Highlands Wealth Advisors

Q3

Quarterly Market Review

Third Quarter 2012

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WEALTH ADVISORS

Market Summary

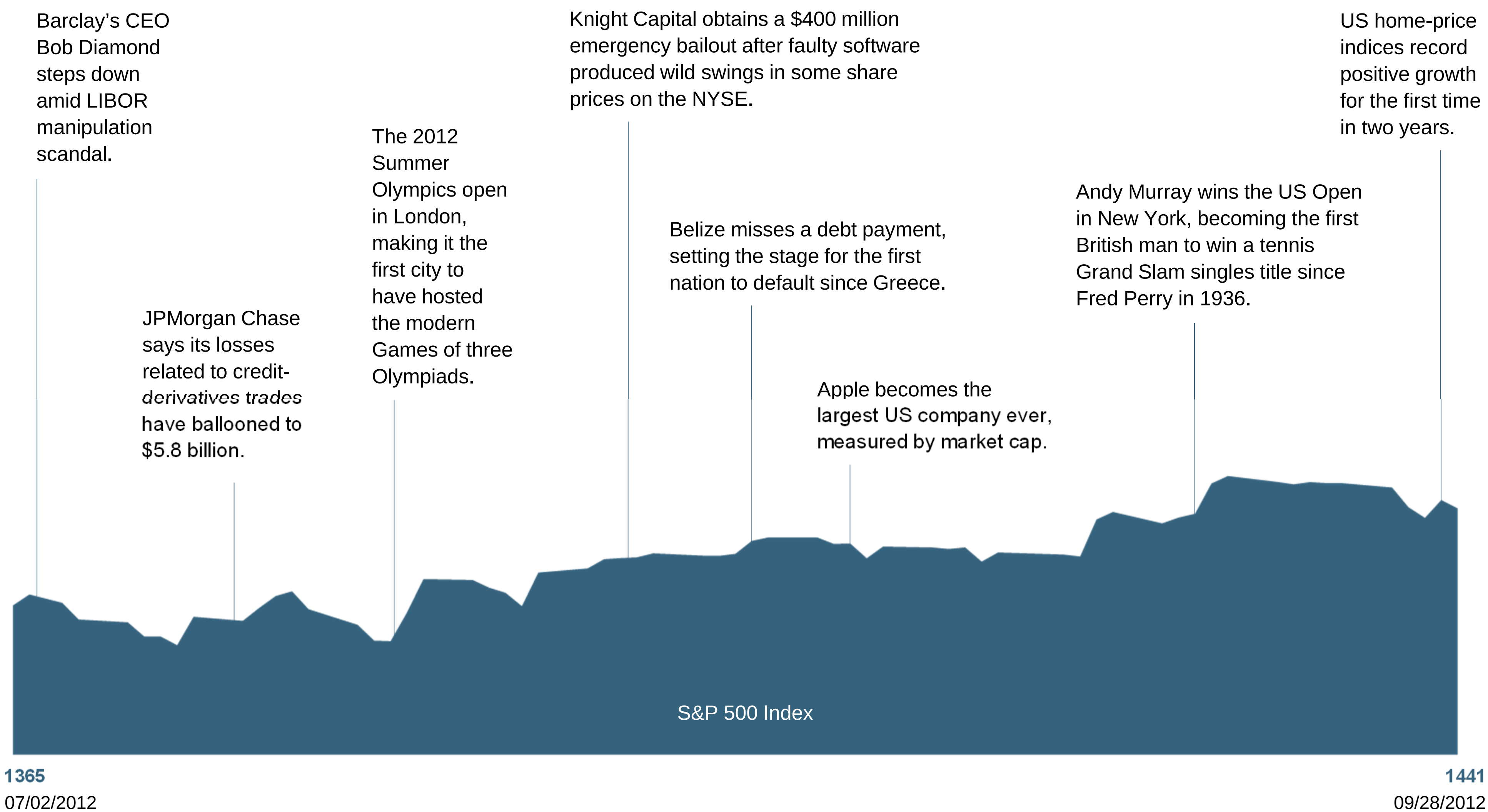
Third Quarter 2012 Index Returns

STOCKS				BONDS	
US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market
+6.23%	+7.30%	+7.74%	+3.31%	+1.58%	+2.00%

