Lawyers, Guns and Money

Review

"*During times of universal deceit, telling the truth becomes a revolutionary act.*" George Orwell

"*Panics do not destroy capital. They merely reveal the extent to which it has previously been destroyed by its betrayal into hopelessly unproductive works.*" John Stuart Mills

The last quarter was a difficult period for risk assets; the following chart displays performance for the major indices we track:

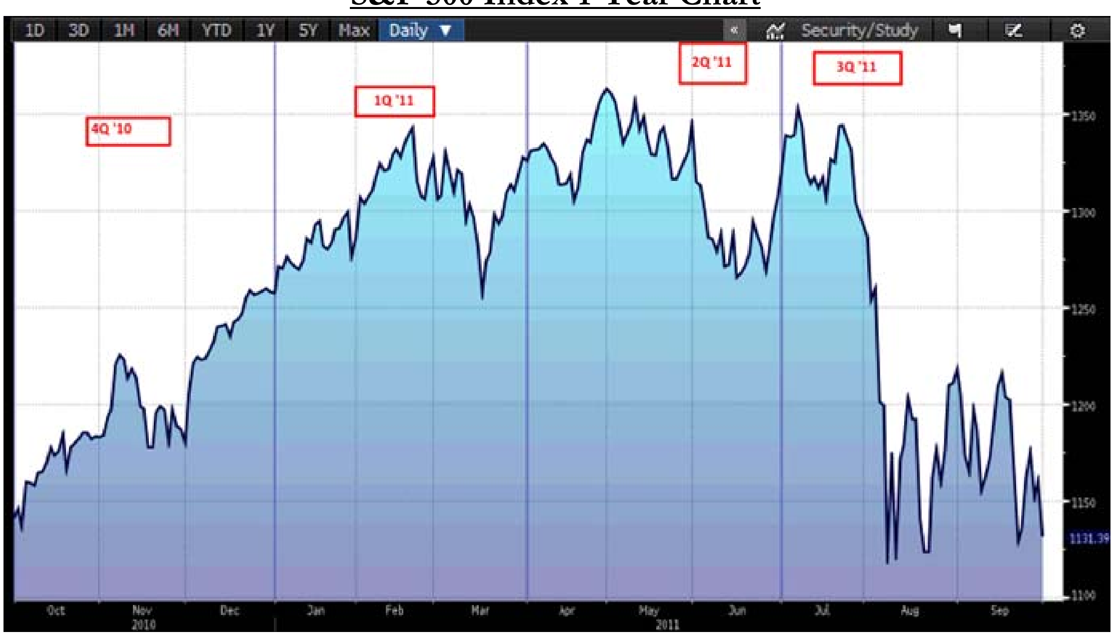
Benchmark Performance
Data as of September 30, 2011

	3Q11	YTD	1 Year	3 Years	5 Years	7 Years
Barclays 5 Year Muni	1.97%	5.40%	3.75%	6.76%	5.55%	4.59%
Barclays Aggregate	3.82%	6.65%	5.26%	7.98%	6.53%	5.58%
S&P 500	-13.87%	-8.68%	1.14%	1.23%	-1.18%	2.29%
Russell 1000	-14.68%	-9.25%	0.91%	1.61%	-0.91%	2.68%
Russell 2000	-21.87%	-17.02%	-3.53%	-0.37%	-1.02%	3.03%
iShares MSCI EAFE	-19.01%	-14.98%	-9.36%	-1.13%	-3.46%	3.32%
iShares MSCI Emerging Markets	-22.56%	-21.88%	-16.15%	6.28%	4.87%	12.21%

Source: Morningstar Direct

Also, the chart of the S&P for the past year is shown below:

