M|W

MW INVESTMENT STRATEGY

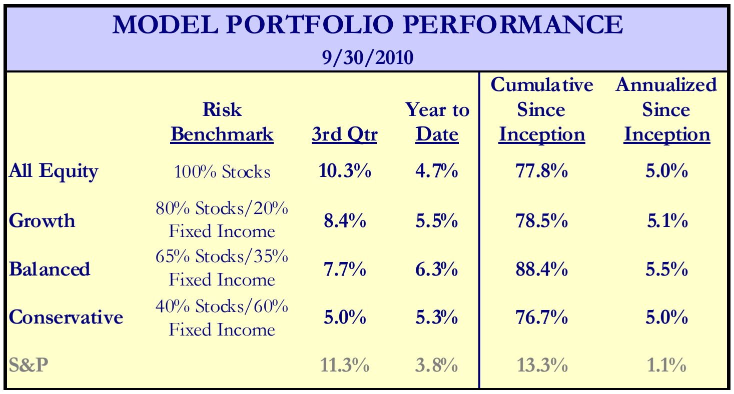
October 2010

The S&P 500 index of large cap US stocks rose nearly 9% in September, turning in its best monthly performance since April of last year, and ending the quarter with an 11.3% return. Foreign stocks also posted strong gains, with the Vanguard Total International Stock index rising 17.9%. Vanguard's Total Bond Market index rose 2.4% for the three-month period.

Model Portfolio Performance[i]

Third-quarter returns for our four portfolio models ranged from 5.0%-10.3%, slightly trailing their respective benchmarks. For the year to date, the performance for each of our four models remains ahead of their benchmarks and the S&P 500 index.

Risk was amply rewarded during the third quarter. Our core equity funds, with a strong preference for those holding higher quality stocks, generally underperformed their benchmarks. Where we added risk, specifically in the fixed income arena, our fund selections added to our quarterly performance. An average 10% portfolio allocation to PIMCO Developing Local Markets gained 11.3% during the quarter and has returned 15.5% for the year to date. Small allocations to lower-risk holdings Hussman Total Return, Arbitrage, and the Eaton Vance Global Macro funds detracted from our portfolios' performance.



MODEL PORTFOLIO PERFORMANCE

9/30/2010

	Risk Benchmark	3rd Qtr	Year to Date	Cumulative Since Inception	Annualized Since Inception
All Equity	100% Stocks	10.3%	4.7%	77.8%	5.0%
Growth	80% Stocks/20% Fixed Income	8.4%	5.5%	78.5%	5.1%
Balanced	65% Stocks/35% Fixed Income	7.7%	6.3%	88.4%	5.5%
Conservative	40% Stocks/60% Fixed Income	5.0%	5.3%	76.7%	5.0%
S&P		11.3%	3.8%	13.3%	1.1%

Portfolio Updates:

With stock market valuations at slightly over-valued levels and market indices near the upper end of what has been a broad trading range for nearly two years, we are keeping our relatively conservative portfolio positioning in place and have made no changes to any of our models.

Fairholme

A success story is always welcome, and Fairholme is one of ours. We identified this fund in 2006, adding it to our portfolios as a complement to our roster of Litman Gregory-researched mutual funds. Under lead manager Bruce Berkowitz, Fairholme was an excellent match for our criteria. Relatively small with below-average expenses, the fund had repeatedly outperformed both on the upside and the downside (this latter often overlooked by investors). Berkowitz ran only this one fund, he had a clear and high-conviction investment approach, and most importantly, management had a significant amount of personal money in the fund. There is nothing that makes a manager pay closer attention to risk-management than the possibility of losing a lot of their own money.

