TITLEIST

ASSET MANAGEMENT, LTD.

MEMBER FINRA-SIPC

2011

Third Quarter Report

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ESTABLISHED 2003

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The equity markets are coming off of the worst quarter since the height of the financial crisis in the fourth quarter of 2008 and the worst third quarter since 1928. The S&P 500 declined 14.33% in the third quarter and is down 10.04% in 2011. Cyclical sectors such as the financials, industrials, and materials were the biggest laggards while the more defensive sectors such as consumer staples, healthcare, and utilities were the strongest performers. Other key indices such as the Russell 2000 declined 22.15% in the third quarter and 17.80% for the year.

The Barclays Aggregate Bond Index appreciated 5.65% in the third quarter and is currently up 8.45% in 2011. High Yield and lower tier investment grade corporate bonds were the biggest laggards while treasuries, agencies, and municipals all posted the strongest returns. Fears of a double-dip recession, flight to safety due to the European debt crisis, and the Federal Reserve's latest initiative referred to as Operation Twist – whereby they sell shorter term treasuries and use the proceeds to purchase longer dated treasuries in hopes of bidding up prices and keeping yields down – were the biggest factors affecting the fixed income markets.

Our expectation for a continuance of the uneven recovery with low to moderate growth has been revised down over the next few quarters. While it is normal to see periodic slowdowns within recoveries the data has been very choppy over the past 3 months. The expectation is that economic growth will continue to deteriorate due to the crisis of confidence created by Washington battling over the debt ceiling, sovereign debt crisis within Europe, slowdown in China, and the impact severe stock market declines has on business and consumer confidence.

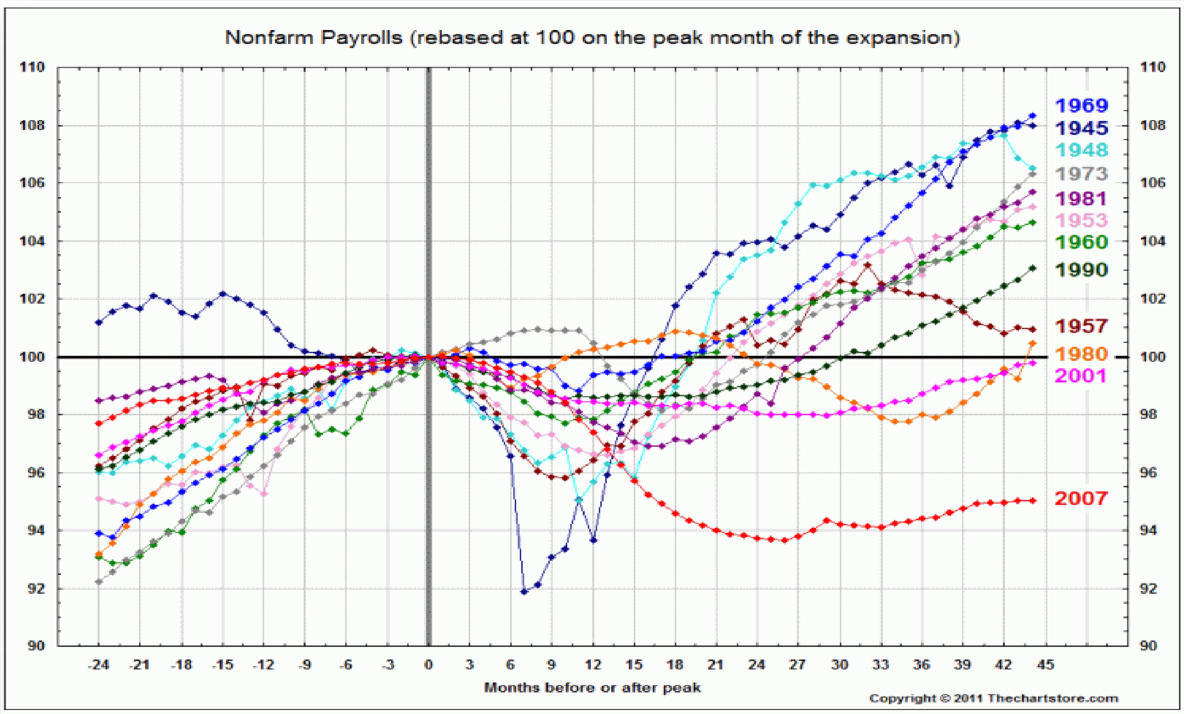
Even though the risks of another economic downturn have definitely increased over the past month, our accounts are still positioned in the more cyclical sectors, low to intermediate term investment grade bonds, and maintain moderate cash levels. Our equity holdings are largely the same companies that have allowed us to outperform the market by such a wide margin over the past 30 months.

