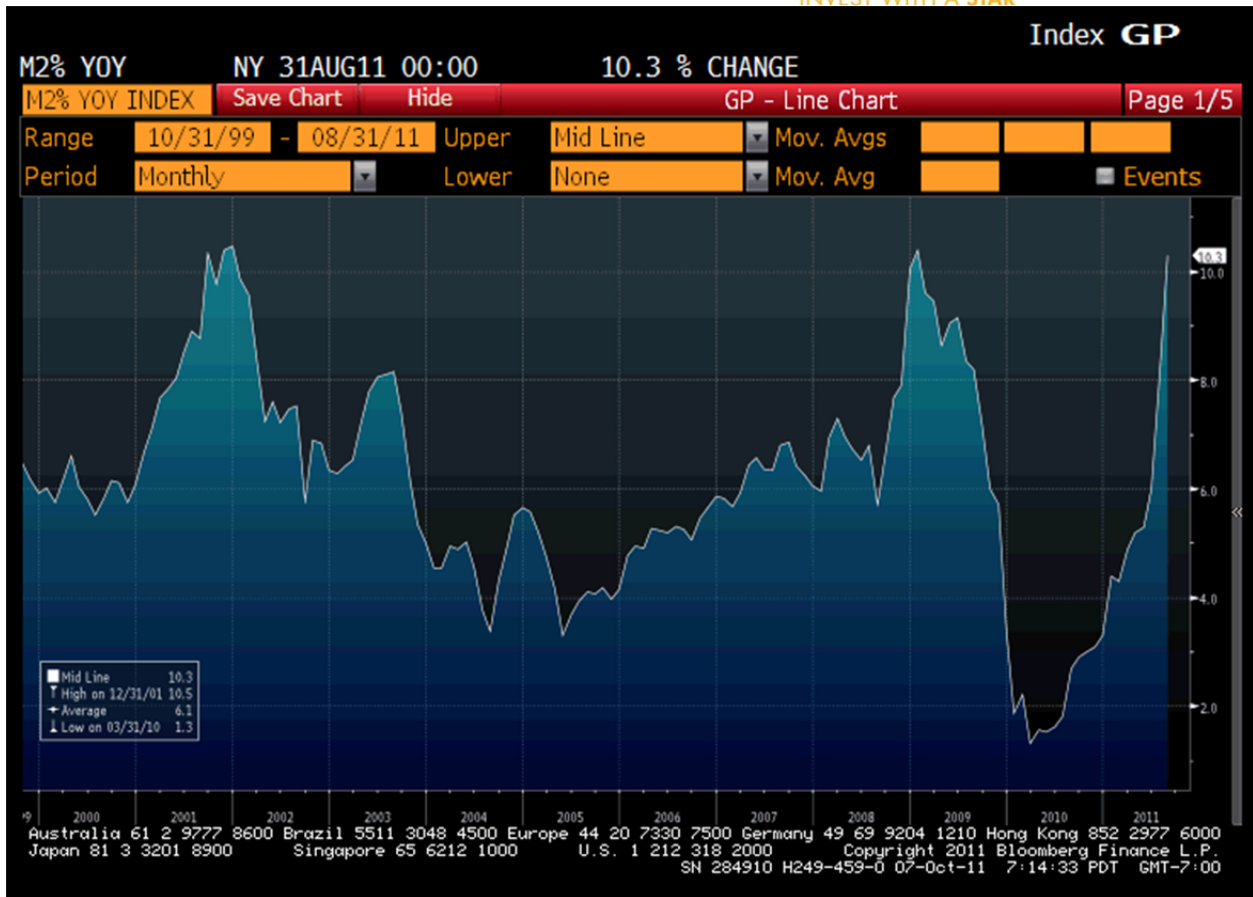
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Spikes in the VIX are typically short-lived. There is a practical reason for this. High levels of implied volatility mean that buyers are willing to pay inflated premiums when purchasing options due to the prevailing uncertainty. But consider that with the VIX at 45 (where it traded recently) a buyer of a call on the S&P 500 would need to earn a 45% return on the index over the course of the following year just to break even should volatility remain at these levels. These are long odds. However, as long as buyers are willing to keep paying these premiums, we are more than happy to sell and pocket the profits.

A second indicator that I find compelling from a contrarian perspective is the level of cash in money market, checking and savings accounts. Known as “M2” it is a good indicator of investor sentiment. When M2 is high, as it is currently, this means investors are fleeing to the relative safety of cash. The higher M2 rises, the more cash there is available on the sidelines to purchase stocks down the road. As the following chart shows, the year over year percentage change in M2 is as high now as it has ever been, including the period following 9/11 and during the Financial Crisis. Needless to say, the market rose in short order following both previous extremes.

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I'll be happy to discuss any of the above items, and to go into more detail about how our strategies are performing, and what we expect going forward during Tuesday's call. In the meantime, remember the slogan of the British Government during WWII "Keep Calm and Carry On."

Best Regards,

Jim Herrell

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