S&P 500 Index 1-Year Chart



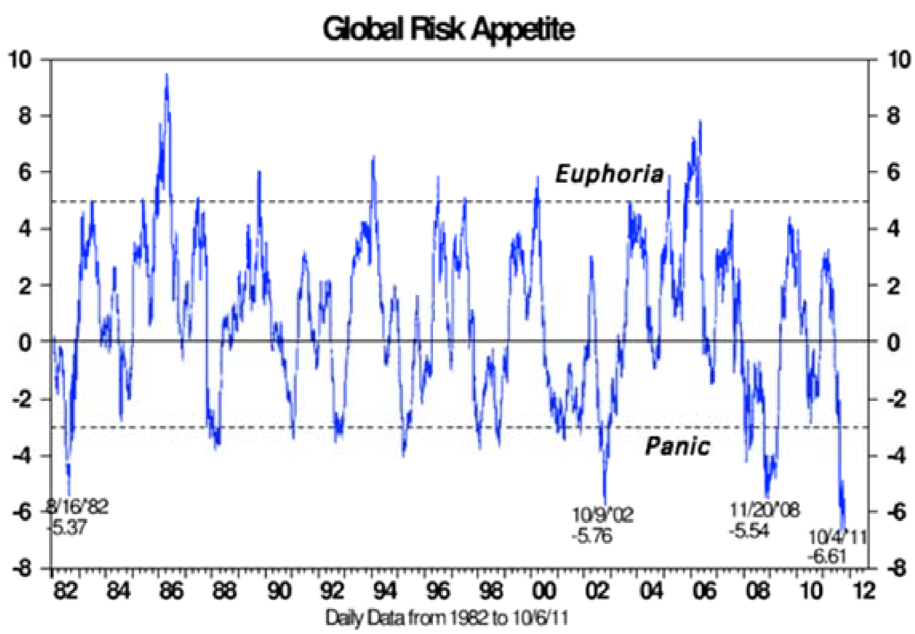
Source: Bloomberg, CWA which is not affiliated with Constellation Wealth Advisors LLC.

1 *Please review important disclosure language on the last page of this letter.*

The equity market corrected in the past quarter, declining over 20% from its May peak to its September trough on an intraday basis. Investors encountered a variety of uniquely negative news flow including the once unthinkable credit rating downgrade of US debt and the possibility of default, continued sovereign debt issues in Europe, the earnings effects of the supply chain disruptions caused by the Japanese disasters, and fears that China would have a hard landing.

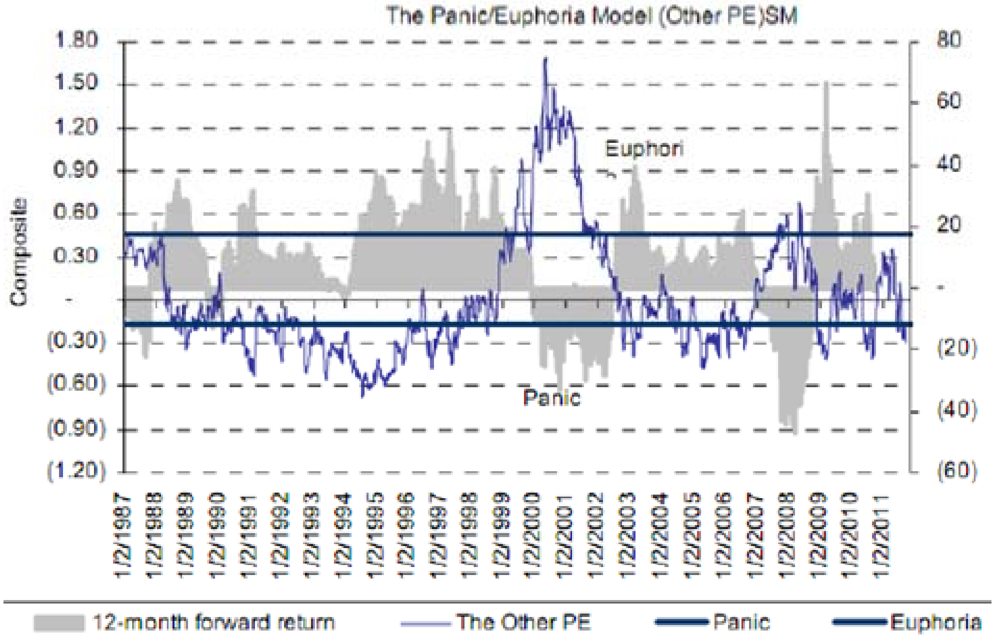
The wrangling over the debt ceiling this past summer was particularly harmful to confidence both here and overseas. The stalemate led Chairman Bernanke to make a rare public rebuke of legislators when testifying before the Joint Economic Committee of Congress, stating that the episode "was a negative for the financial markets…it's no way to run a railroad."

Needless to say, sentiment in the marketplace got to extreme levels. The following chart is from Credit Suisse and depicts the global risk appetite for both equities and credit according to their proprietary index:



Source: Credit Suisse which is not affiliated with Constellation Wealth Advisors LLC.

This gauge reached a new all-time low on October 4th, surpassing prior lows from the 2008 financial crisis; the 2000-2002 tech crash and the 1982 double dip recession. Citigroup's Panic/Euphoria model also signaled extreme negativity as represented by the blue line in the graph below:



Source: Citigroup which is not affiliated with Constellation Wealth Advisors LLC.

