PRIVATE CAPITAL MANAGEMENT, INC.

TEL: 303.370.0055
FAX: 303.370.0066

WWW.PCM-INC.COM

250 STEELE STREET • SUITE 350 • DENVER, COLORADO 80206

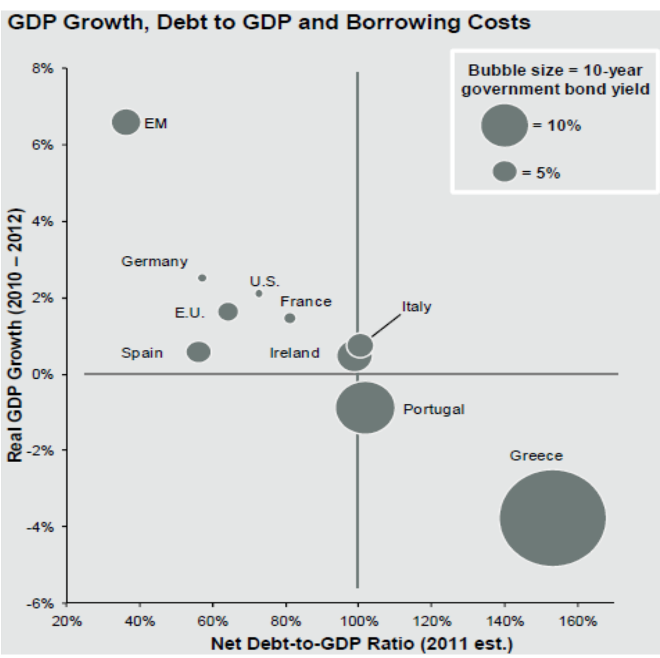
Third Quarter 2011

"IT IS NOT MY INTEREST TO PAY THE PRINCIPAL, NOR MY PRINCIPLE TO PAY THE INTEREST."
-RICHARD BRINSLEY SHERIDAN

It's been a long and difficult quarter in the equity markets culminating in losses of -14% for the S&P 500, -22% for the Russell 2000, -19% for the MSCI EAFE and -23% for the MSCI Emerging Markets. The volatility during August and September has been extreme with the Dow Jones Industrial Average experiencing moves of greater than 1% on 29 days and moves of more than 2% on 15 days.

Are the P.I.I.G.S. contagious? Revisited…

In our Second Quarter Commentary we noted the "global impact of a default by a member of the EU will depend largely on how orderly the events unfold". During the last three months, the ECB, EU and IMF (referred to as the 'troika') have been bleeding money into Greece to prevent an immediate default on Greek debt that could kick off a global financial crisis. Part of the purpose has been to buy more time for European and large global banks to prepare themselves for what will likely be a restructuring of Greek debt. In the scatter plot below you can see the relative magnitude of the problems in the major EU member countries and the US.

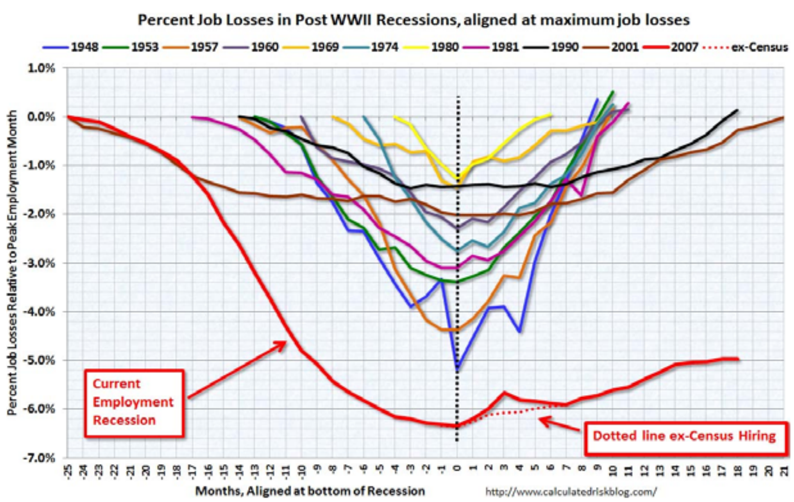


Source: IMF, BLS, J.P. Morgan Asset Management.

It's worth noting that while the US lost its AAA credit rating with Standard and Poor's on August 5^{th}, the 10 year Treasury yield actually fell from 2.57% to a record low of 1.67% on September 9^{th}. As the relative size of the US bubble on the chart shows, the US Treasury remains a safe haven investment.

US Economy

Second Quarter real GDP growth was revised higher to 1.3% from the prior estimate of 1.0% and this marks an improvement from First Quarter growth of only 0.4%. Unemployment remains a major economic headwind because the consumer makes up roughly 70% of the US economy. As one can see in the graph below, unemployment during this last recession has been deeper and taken longer to recover than any recession since WWII.



