

Letter to Investors



ADVISORS CAPITAL
MANAGEMENT

Dr. Charles Lieberman, Chief Investment Officer

A quarterly report from Advisors Capital Management, LLC a registered investment advisory firm

Third Quarter 2011

ACM Quarterly Letter to Investors: November, 2011

Equity markets tumbled hard in the third quarter, as concern arose over the risk of default in Europe and the possibility of recession in the U.S. Europe moved painfully slowly to corral a possible default of Greece and to contain the risk of contagion to other sovereign borrowers and capital losses of the banks. While European leaders fiddled, markets eroded. This continued until the damage to European markets could no longer be ignored and policymakers were finally forced to address the issue. Fears of a recession in the U.S. seem to be overblown and contradicted by incoming data that points to ongoing slow growth.

Europe's financial troubles remain the primary concern for investors. In July, investors began to worry that the debt contagion could spread outside of Greece, first to Portugal and Ireland and then into Spain and Italy, which are much larger. Credit spreads widened substantially, which reflected these concerns, yet also worsened them. Nonetheless, policymakers were slow to respond to the situation and sent confusing messages to the market. Some alarmists went so far as to question whether the European Union could handle any crisis situation and should be dismantled. As markets oscillated in response to each media headline (rumor or fact) out of Europe, panic began to set in. Money market funds reduced holdings of EU bank debt, drying up liquidity for EU banks. This forced the major global central banks to provide a short-term funding facility to ensure liquidity for the banks.

Policymakers finally began to face up to Europe's credit market problems following the G-7 meeting. Since then, public statements by Merkel and Sarkozy indicate they are ready to provide strong support for sovereign borrowers and to recapitalize the banks following write downs of their bond holdings. They no longer talk half measures. Instead of a 20% haircut for Greek bonds, leaks suggest a 50% haircut, which will make Greece's debt far more manageable, for example. This also reduces the need for large spending cuts and tax hikes that hurt Greek growth prospects.

A write down of Greece's debt may significantly improve Greece's finances, but it implies sizable losses to the European banks that own the debt and must suffer capital losses that they are not currently prepared to absorb.

Very simply, these banks must raise capital to replace their Greek losses. The market has understood this for some time, so the share prices of European banks have been quite depressed, which discouraged these banks from issuing new shares to replenish their capital needs. This logjam worried investors, who feared a messy, unmanaged default by a large European bank as direct fallout from a Greek default. Investor's greatest fear was that a Greek default could spread to other sovereigns like Spain or Italy and would crush bank capital and cause widespread defaults in the banking sector. Leaks from policymakers suggest that the European banks will be given several months to raise capital from the public market and they will be forced to accept public investment if they do not raise enough themselves.

Even the timeline for these new developments is becoming clearer. Major pan-European meetings are scheduled over the next few weeks. Government leaders are suggesting they wish to have agreements or plans in place by early November.

Governments are approving the European Financial Stability Fund (EFSF) to provide a facility for lending to sovereign governments in need. At less than 500 billion in euros, it is too small to provide the capital pool that may be needed. So, it will most likely be used as an insurance facility instead of a lending facility, thereby increasing its firepower by four or five times. New stress tests are being implemented to determine how much capital each bank may need as a result of the large write down of Greek debt. Governments will provide capital, similar to the U.S. TARP program, if the banks are unable to raise this capital directly in the market. These actions should restore confidence to the market that a messy default will not occur.

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First Quarter 2011

Domestically, the quarter began with a most distressful display of politics, as the White House, Democrats and Republicans wrangled over the US debt ceiling to press their political agendas. The debt ceiling was eventually passed with last minute drama, but the collateral damage was done. S&P soon downgraded US credit rating, blaming it on a dysfunctional political system unable to address budgets, which sent markets into a frenzy and devastated consumer confidence. Some analysts suggested this turmoil would inevitably lead to a US double-dip recession.

Nonetheless, macroeconomic data showed ongoing slow growth, with minimal signs of recession. More recent data for October contradicts recession forecasts with some economic reports actually suggesting a pickup in growth. As disappointingly as the debt ceiling imbroglio was handled, it lasted only a few weeks and conditions reverted to normal. Lower unemployment claims filings,

rebounding car sales, stronger retail sales, and other measures are suggesting improvement. While talk of recession was rampant as recently as September, only perma-bears suggest that recession risks remain high by mid-October. Other analysts have also backed away from forecasts of weakness. It is therefore not surprising that the healthier outlook and progress in Europe have enabled our equity market to rally in the first two weeks of October.

The third quarter has been a period of exceptional volatility. Following its sharp sell-off in August, the equity market has been in a trading range, but the high level of volatility had it bouncing off the highs and lows of its trading range within rather short periods of time. At the time of the writing of this letter, we are again back to the highs of this range. We see the market primed for a dramatic rebound if the Europeans are able to get their financial house in order and the U.S. expansion simply remains on its current sluggish growth track.

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Advisors Capital Management is expanding its wealth management services. We are seeking independent investment advisors, Certified Financial Planners, registered representatives and financial professionals looking for combined broker dealer and investment advisory services that can benefit from our unique investment management services, experience and diverse broker dealer relationships. Contact Kevin Kern for more information at 201-426-0081 or email at Kevink@advisorscenter.com

Q3 2011 Composite performance reports and ACM's Form ADV Part 2a are available upon request.

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