History has demonstrated that when this sentiment index gets to current levels, the stock market's ensuing 12- month return has been positive over 90% of the time, averaging mid-double digit returns. Other sentiment surveys that we have highlighted in the past have also moved to, or stayed at levels that represent extreme bearishness.

China and other emerging market economies have been raising rates and undertaking additional measures to slow growth and control inflation (many emerging countries have since reversed policy). Fears surfaced that policymakers had gone too far, raising the potential for a hard landing in China with negative effects on those emerging economies, as well as on global growth. Below is a one year chart of the Shanghai Composite Index which continues to hit new lows (back to 2009 levels) and China sovereign CDS or the cost to insure Chinese debt, which spiked during the quarter:

<u>Shanghai Composite Index (Blue) and CDS (Orange) – 1 Year Chart</u>

Source: Bloomberg, CWA.

Despite conjecture about China being the new economic superpower, most investors do not realize that the cost to insure Chinese sovereign debt was over three times that to insure US debt (it has since declined to a bit more than twice the cost).

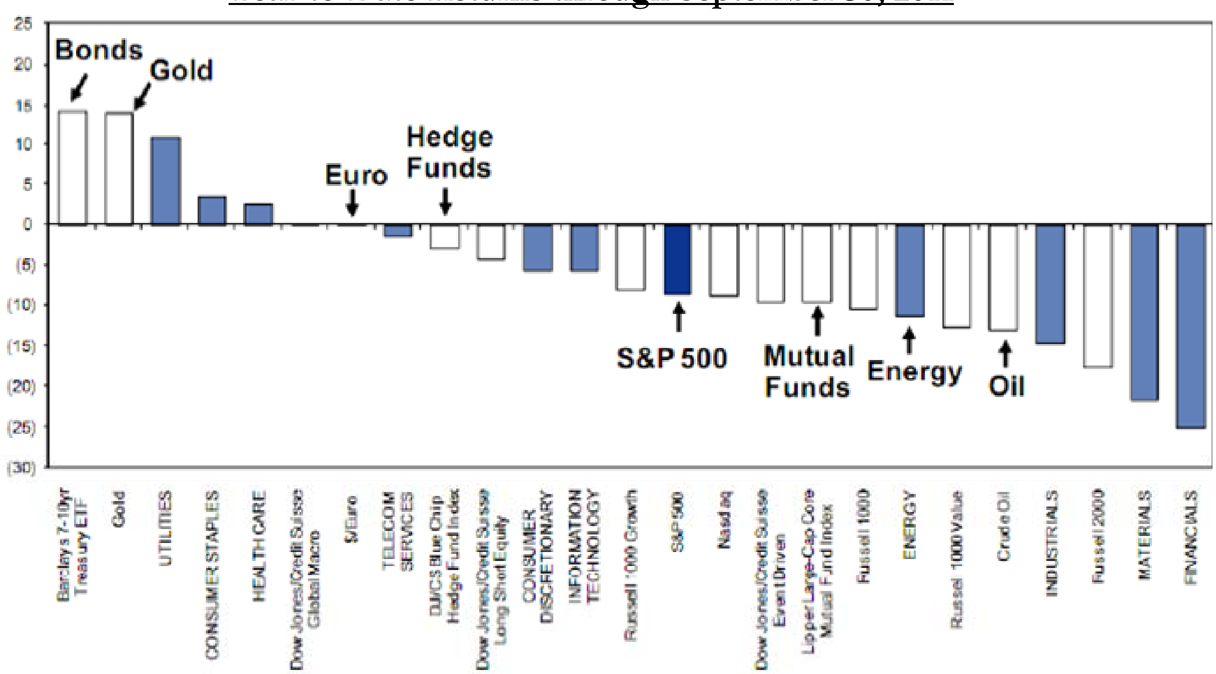
Fears about China and the realization that the world economy was slowing resulted in money flowing out of commodities. That asset class suffered a correction of close to 20% as measured by the NY Board of Trade's Continuous Commodity Index as seen below:

<u>Continuous Commodity Index – 1 Year Chart</u>

Source: Bloomberg, CWA

In fact, there have been very few places to make money this year as the fear trade (Treasury bonds and gold) has dominated the markets. The chart below profiles the returns of various asset classes, as well as some specific hedge fund and stock sectors, on a year-to-date basis through September 30th:

<u>Year-to-Date Returns through September 30, 2011</u>



Source: Goldman Sachs which is not affiliated with Constellation Wealth Advisors LLC, Ironically, it was after the S&P downgrade of US debt that Treasuries had a dramatic drop in yields (rise in price). For the quarter, the yield on the 30 year bond fell from 4.45% to an intraday low of 2.69% while the ten year fell from 3.21% to 1.69% before rebounding somewhat in the past two weeks. Longer dated Treasuries were helped by the Fed's decision to undergo what has been called "Operation Twist" in which the Fed will sell $400 billion of short term paper from their balance sheet and then purchase longer dated Treasury securities. The chart below shows that through June of 2012, which is the time period through which the program will be enacted, the Fed is projected to purchase almost **all** of the new issuance of long dated Treasuries.