Market segment (index representation) as follows: US Stock Market (Russell 3000 Index); International Developed Stocks (MSCI World ex USA Index [net div.]), Emerging Markets (MSCI Emerging Markets Index [net div.]), Global Real Estate (S&P Global REIT Index), US Bond Market (Barclays Capital US Aggregate Bond Index), and Global Bond Market (Barclays Capital Global Aggregate Bond Index [Hedged to USD]). The S&P data are provided by Standard & Poor's Index Services Group. Russell data copyright © Russell Investment Group 1995–2012, all rights reserved. MSCI data copyright MSCI 2012, all rights reserved. Barclays Capital data provided by Barclays Bank PLC. US long-term bonds, bills, and inflation data © Stocks, Bonds, Bills, and Inflation Yearbook™, Ibbotson Associates, Chicago (annually updated work by Roger G. Ibbotson and Rex A. Sinquefield). Index performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results.

Timeline of Events: Quarter in Review

Third Quarter 2012



The graph illustrates the S&P 500 index price changes over the quarter. The return of the price-only index is generally lower than the total return of the index that also includes the dividend returns.
Source: The S&P data are provided by Standard & Poor's Index Services Group. The events highlighted are not intended to explain market movements.

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Knightmare on Wall Street

Third Quarter 2012

QUESTION:
Which of the following statements applies to this summer's stock market behavior?

A) Computer errors at a major trading firm generated millions of faulty trades, causing dramatic and puzzling price swings in dozens of stocks.

B) A *New York Times* columnist fumed that "Wall Street has created its own Frankenstein. The machines are now in charge."

C) The S&P 500 Index rose 13.51% for the year through the end of August.

ANSWER: All of the above.

The July 31 trading session was marked by unusual activity in 148 stocks listed on the New York Stock Exchange, many of which swung sharply in the first hour of trading due to an apparent error in a newly installed software program developed by seventeen-year-old Knight Capital Group Inc., one of the country's largest market-making and trading firms.

For some, the incident was an unwelcome reminder of the so-called "flash crash" on May 6, 2010, which saw the Dow Jones Industrial Average plunge over 700 points in fifteen minutes. *Wall Street Journal* columnist Jason Zweig sounded out a number of individual investors for their thoughts on the market gyrations and got an earful. A New York lawyer observed that the investors he talks to are convinced "the game is stacked against them" and that earning a pittance in safe fixed income investments was preferable to "losing it all on a roulette-wheel stock market."

Incidents such as the "flash crash" are often cited as a contributing factor to investor skepticism of equity investing. One can sympathize with investors who fear that the investment industry machinery somehow places them at a disadvantage, but we think such concerns should be placed in a proper context. We live in a complicated world, and it's unrealistic to expect power plants, airliners, or stock exchanges to work perfectly 100% of the time. The lights go out, flights are canceled on short notice, and computers freeze up just when we need to print that important document. These malfunctions serve to remind us that technology is a mixed blessing, but few of us would prefer a permanent return to the era of spinning wheels and candlelight.

Some of us are old enough to remember the commission schedule at NYSE-member firms in the days before negotiated commission rates and high-speed trading algorithms. A 100-share order of IBM or Procter & Gamble used to cost $80.73. These days, a customer with a meaningful checking account balance can execute one hundred trades a year for free. More traders and more trading paves the way to greater liquidity and lower transaction costs.