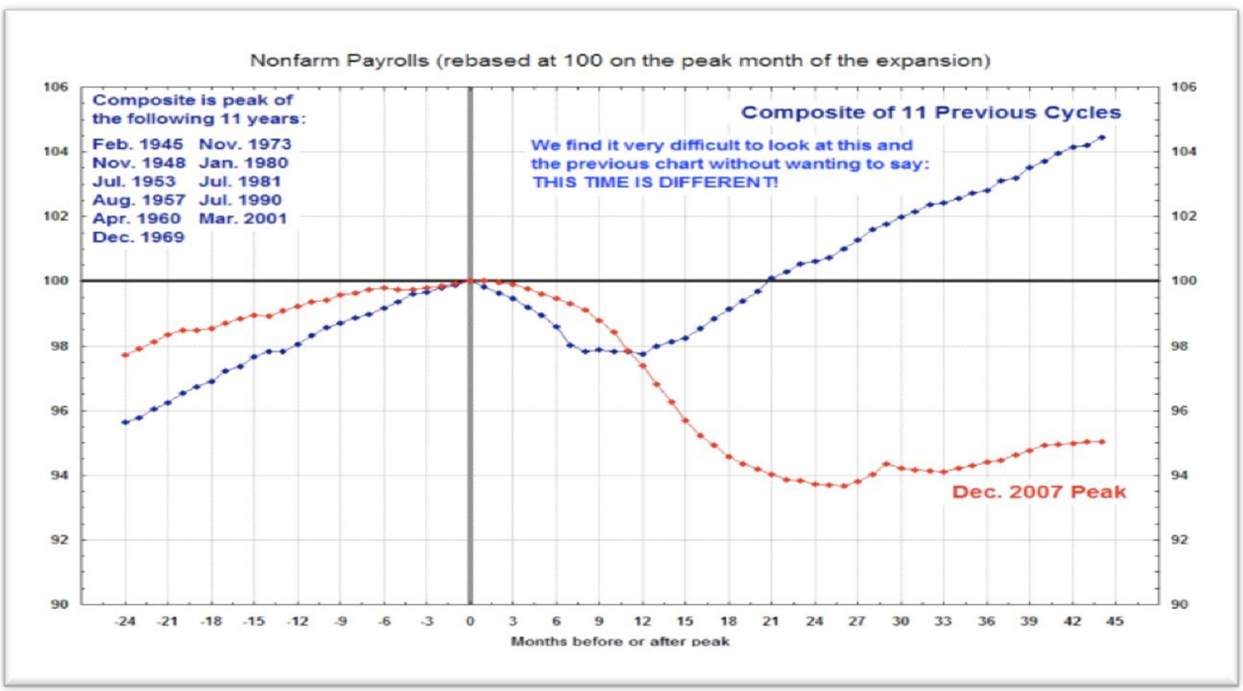
We remain underweight the healthcare sector and industrial conglomerates with large defense businesses due to their dependence on government spending and remain very optimistic about our positions in the energy, consumer discretionary, and technology sectors.