Maturity Range	Dollar Amount Purchased by Fed	Treasury Auction Amount	Percent of Issuance for Fed to Buy
6-8 Years	$128 billion	$261 billion	49%
8-10 Years	$128 billion	$198 billion	65%
20-30 Years	$116 billion	$126 billion	92%

Source: Miller Tabek which is not affiliated with Constellation Wealth Advisors LLC,

While the Fed's move has been somewhat controversial, it should accomplish their goal of lowering long term rates (all else being equal) without having to increase the size of their balance sheet; in our opinion, a far more palatable action than undergoing another round of quantitative easing.

The economic data during the quarter were weak but appear to be firming recently, coming in above levels indicative of a double dip recession, a major concern among stock investors. Job creation remains in positive territory; although, not enough to lower the unemployment rate meaningfully (between population growth and increased productivity, the country needs to create roughly 150,000 jobs per month to keep the unemployment rate unchanged).

The markets are currently awaiting the next iteration of proposals from the EU to address their crisis. Subsequent to September 30, risk assets have staged a rally in anticipation that a viable resolution will be forthcoming. While the markets may initially react favorably, we have seen no reason to be excited about the next proposal. Europe is slowly coming to the realization that when there is no one left to borrow from, printing money is the only alternative. Thus if Germany wants to preserve the Euro, they will likely either have to accept the ECB (European Central Bank) funding their rescue vehicle (by printing) or they will have to be willing to potentially assume other member country's liabilities.

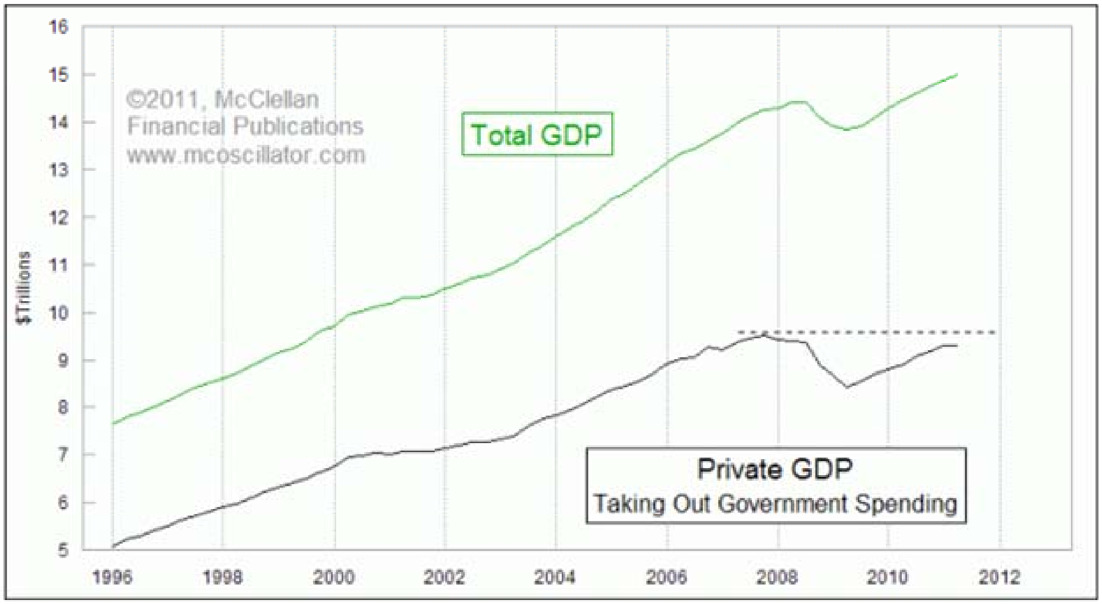
Outlook

"*My choices in life were either to be a piano player in a whore house or a politician. And to tell the truth, there's hardly any difference!*" President Harry Truman

