Davenport Asset Management®

# FundAdvisor

Q3

**Quarterly Update** September 30, 2011

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**It was a brutal quarter** as the lingering negativity and uncertainty around the globe took their toll on the equity markets. In fact, we've just endured the toughest stretch for stocks since the 2008 financial crisis. Major stock indices have declined for the last five months and the declines certainly accelerated in August and September. The S&P 500 and Russell 2000 declined 13.9% and 21.9%, respectively, during the quarter and are now down 8.7% and 17.0%, respectively, on a year-to-date basis. Developed overseas markets have now trailed domestic stocks for the better part of four years as the turmoil and uncertainty in Europe drove international markets down 19.6% in the quarter and 17.2% for the year.

The bottom line to all of this is that equity portfolios that are diversified away from the largest U.S. based stocks have had a difficult run thus far in 2011. In fact, the Dow Jones Industrial Average, which consists of 30 of the largest companies in the U.S., has been one of the best performing equity indexes in the world. Historically, though, it has not been unusual to see a flight to the quality and perceived "safety" of large cap U.S. stocks in times of market turmoil. This year has simply been more pronounced than we have seen in the last two market cycles spanning more than 10 years.

We want to reiterate that the concept of diversification is predicated on the idea that some pieces of your portfolio will do better than others in any given time period, but that over the longer term you will be better served by diversifying into small cap, international, and emerging market stocks. This has certainly been the case over the 9 year history of the Fund*Advisor* program and we think it will prove to be the case going forward. That said, there will be years that the S&P 500 trumps everything else, and 2011 seems to be one of those years.

## *Economic Discussion*

We thought that since macroeconomic factors have had such a profound impact on the market recently and are likely to be significant drivers of future volatility, we would close with some insights from the Davenport Asset Management quarterly letter:

Clear signs of renewed economic weakness have emerged and have bolstered the case for a "double dip" recession. Unemployment remains elevated and the housing market continues to struggle. Furthermore, investor angst has been exacerbated by political discord out of Washington D.C. Politics in our country definitely seem to have hit a new low point and have eroded consumer, corporate and investor confidence. We also think market declines have taken on somewhat of a self-fulfilling nature. In other words, a prolonged downtrend has weighed on consumer and business demand, which in turn is weighing further on markets. While we have yet to see a broad based reduction of corporate earnings outlooks, we have seen some indications of weakness and the stock market is clearly saying there are more to follow. We definitely expect to hear some cautious commentary when companies report third quarter numbers in coming weeks.

We aren't sure monetary policy can save us this time around. While current easy policy is expected to persist, there aren't many more arrows in the Federal Reserve's quiver. Recently, the Fed announced what was dubbed "Operation Twist". Essentially, this entails shifting government bond purchases towards longer-dated notes with the intent of lowering long-term interest rates. The Fed's plans and a general flight to safety have driven up bond prices. In theory, this would not only encourage borrowing, but would also entice investors to take on more risk in search of higher returns. Equities have performed quite poorly since the announcement as the marginal impact of these policy moves has been called into question. Meanwhile, commodity prices have plummeted alongside deflation worries (a significant change from six months ago when inflation was the focal point). Even Fed Chairman Ben Bernanke has noted that economic conditions are now more dependent on sound fiscal policy from Washington.

We are worried, but not as worried as we were in 2008. There's no doubt that Europe's problems will weigh on multinational companies and emerging markets are beginning to cool.

*cont. on page 3*

## Returns as of September 30, 2011

**2011 HAS BEEN VERY DIFFICULT YEAR FOR THE MUTUAL FUND INDUSTRY.** According to our research, only about one third of equity fund managers have been able to outperform their benchmarks in the first three quarters of 2011 (Source: Morningstar). Additional research from JPMorgan indicates that 47% of mutual funds have underperformed their benchmarks by more than 2.5%. Within our Fund*Advisor* models, only 2 of the 9 equity funds have underperformed to that magnitude and we are monitoring them closely. Overall, we feel very good about the funds that make up our models and believe that they are run by some of the best investment minds in the industry. The performance of all of the funds in the Fund*Advisor* program is listed below.