The United States is in a much different position than we were going into the financial crisis in 2008. Our banks were heavily levered as opposed to being heavily overcapitalized now. The housing bubble was just starting to burst and it would be unprecedented to see another steep decline after already falling 30%. So many of the biggest financial institutions - Bear Stearns, Lehman, Countrywide, Wachovia, AIG, Citi, Fannie Mae, Freddy Mac - have already declared bankruptcy, been quasi-nationalized, or had government assisted takeovers.

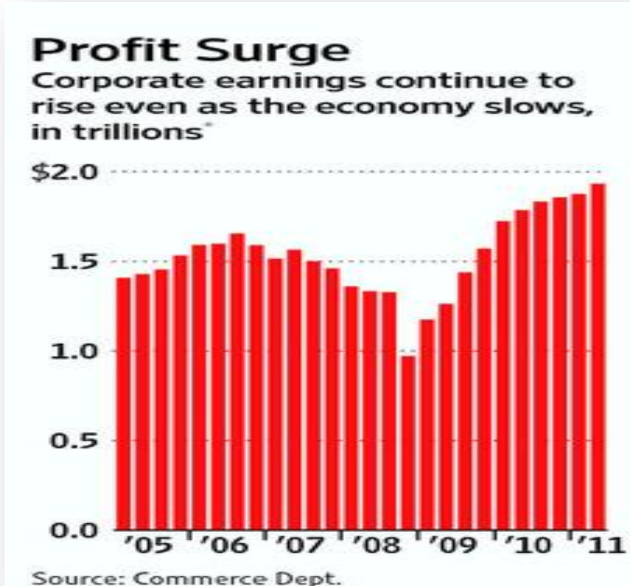
Hundreds of billions of dollars in bad loans have been written off the bank balance sheets and currently corporate balance sheets have never been healthier with record levels of cash. Households are much less indebted with a large portion of the mortgage and consumer debt being paid down or written off. Federal Reserve statistics show debt service burdens at the lowest levels since 1994. Corporate earnings have more than doubled where they finished in 2008 and are currently at all-time highs, a very impressive statistic in what can only be described as a very difficult economic period.

The two charts below illustrate how weak job growth has been during this recovery relative to other recoveries post WWII. The first chart shows each individual recession and recovery and the second takes the average of all prior recessions and recoveries and averages them out. Notice that prior to the current recovery the deeper the losses the stronger the gains.



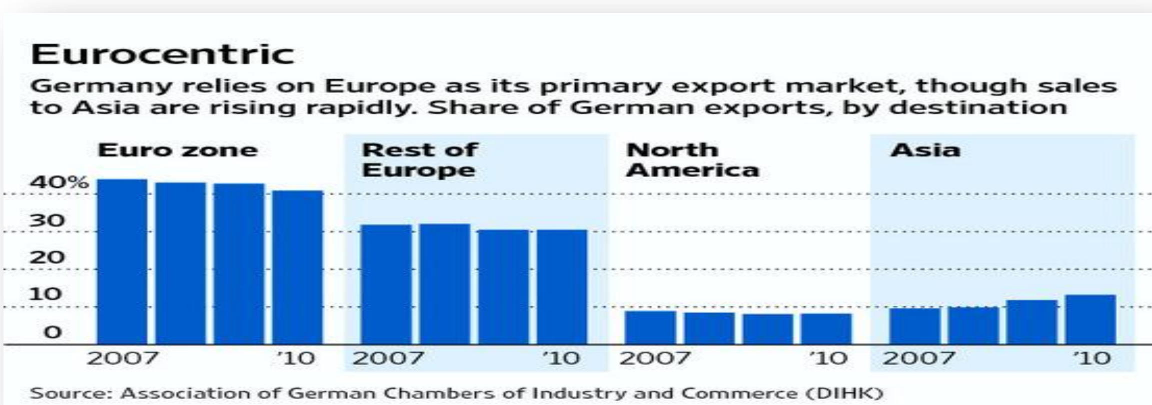


Even if you revise consensus estimates down 10-15% in 2012 the market is trading at very modest valuations relative to historical levels, especially considering where Treasuries are currently trading. The chart below illustrates how strong profits have been throughout the last cycle and are at all-time record highs as of this quarter.