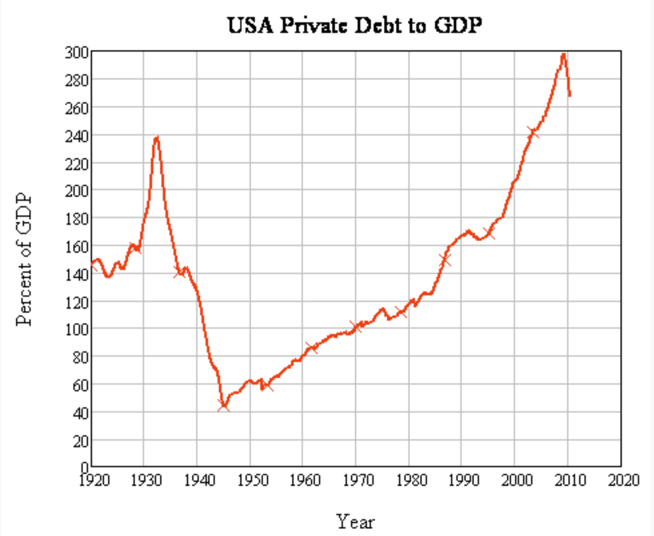
Fairholme has outperformed the market in each of the years since we have owned it, and not by small margins. Last year, the fund returned 39% to the S&P's 27%, and, in 2008's sell-off, Fairholme bested the S&P 500 by seven percentage points. Berkowitz prides himself in his unconventional and highly contrarian approach, sometimes holding a very large cash position and other times taking on substantial risk, as with the current allocation of 10% of his portfolio to the fallen insurance giant AIG[1].

And yet for all of, or more accurately because of, its stellar record, Fairholme is at a stage where funds can become victims of their own success. Highly-publicized outperformance brings with it a flood of new investor money and Fairholme has been no exception. The fund now boasts $18B in assets under management and is nearly 10 times as large as when we bought it. There are practical, if difficult to pinpoint, limits to the amount of money a manager can successfully deploy. Typically, as assets grow beyond these limits, fund performance will decline to the average or worse. This poses a challenge for fund companies to limit their growth, one that, sadly, most fail. While there have been exceptions to the size rule (Fidelity Magellan under Peter Lynch comes to mind), a concentrated fund like Fairholme should be expected to have a harder time maintaining its edge as it grows.

In a universe of thousands of managers, there are few who meet our criteria. We are not happy to have to pose difficult questions regarding one of our most successful portfolio holdings, a fund that was responsible for much of our outperformance in 2009. But it's part of the job. Unfortunately, there are no clear signs (well, in one case there was, when a manager bought himself a private jet) that can signal when a fund's ability to earn excess returns will end. Asset size is not sufficient by itself to justify moving assets away from a manager who has consistently demonstrated a substantial investment edge. Perhaps Berkowitz will turn out to be the next Peter Lynch, or better yet, Warren Buffett, his role model. But the fund is on our radar screen for closer scrutiny. And as always, we are poring through data, seeking to identify the next great manager to add to our portfolio roster.

Deleverage and the Wealth Effect in Reverse

If there were just one image that portrays the basic narrative of our nation's economy during the last 50 years, I believe it would be the unembellished graph at right[2]. This chart tells the story of debt, way too much debt, amassed over multiple decades. As private individuals and businesses, we borrowed and borrowed and then borrowed yet more until we finally reached that point where further borrowing was no longer possible. The pace of our debt accumulation grew more rapid (see the increasing slope of the red line) during the 1980s. And this pace picked up even further in the 1990s. By 2008, we had achieved an unprecedented level of indebtedness, a level far exceeding that of the 1920s.



[1] Fairholme sold defensive healthcare positions in early 2010 to become the largest private shareholder of AIG. At the end of September, a major reorganization was approved by AIG's Board of Directors to convert the US government's majority ownership stake in the company. The stock is up nearly 30% for the year.

[2] Total private debt as a percentage of GDP chart from Steve Keen's Debtwatch

The graph depicts the increasing systemic leverage that enabled us as a nation to sustain levels of consumption that were well in excess of our incomes. This extra consumption in turn caused our economy to grow faster than it might have otherwise. Simultaneously the ever-increasing leverage fueled higher asset prices, from stocks to real estate. Rising asset prices enhanced our perception of our wealth, a “wealth-effect” that in turn fed more borrowing, and yet more consumption. A virtuous cycle.

Now this cycle is running in reverse. The prior tailwind of debt creation has turned into a headwind of debt destruction, as we find ways to live within our means and reduce our accumulated debt. The wealth effect is also operating backwards as we feel, and in fact are, poorer than we thought we were just a few years ago. These twin cycles - of debt destruction and wealth contraction - explain why the current economic downturn is not in any way comparable to a typical recession. Until consumers have completed the long process of “balance sheet repair,” reducing debt to more sustainable levels, it is difficult to see how economic growth can return to its prior levels. This is not to suggest the US economy is going to fall off the proverbial cliff, but that the process of retrenchment is likely to put a damper on growth for years to come.