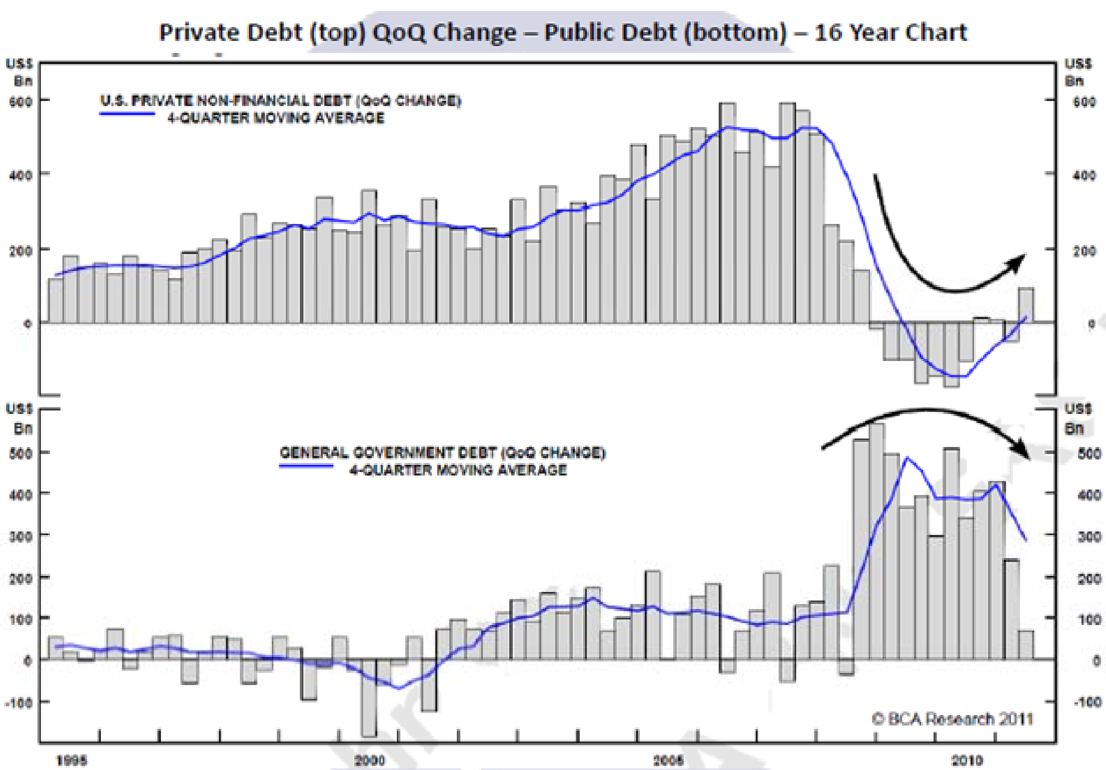
"*Bull markets are about cooperation, bear markets are about divisiveness*" Jeffrey Gundlach, Doubleline Capital LP

The economy remains on a path that is uninspiring but should avoid the double dip recession that was feared by the slowdown that occurred in the summer. Overall GDP, as seen below in green is back to all-time highs; however, that is the result of a massive increase in government spending. The grey line isolates private sector production which has not yet fully recovered:

Total and Private GDP 1996-2011

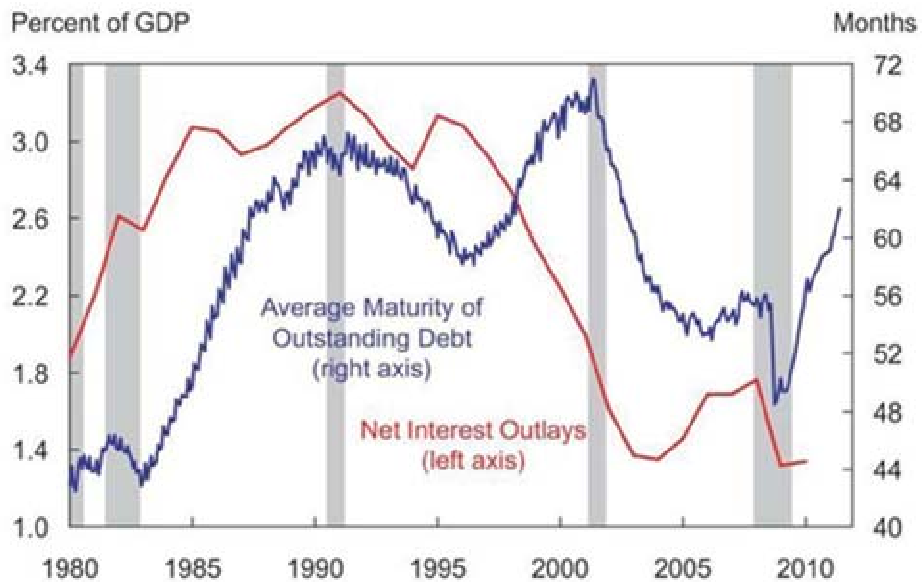


The financial crisis shocked the private sector into reducing debt and repairing their balance sheets – this was evidenced by a sharp rise in the personal savings rate and a concomitant reduction in consumption (70% of our economy). The government's decision to increase spending in the hopes of limiting the extent of the economic contraction resulted in a massive build-up of public sector debt. The capacity of government to assume more debt has rightly come into question both here and especially in Europe, raising the prospect of implementing fiscal austerity. This highlights the need for the private sector to regain traction. The public for private debt swap over time is pictured below:



Source: Bank Credit Analyst

While government's debt is at a record dollar amount, historically low interest rates have translated into 30 year lows in the level of interest expense as a percentage of GDP. This is unfortunate as it fosters further complacency in Congress with respect to addressing what is for sure a ticking time bomb. It also facilitates the politically expedient temptation to keep increasing government spending as an answer to the country's economic woes - perhaps through sustainable levels should rates rise (if we are not there already):

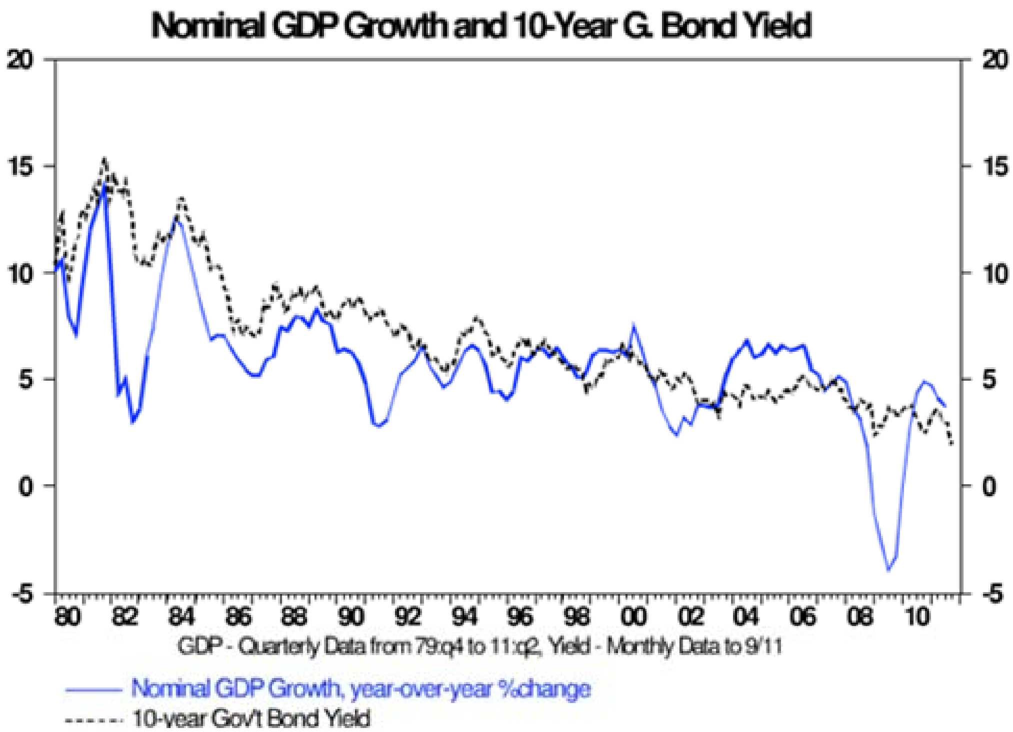


Source: U.S. Treasury

In 2000 the country had roughly $5.7 trillion in debt at an average interest rate of 6.63% resulting in $378 billion of interest expense. Currently, we have $14.8 trillion of debt at an average rate of 2.89% for total interest expense of $427 billion. Thus, at triple the level of debt, we have only 13% more interest on a much bigger economy. If rates were to return to levels that existed in 2000, interest on the debt alone would amount to $1 trillion dollars per year – a scary scenario.

One mitigating factor to a potential rate shock has been the Treasury Department's decision to lengthen the term structure of the outstanding debt as depicted above in blue. Given the current low rates of interest, we would expect this maturity extension to continue.

We maintain our belief that the odds favor a slow growth environment for several years to come. This is primarily due to the deleveraging process and large government presence in the economy. Such a backdrop should allow interest rates to stay low. Historically, the yield on the ten year note has closely correlated with the nominal (including inflation) growth rate of the economy. The chart below highlights this relationship:



Source: BEA which is not affiliated with Constellation Wealth Advisors LLC.