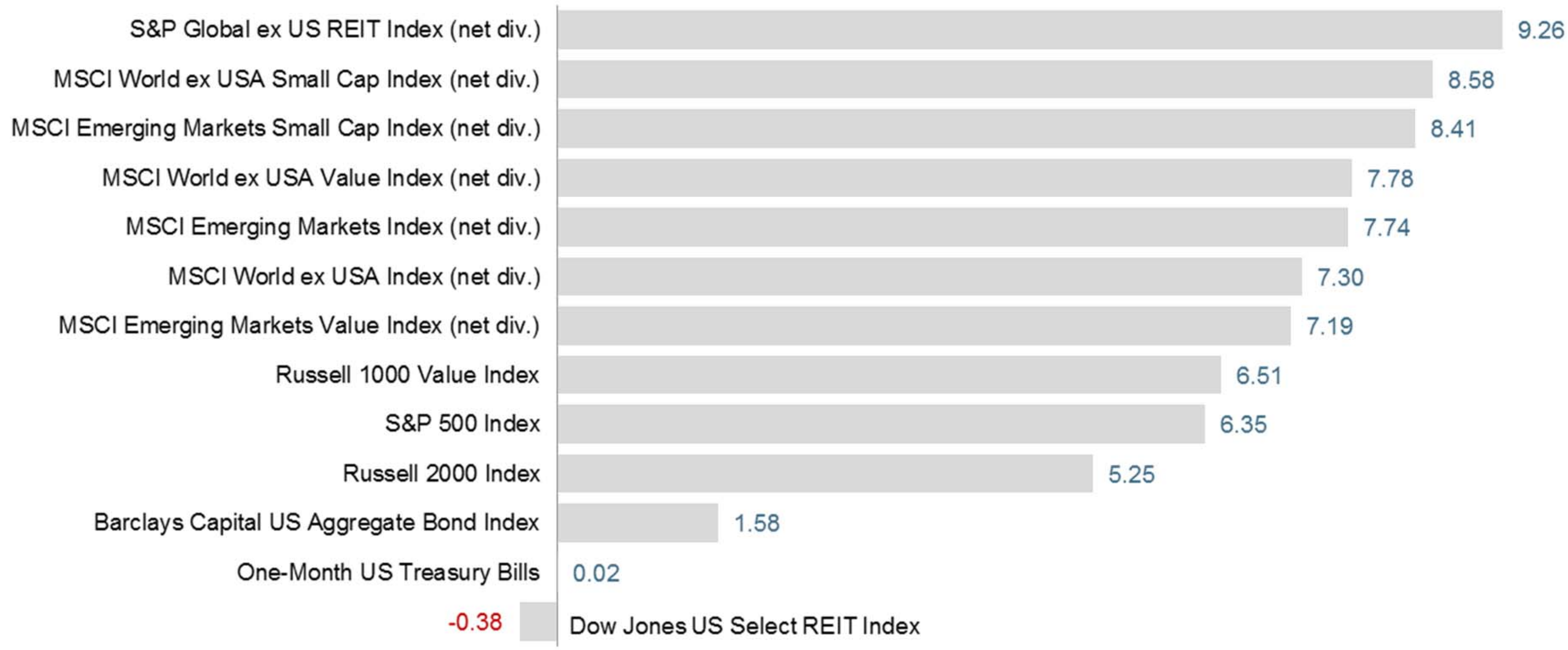
We do wonder how many investors were even aware of the trading gyrations as they were taking place. We suspect those expressing the greatest alarm were accustomed to watching market developments minute by minute.

In this regard, we cannot improve on Jason Zweig's observation, so we'll quote him directly: "It's harder than ever for long-term investors to ignore the trading madness of Mr. Market. But ignoring it remains the very essence of what it means to be an investor."

World Asset Classes

Third Quarter 2012 Index Returns

Global equity markets posted strong returns in the third quarter, turning the tide on the year-to-date figures and bringing them back firmly into the positive. Continued quantitative easing in the US, Japan, and EU seemed to improve overall investor sentiment toward equities while also keeping fixed income yields at historical lows.



Market segment (index representation) as follows: US Large Cap (S&P 500 Index), US Small Cap (Russell 2000 Index), US Value (Russell 1000 Value Index), US Real Estate (Dow Jones US Select REIT Index), Global Real Estate (S&P Global ex US REIT Index), International Developed Large, Small, and Value (MSCI World ex USA, ex USA Small, and ex USA Value Indexes [net div.]), Emerging Markets Large, Small, and Value (MSCI Emerging Markets, Emerging Markets Small, and Emerging Markets Value Indexes), US Bond Market (Barclays Capital US Aggregate Bond Index), and Treasury (One-Month US Treasury Bills). The S&P data are provided by Standard & Poor's Index Services Group. Dow Jones data (formerly Dow Jones Wilshire) provided by Dow Jones Indexes. Barclays Capital data provided by Barclays Bank PLC. US long-term bonds, bills, and inflation data © Stocks, Bonds, Bills, and Inflation Yearbook™, Ibbotson Associates, Chicago (annually updated work by Roger G. Ibbotson and Rex A. Sinquefield). Index performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results.