Ending on a more positive note

> *"The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born, not an infant, but a giant."* - A.C. Pigou[3]
>
> *“I’m a huge bull on this country … we won’t have a double-dip recession. I see our businesses coming back almost across the board … it’s night and day from a year ago.”*
> Warren Buffett

Warren Buffett is one of several highly respected business leaders sounding a positive note on the US economy of late. Bruce Berkowitz, Fairholme’s manager mentioned earlier, is also betting on a stronger recovery than the markets are anticipating. We would be the last person to disagree with either and we remain mindful as well of falling into the decision-error trap of the Pigou quote.

Yet, while we are acutely aware of both the risks and the potential in the current environment, our core outlook has not changed. We expect continued muted growth in the developed world for many years, a result of the deleveraging cycle discussed above. Investors should expect returns that are below their historical averages until the economy has fully digested the excesses of prior decades. That is not to say there will not be pockets of investment opportunity and even dramatic market rallies, and falls, along the way. We continue to count on the managers we trust to make good decisions for our clients. And we continue to look to identify opportunities in undervalued asset classes that we can overweight, such as our current allocations to developing markets fixed income and large dividend-paying US and global stocks, in order to enhance longer-term returns for our clients.

Martin Weil
Principal

[3] *An under-appreciated economist of the 20th century, Pigou is credited with developing the concept of “externalities”*

[i] **Model Portfolio Performance Disclosures:**

a) Performance shown is for each portfolio model and is not a composite of the performance of actual client accounts. While our goal is that each client account will closely mirror the holdings and performance of our models, client account performance may, and does, vary according to several factors. Some of these are listed below. In addition, there have been periods, and may again be in the future, when our evaluation of major economic and/or market events leads us to manage client account allocations in a materially different manner than is shown in our models. At these times, client performance results will vary from that of our models. A specific example is the period August-December 2008, when all of our actual client accounts held cash positions that were substantially in excess of the cash positions reflected in our models.

b) All MWI managed client accounts are based on one of four diversified model portfolios, composed of no-load mutual funds, exchange-traded funds and other publicly traded securities. These four models are geared to different levels of investor risk tolerance. New accounts are invested following one of these models, typically using dollar-cost averaging over a period of months, not to exceed one year. Once an account is fully invested, it is expected to track the performance of its underlying model. Exceptions to this include accounts with restrictions such as: the client-directed retention of legacy holdings and/or excess cash, substantial withdrawals or additions. Accounts smaller than $100,000 are restricted by purchase minimums at certain mutual funds and as a result do not hold all the same positions. The performance of these accounts may differ somewhat from these models. Accounts employing municipal bond funds in place of the taxable bond funds used in models will slightly underperform on a pre-tax basis.

c) Benchmarks for each model are custom created following the neutral asset allocation for each portfolio. They are constructed from Vanguard's S&P 500 index fund, iShares Russell 2000 index, Vanguard Total International and Total Bond index funds. The S&P 500 index is calculated with dividends included.

d) Net of fees: The performance for MWI model portfolios is calculated net of our maximum annual management fee, and brokerage charges, if any. The returns of the portfolio benchmarks do not include any fees or charges other than those of the index vehicles employed in the benchmark. All returns assume dividends and income are reinvested.

e) Rebalancing: Model portfolios are routinely rebalanced every six to twelve months on the last day of a quarter. Actual client accounts may be rebalanced as needed. With tax-efficiency a part of our decision criteria, taxable accounts may be rebalanced less often and/or less completely than retirement and other accounts not subject to current taxation. This may result in performance discrepancies between taxable and non-taxable accounts managed following the same portfolio model.

f) Model allocation changes: Changes to model allocations are infrequent but can and do occur at any time. When a model is changed, allocations to client accounts are changed as soon as is practical. However, changes to the model portfolios are only recorded for performance purposes on the last day of any quarter.

g) Closed funds: From time to time, mutual funds that form part of MWI model portfolios close to new investors. Clients already owning closed funds in their accounts will generally continue to hold and/or add to their positions. New client accounts will be invested in alternate funds. At year-end, MWI will substitute in its models for any funds that have closed during the year with the alternate funds available then to new clients. As a result, performance disparities may develop between older and newer client accounts, and between older client accounts and current model performance.

h) Historical performance is not a guarantee of future results. While the performance period since January 1999 includes both rising and falling stock markets, there can be no assurance that the portfolios will perform as well under future market conditions.