This relationship, of course, would not hold should a complete lack of confidence develop in the financial markets and result in a dollar crisis. And confidence is in short supply these days. Below is a poll conducted by Gallup recently which asked who is to blame for the US's current economic woes:

If you had to choose, who do you blame more for the economic problems facing the United States -- [ROTATED: financial institutions on Wall Street (or) the federal government in Washington]?

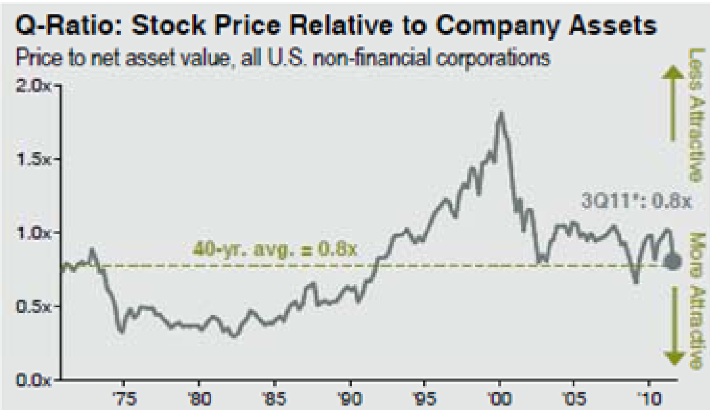
	Financial institutions	Federal government	No opinion
Oct 15-16, 2011	30%	64%	5%

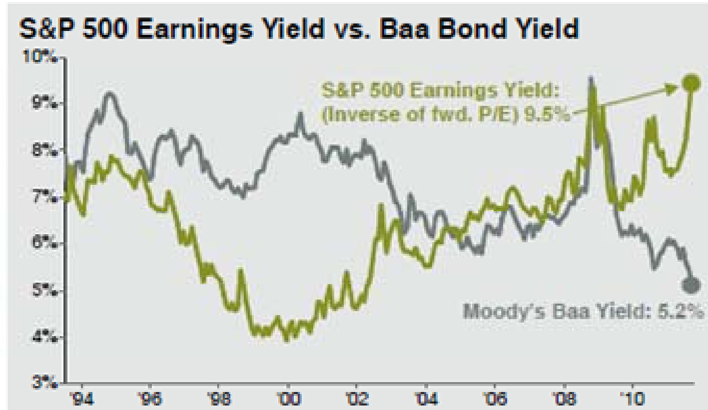
Source: Gallup.com

Despite all the publicity to the contrary and the recent "Occupy Wall Street" movement, the general population still blames government by over twice the percentage over financial institutions. The combination of needing government action and widespread lack of confidence in government makes for a difficult social construct. This is amplified by the tough economic straits many people are in. That said, in our careers, we cannot remember seeing so many professional investors being this bearish. And many are not just bearish on stocks; many see the equivalent of financial and social Armageddon.

It is important to remember that before the financial crisis, most market participants were focused on the micro – picking stocks in what was a relatively low volatility environment and ignoring the large and growing macroeconomic calamity looming in the near distance. Now post-Lehman, we are seeing the complete opposite behavior; everyone has become a macroeconomic expert focusing on the disconcerting, but well known, uncertainties at hand. In the meantime, great companies are selling for extremely low multiples with high dividend yields relative to bonds. By almost any metric, this market compares favorably versus historic averages; over 45% of stocks in the S&P 500 yield above the yield on the 10-year

Treasury note and price to earnings multiples are favorable. As seen in the chart on the right side below, the earnings yield of the S&P 500 is at its most favorable comparison to BBB bond yields in over seventeen years:





Source: JP Morgan

The chart above on the left displays what is called the Q-Ratio or Tobin Q and calculates the market value of a company's equity relative to its assets. One would expect in a knowledge based economy such as ours that the Q ratio would rise over time as fewer American companies have a large asset base (think Coke, Accenture and Google). However, even that measure is back below its 40 year average.

It is intuitive that there would be a close relationship between the multiples investors are willing to pay for stocks and the level of consumer confidence in the economy. The chart below shows this to be the case:

Source: JP Morgan

While most likely not a causal relationship (consumer confidence is a function of the economy and the economic woes/uncertainty weigh on earnings and multiples), we expect that the confidence surveys are nearing lows that should hold – and eventually improve even if it takes longer than in prior cycles.