Even though our banks are in much better shape than their European counterparts, we live in an interconnected world. In the event the European banking system starts to have systemic effects on the global financial system and our banks it is almost an absolute certainty that Washington will not have the political will to step in and do the right thing. Unlike non-financial companies, perception alone can turn a poor situation into a bankruptcy very quick when counterparties start fading away, people start pulling deposits, other firms back off of deals, and liquidity dries up. Perception can quickly become reality when it relates to financial companies, especially during a panic.

The French banking system is probably where you can draw the line on the EU debt crisis becoming systemic. The question now becomes whether or not the German politicians allow Germany to bear some of the burden to prevent sovereign defaults from bringing down the large European banks. Germany's economy has had over a 1 trillion dollar trade surplus with other Eurozone countries over the past 10 years and their economy has benefitted enormously from the creation of the Euro. Germany has a lot of incentive to keep stability in the EU. The chart below illustrates how much of Germany relies on other European Union members for exports.



According to the WSJ, France's three largest banks – BNP, Societe Generale, and Credit Agricole – together hold almost $57 billion in Greek sovereign and private debt versus $34 billion held by the largest German banks and $14 billion at the British banks. In addition, French banks hold over €140 billion in total Spanish debt and €400 billion in Italian debt as of the beginning of this year according to the Bank for International Settlements.

According to Nicolas Lecaussin, the director for development at France's Institute for Economic and Fiscal Research, the French banks were mostly owned by the French government in the late 1980's and were largely insolvent in the 1990's. He points out the French banking sector decreased by almost 50% during the decade, while those in other countries such as Britain and the U.S. grew by 39% and 50%, respectively.

There are rumors that the Chinese will step in with a commitment to purchase more European sovereign debt but nothing has been confirmed yet. Approximately 25% of China's reserves are in Euro denominated debt so there is definitely room for them to increase their position. The Chinese sell more goods and services to the Europeans than they do the U.S. so it is definitely in their best interest to ensure Europe's economy does not suffer a banking crisis and economic collapse.

The politics surrounding the EU are very complex and seem to be changing by the day. We expect the capital markets to remain volatile until the relevant parties - EU member country governments, ECB, IMF, and central banks around the world - come out with a coordinated resolution the market believes.

It is possible that the negative feedback loop associated with chaos in the capital markets becomes self-fulfilling. According to Capital Economics, every $100 loss a household has on investments translates into $3-$5 less each household is willing to spend. If that statistic is correct this equates to $140 billion less in spending based on the last two months of market declines. Personal spending increased 0.2% in August, however, the drop of 0.1% in personal income - the first decline in almost two years - raises doubts about the sustainability of future consumption.

One could very easily make the argument that the equity, fixed income, currency, and commodity markets have already discounted a mild recession. However, none of the major asset classes have priced in a major economic catastrophe such as the sovereign debt crisis leading to a collapse of the European Union or a major global recession.

Our view is the equity markets have all but priced in a garden variety economic slowdown and the fixed income markets a more severe recession. Companies in the benchmark gauge for American equities trade at 10.2 times 2012 forecast earnings, compared with the average in economic contractions since 1957 of 13.7, according to data compiled by Bloomberg.

We expect the markets to remain volatile heading into an election year. Unfortunately, the headlines in the Washington Post and Politico will probably have a bigger influence on the capital markets than the headlines in the Wall Street Journal or Bloomberg. The biggest risks are a further deterioration of the debt crisis in Europe, a severe slowdown in China, protectionist measures restricting global trade, and the lack of political will both here and abroad to address any shocks in the financial system from becoming systemic.

Looking ahead, we will continue to manage risk until we have more clarity on earnings and economic data. We expect earnings will be strong this quarter, however, it is almost a given that guidance will be tempered due to all the uncertainty around the globe. We have already made significant adjustments to our portfolios in August and do not anticipate making any more changes until we have a better understanding on how the European Union intends on resolving this crisis. Thank you for your continued confidence in our firm.