### Asset Classes
*Year to Date Returns*

1. **Bonds** (BarCap Interm Govt/Credit) 4.92%
2. **Large Cap** (S&P 500) -8.68%
3. **Mid & Small Cap** (Russell 2500) -14.87%
4. **International** (MSCI EAFE) -17.18%
5. **Emerging Markets** (MSCI EM) -21.66%

### Styles
*Growth vs. Value*

| Growth (Russell 3000 Growth) | Value (Russell 3000 Value) |
|---|---|
| -7.90% | -11.85% |

| Fund / Index Name | Fund / Index Performance at Net Asset Value* | | | | | Expenses | |
|---|---|---|---|---|---|---|---|
| **Large Cap** | **YTD** | **1 Year** | **3 Years** | **5 Years** | **10 Years** | **Gross** | **Net** |
| S&P 500 Index | -8.68 | 1.14 | 1.23 | -1.18 | 2.82 | - | - |
| American Funds AMCAP F2 | -8.63 | 1.72 | 4.18 | - | - | 0.49 | 0.49 |
| Pioneer Cullen Value Y | -13.24 | -5.60 | -2.27 | -2.39 | - | 0.78 | 0.78 |
| FMI Large Cap | -8.33 | -0.13 | 2.67 | 1.26 | - | 0.97 | 0.97 |
| **Mid Cap and Small Cap** | **YTD** | **1 Year** | **3 Years** | **5 Years** | **10 Years** | **Gross** | **Net** |
| Russell 2500 Index | -14.87 | -2.22 | 0.19 | 7.08 | 11.98 | - | - |
| Eagle Mid Cap Stock A | -17.85 | -5.70 | -0.03 | -0.71 | 4.83 | 1.20 | 1.20 |
| Royce Value Investment | -17.01 | -2.80 | 3.24 | - | - | 1.16 | 1.16 |
| Keeley Small Cap Value A | -18.74 | -4.16 | -5.54 | -2.21 | 8.02 | 1.36 | 1.36 |
| **International** | **YTD** | **1 Year** | **3 Years** | **5 Years** | **10 Years** | **Gross** | **Net** |
| MSCI EAFE Index | -17.18 | -12.02 | -4.02 | -6.14 | 2.42 | - | - |
| Thornburg International Value I | -16.38 | -9.77 | 0.53 | 0.80 | 8.97 | 0.92 | 0.92 |
| Dodge & Cox International Stock | -19.38 | -12.96 | -0.02 | -2.16 | 8.95 | 0.65 | 0.65 |
| **Emerging Markets** | **YTD** | **1 Year** | **3 Years** | **5 Years** | **10 Years** | **Gross** | **Net** |
| MSCI Emerging Markets Index | -21.66 | -15.89 | 6.59 | 5.17 | 16.41 | - | - |
| T. Rowe Price Emerging Mkts Stk | -22.82 | -17.99 | 3.72 | 2.75 | 15.24 | 1.27 | 1.27 |
| **Intermediate Government/Credit** | **YTD** | **1 Year** | **3 Years** | **5 Years** | **10 Years** | **Gross** | **Net** |
| BarCap US Govt/Credit Interm Index | 4.92 | 3.40 | 7.02 | 5.92 | 5.12 | - | - |
| Delaware Diversified Income A | 4.07 | 3.76 | 11.76 | 8.30 | 8.01 | 0.98 | 0.93 |
| PIMCO Total Return A | 1.59 | 0.54 | 9.36 | 7.33 | 6.10 | 0.90 | 0.90 |
| Vanguard Short-Term Inv Gr. | 1.45 | 1.36 | 5.92 | 4.45 | 3.98 | 0.22 | 0.22 |
| **Dynamic Allocation** | **YTD** | **1 Year** | **3 Years** | **5 Years** | **10 Years** | **Gross** | **Net** |
| S&P 500 Index | -8.68 | 1.14 | 1.23 | -1.18 | 2.82 | - | - |
| MSCI World Index | -12.20 | -4.35 | -0.07 | -2.23 | 3.71 | - | - |
| BlackRock Global Allocation I | -7.60 | -2.15 | 4.68 | 4.16 | 8.82 | 0.88 | 0.81 |
| IVA Worldwide I | -5.92 | 1.09 | 11.92 | - | - | 1.06 | 1.06 |
| Kinetics Paradigm No Load | -18.75 | -8.62 | -1.53 | -3.06 | 7.27 | 1.76 | 1.64 |
| Quaker Strategic Growth I | -14.95 | -4.02 | -6.21 | -3.18 | 2.07 | 1.97 | 1.74 |
| Wintergreen | -8.07 | -1.45 | 5.23 | 3.94 | - | 1.89 | 1.89 |
| Ivy Asset Strategy I | -13.53 | -7.12 | 2.51 | - | - | 0.77 | 0.77 |