Recommendations:

The story is familiar and we have touched on many of the issues facing the U.S., Europe and the developing world in many of our prior letters. While we realize the hangover from our current problems will likely be with us for longer than we would prefer, we also need to realize that markets often discount the future well ahead of when participants begin to feel better about it. This most likely is one of those times. It is tempting to wait to invest when things feel better or when clarity returns. It stands to reason that when that occurs, valuations will have already anticipated the better times and a large portion of the current opportunity set will fail to be captured. This period is unique in that you can be paid to wait, earning yields above those on long term bonds, with some inflation protection and the possibility of growing coupons as companies raise their dividends.

Equities*:* Despite the bullish tone, we still believe that the U.S. equity market will be in a trading range (but a potentially rising one) as we work through our deleveraging process. Also, we are not completely comfortable putting our faith in policymakers that have not earned it, especially since the crisis first unfolded three years ago. We cannot dismiss the possibility that governments both here and in Europe fail to act proactively to prevent another market disruption. That said, the equity markets have all but discounted another recession that may not come to pass. Valuations are attractive but the uncertainty around the economic outlook prohibits the expansion of PE multiples for now. We continue to recommend dividend oriented equities as their yields and valuations offer enough reward to offset the above average volatility. In emerging markets, policymakers have begun to reverse some of the rate increases of the past year. The headwinds we expected for equities arrived and the MSCI Emerging Market Index corrected by over 33% peak to trough from their early May high. We still believe that the growth story is intact and that averaging into these markets over time is the prudent move.

Fixed Income: Since the quarter began, bond yields have generally headed straight down, troughing at quarter-end. We recommend a barbell or intermediate ladder for bond portfolios using the rise in yields that accompanies the "risk on" trade to add to the intermediate portion of one's portfolio. Given the relationship between economic growth and bond yields (as shown earlier), we continue to believe that barring a crisis, yields may stay low longer than many participants expect.

Alternatives: We have written about living with higher than average equity volatility and we have received that in abundance. The environment has made for a difficult year for long/short hedge fund strategies. Increased correlation within and between markets has made adding "alpha" (historically the source of the majority of most funds' excess returns) much more difficult in this cycle. Managing risk has become more expensive as well and the more successful managers have been able to control their market exposure (beta trade) more nimbly while developing asymmetric risk management strategies that allow for positive returns. That said, we do not believe that the volatility will abate and expect those managers that navigated the market successfully to continue to earn relatively attractive risk-adjusted returns. Besides long/short equity and credit managers, we recommend investments that can distribute tax-preferenced cash flows such as yield oriented real estate.

As always, we thank you for your trust and confidence. Please feel free to contact us with any questions or comments.

DISCLOSURES

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Hedge and private equity funds are solicited and offered through the delivery of the (Confidential) Private Placement Memorandum. Prospective investors may be required to meet certain eligibility criteria in order to subscribe in these offerings.

INDICES

Barclays 5 Year Municipal Bond Index is composed of 35% state general obligation bonds, 50% revenue debt and 15% pre-funded bonds.

Barclays ("Capital") Aggregate Bond Index, is a broad base index, maintained by Barclays Capital and is often used to represent investment grade bonds being traded in United States.
S&P 500® index has over US$ 4.83 trillion benchmarked, with index assets comprising approximately US$ 1.1 trillion of this total. The index includes 500 leading companies in leading industries of the U.S. economy, capturing 75% coverage of U.S. equities. The S&P 500 is a free-float capitalization-weighted index published since 1957 of the prices of 500 large-cap common stocks actively traded in the United States.

Russell 1000 measures the performance of the large-cap segment of the U.S. equity universe and is constructed to provide a comprehensive and unbiased barometer for the large-cap segment and is completely reconstituted annually to ensure new and growing equities are reflected.

Russell 2000 measures the performance of the small-cap segment of the U.S. equity universe and is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

iShares MSCI EAFE measures the performance of publicly traded securities in the European, Australasian and Far Eastern markets.

iShares MSCI Emerging Markets Index is designed to measure the equity market performance in the global emerging markets. The index consists of 21 emerging markets with the three largest sectors by component weighting were financials, energy and materials.

Citigroup Panic/Euphoria Model is an aggregate measure of sentiment.

The Shanghai Composite index comprises all of the A shares and B shares listed on the Shanghai Stock Exchange. The index can be tracked all the way back to Dec 19, 1990 and to a price of 100. Index trade volume is scaled down by a factor of 1000.

The New York Board of Trade Continuous Commodity Index is an index composed of 17 commodity future prices and is recognized as a broad and reliable benchmark for the performance of the commodity sector.