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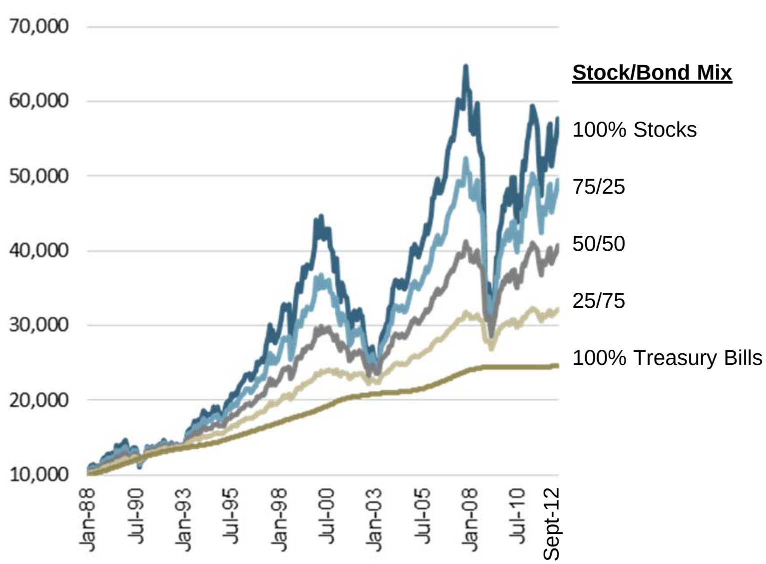
Global Diversification

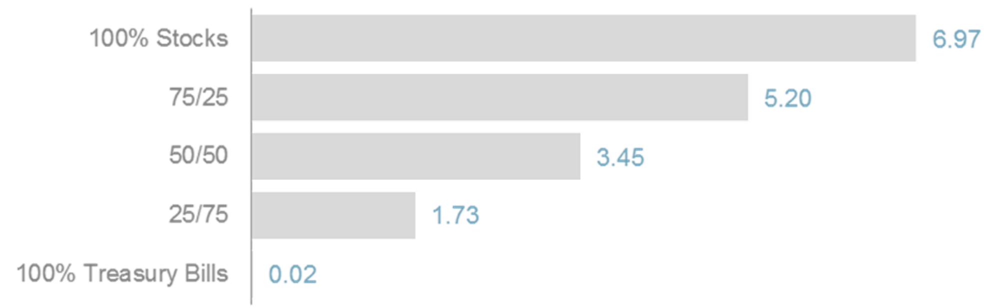
Third Quarter 2012 Index Returns

These portfolios illustrate the performance of different global stock/bond mixes and highlight the benefits of diversification. Mixes with larger allocations to stocks are considered riskier but also have higher expected returns over time.

Growth of Wealth:
The Relationship between Risk and Return



Ranked Returns for the Quarter (%)



Period Returns (%)

Asset Class	1 Year	3 Years*	5 Years*	10 Years*
100% Stocks	21.67	7.78	-1.54	9.16
75/25	16.18	6.10	-0.55	7.55
50/50	10.74	4.24	0.12	5.76
25/75	5.35	2.23	0.50	3.80
100% Treasury Bills	0.04	0.07	0.58	1.69

** Annualized*

Hypothetical allocations are for illustrative purposes only. Asset allocations and the hypothetical index portfolio returns are for illustrative purposes only and do not represent actual performance. Indices are not available for direct investment. Index performance does not reflect expenses associated with the management an actual portfolio.

Global Stocks represented by MSCI All Country World Index (gross div.) and Treasury Bills represented by US One-Month Treasury Bills. Globally diversified portfolios rebalanced monthly. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results.