One driving force in the employment situation is the continued malaise in the housing market which usually provides a job boost after recessions. According to the Federal Reserve of St. Louis, in the two years following most recessions, housing has added around 0.5% to annual GDP growth but recently the contribution has been negative.[1]

Well Positioned

Non-Financial U.S. corporations are carrying nearly $2 trillion in cash which is enough to operate for 73 months according to Standard & Poor's.[2] This is up dramatically from the $1.38 trillion level in 2008 and marks the highest level since 1963.[2] Birinyi Associates reported that cash as percent of market capitalization for S&P 500 non-financial companies was a lofty 7.4% as of July.[3] Dr. Michael Hasenstab, Portfolio Manager at Franklin Templeton

Investments, appropriately reminds us that companies have already shed tremendous amounts of labor, are already running lean, and have arguably under-hired and under-spent during the last three years. In his view, while the US could have another recession, the excesses do not exist that would support a massive contraction.[4]

A word on Valuations…

During the quarter, valuations on the S&P 500 continued to compress from 12.4 times forward earnings to only 10.6. The graph below shows the Trailing Price-to-Earnings ratio is also currently at 10.6 times, which compares to an average of 12.7 during recessions and 13.9 during expansions. Bob Doll, Chief Equity Strategist at BlackRock, believes the markets are pricing in a greater-than-50% chance the US enters recession while he estimates the risk is closer to 30% and a Wall Street Journal economist poll averaged 33%.[5]

Source: BEA, Federal Reserve Board, Wilshire Associates, J.P. Morgan Asset Management.

The table below shows the primary valuation metrics for the S&P 500, most of which are below year ago levels and historical averages. In addition, the 2.5% dividend yield on the market is higher than average and well above the 10 year US Treasury yield.

S&P 500 Index: Valuation Measures

Valuation Measure	Description	Latest	1-year ago	Historical Averages 3-year avg.	5-year avg.	10-year avg.	15-year avg.
P/E	Price to Earnings	10.6x	12.4x	12.9x	13.4x	15.0x	17.0x
P/B	Price to Book	1.9	2.0	2.1	2.3	2.6	3.1
P/CF	Price to Cash Flow	7.3	8.2	8.1	8.9	10.2	11.1
P/S	Price to Sales	1.0	1.1	1.1	1.2	1.3	1.5
PEG	Price/Earnings to Growth	0.8	0.6	1.1	1.2	1.2	1.2
Div. Yield	Dividend Yield	2.5%	2.1%	2.3%	2.2%	2.0%	1.9%

Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management.

Tactical Asset Allocation… from the Bottom-Up

Several clients have asked what we are doing tactically with Asset Allocation during this time. As you know, we often use managers that have flexible mandates that allow them to carry large amounts of cash, invest in multiple asset classes and sometimes even hedge and short certain securities. Part of our tactical approach to asset allocation is to allow these managers to make changes in their portfolios based on the bottom-up fundamental risk/reward opportunities they identify. This is not designed to get clients in and out of the markets, but rather to make fundamentally based adjustments in portfolios. To be clear, we have not eliminated all exposure to further declines in the equity markets, but we do have our defensive players on the field. If the markets continue to fall, we expect our current managers to deliver good results relative to their benchmarks while not yielding all upside if the markets turn higher.

Thank you

We would like to take this opportunity to thank those of you that referred new clients to PCM during the quarter. Client referrals are the lifeblood of our business and are deeply appreciated.

In addition, we would like to thank you for allowing us to help guide you through these uncertain times. We remain committed to careful generation of long term value for all of our clients. Should your personal financial situation change, or if you would like to adjust, review or discuss your asset allocation, please do not hesitate to call us.

~The PCM Team

By the numbers…

Index	Close	Third Quarter	Year to Date
S&P 500	1131	-14.3%	-10.0%
MSCI EAFE	1373	-19.6%	-17.2%
MSCI Emerging Markets	880	-23.2%	-23.5%
Barclay's US Aggregate Bond	122	+3.0%	+3.9%
DJ|UBS Commodity	140	-11.3%	-13.7%

(Data provided by Thomson Financial as of 9/30/2011)

1 "Home Forecast Calls for Pain" Nick Timiraos Wall Street Journal 9/21/2011
2 "Companies' $2 Trillion Conundrum" Vipal Monga Wall Street Journal 10/5/11
3 "S&P's Sideline Cash May Stay On The Sideline" Mark Gongloff www.wsj.com 6/22/11
4 "Dr. Michael Hasenstab on Recent Market Volatility" www.franklintempleton.com 9/28/11
5 "BlackRock Investment Directions" Fourth Quarter 2011 www.blackrock.com

Disclosures