## *Past performance is no guarantee of future results.*

It is important to note that short-term and trailing performance will fluctuate. We expect all of the funds at some point to experience underperformance versus their benchmarks and peer groups. However, we believe that our research process has helped us identify funds that are likely to perform well over the long-term. Our decision to remove a fund is not based on short-term performance, but on in-depth analysis using our Monitoring Criteria.

## *Economic Discussion cont.*

Domestically, however, we aren't coming off the same high as we were in '08 and many industries are already operating at depressed levels. 2008 followed a period when many American individuals and companies did unwise things (mainly excessive borrowing) and growth was inflated. A financial/liquidity crisis, which we don't expect to recur, prompted a period of more conservative behavior and repairing past mistakes. Now, companies generally are in good shape, many with little debt, large cash positions, lean cost structures and access to cheap capital. Corporate America is now much better suited to absorb any economic weakness.

Oftentimes, extreme levels of dread and uncertainty can lead to market gains as obstacles are overcome. We are hopeful that Eurozone leaders can arrange a comprehensive budget solution, even if it means slower growth in coming years. We are also hopeful that U.S. leadership will introduce constructive economic policy that instills confidence in businesses and consumers. Who knows, maybe the threat of not being re-elected in 2014 will drive more decisive action by many politicians? Market weakness has been very broad based and many companies are trading at low double-digit earnings multiples. We feel that the fund managers in Fund*Advisor* are using this as an opportunity to upgrade their portfolios, to focus on their top picks, and to take advantage of low valuations. In doing so, they can lay the foundation for years of strong absolute and relative performance. We thank you for your trust and look forward to reporting back to you at year end.

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*Mutual funds are offered in the Fund*Advisor* program at net asset value, but are subject to an annual investment advisory fee of up to 1.25% with a minimum fee of $125 per quarter. The Davenport wrap fee includes investment advice and brokerage execution. In addition to the Fund*Advisor* fee, clients will bear a proportionate share of each mutual fund's management and administrative expenses, including advisory fees paid to the mutual fund's investment advisors. This chart shows the actual performance of the shares at net asset value, and does not represent individual account performance. Past performance is no guarantee of future results. Current performance may be lower or higher than the data quoted. To obtain performance data current to the most recent month-end, please visit the following web sites: www.americanfunds.com, www.blackrock.com, www.delawareinvestments.com, www.dodgeandcox.com, www.eagleasset.com, www.fiduciarymgt.com, www.ivafunds.com, www.ivyfunds.com, www.keeleyfunds.com, www.kineticsfunds.com, www.pioneerinvestments.com, www.quakerfunds.com, www.roycefunds.com, www.thornburginvestments.com, www.troweprice.com, www.vanguard.com, www.wintergreenfund.com. The investment and principal value of an investment will fluctuate. An investor's shares, when redeemed, may be worth more or less than their original cost. Mutual Fund and Index returns are provided by Morningstar.

***You should consider each mutual fund's investment objectives, risks, charges and expenses carefully before investing. Each mutual fund's prospectus contains this and other important information, should be read carefully before investing or sending money, and can be obtained by contacting your Investment Executive, or by calling 1-800-853-2060.***

**Gross Expense Ratio:** The total annual operating expenses of a fund divided by its average net assets. **Net Expense Ratio:** The total annual operating expenses of a fund, less any fee waivers, divided by its average net assets. This is the expense ratio actually charged by the fund for the previous fiscal year.

[1]The Fund's distributor, Delaware Distributors, L.P. (Distributor), has also contracted to limit the Class A shares' 12b-1 fees from February 28, 2011 through February 28, 2012 to no more than 0.25% of the average daily net assets. Waivers and reimbursements may only be terminated by agreement of the Manager and the Distributor, as applicable, and the Fund. [2]Total Annual Fund Operating Expenses excluding interest expense is 0.90%. [3]Net operating expenses exclude investment interest expenses, acquired fund fees, if any, and certain other fund expenses net of all waivers and reimbursements. BlackRock has agreed voluntarily to waive certain fees and expenses, but may discontinue the voluntary waivers at any time without notice. [4]The Investment Adviser to the Paradigm Portfolio has voluntarily agreed to waive management fees and reimburse Fund expenses so that Net Annual Fund Operating Expenses do not exceed 1.64%, excluding AFFE, through April 30, 2011. These waivers and reimbursements may be discontinued at any time by the Investment Adviser after April 30, 2011.

**Index Definitions:**

The **Barclays Capital Intermediate Government/Corporate Index** is an unmanaged index composed of debt securities with maturities from one to ten years issued or guaranteed by the U.S. Treasury, U.S. Government agencies, quasi-federal corporations and fixed rate dollar denominated SEC-registered corporate debt that are rated investment grade or higher by Moody's Investors Service and Standard and Poor's Corporation or Fitch Investor's Service, in that order. The **MSCI EAFE® Index (Europe, Australasia, Far East)** is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the U.S. & Canada. **MSCI EM (Emerging Markets) Index** is a capitalization-weighted index of stocks from 26 emerging markets that only includes issues that may be traded by foreign investors. The reported returns reflect equities priced in U.S. dollars and do not include the effects of reinvested dividends. The **MSCI World Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The **Russell 2000 Index** measures the performance of the 2000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. The **Russell 2500 Index** measures the performance of the small to mid-cap segment of the U.S. equity universe, commonly referred to as "smid" cap. The Russell 2500 is a subset of the Russell 3000® Index. It includes approximately 2500 of the smallest securities based on a combination of their market cap and current index membership. The **Russell 3000® Growth Index** measures the performance of the Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. The stocks in this index are also members of either the Russell 1000 Growth or the Russell 2000 Growth indexes. The **Russell 3000® Value Index** measures the performance of the Russell 3000 Index companies with lower price-to-book ratios and lower forecasted growth values. The stocks in this index are also members of either the Russell 1000 Value or the Russell 2000 Value indexes. The **S&P 500 Index** is comprised of 500 U.S. stocks and is an indicator of the performance of the overall U.S. stock market. ***An investor cannot invest in an index, and its returns are not indicative of the performance of any specific investment.*** International funds invest primarily in equity securities of issuers outside the United States. International investments are subject to additional risks such as currency fluctuations, political instability, and the potential for illiquid markets. Funds that invest in foreign securities may involve greater risks, including political and economic uncertainties, as well as risk of currency fluctuations. Small and mid-cap company stocks may be more volatile than stocks of larger, more established companies. Investments in bonds and other fixed income securities may fall in value if interest rates change. Generally, the prices of debt securities rise when interest rates fall, while their prices fall when interest rates rise. Longer term debt securities are usually more sensitive to interest rate changes. An issuer suffering an adverse change in its financial condition could lower the credit quality of a security, leading to greater price volatility of the security. Funds investing in lower quality debt securities are more susceptible to these problems and their value may be more volatile. The mutual fund categories are determined by Davenport using a combination of Morningstar categories and a returns-based style analysis provided by Zephyr StyleADVISOR.

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