

# GATEWAY INDEX/RA CALMS A TURBULENT EQUITY MARKET IN THE SECOND QUARTER OF 2011

## MARKETS REVIEW

The S&P 500 Index followed a strong April performance with a nearly 7% slide through June 15, 2011, before a late-month rally in June rescued the quarterly performance. When the second quarter ended, the Index was virtually even, earning a return of 0.10%. Global market risk centered around the ongoing drama over the Greek debt, its impact on a number of major European financial institutions and the potential negative consequences for the European Union. The late June rally, which restored quarterly performance to positive territory, was built around the expectation of a favorable outcome for the Greek credit crisis. On the domestic side, stubborn unemployment above 9%, a weak housing sector and the end of the Federal Reserve Open Market Committee's massive liquidity program, QE2, also weighed on investors' minds. With gross domestic product growth hovering in the 2% range, equity markets decided to retrench.

The final tally left the S&P 500 Index ahead a healthy 6.03% for the first six months of 2011, although down from the 9.05% performance for the first four months of the year. While negative news dominated the landscape, corporate earnings increases and gains in the manufacturing sector raised hopes for continuing a slow yet steady recovery in the United States, with concomitant opportunities being created in developing economies.

Equity market implied volatility, as measured by the Chicago Board Options Exchange Volatility Index, the ("VIX"), dropped from 17.74 to 16.52 during the second quarter, although it ranged from 14.62 on April 28 to 22.73 on June 16. Despite the overall downtrend, the choppy VIX path nevertheless provided ample opportunity for sellers of index call options to earn option premium. This pattern, which has dominated 2011, is reflective of muted overall volatility based on excessive liquidity and a general positive trend in the market. The frequent spikes in volatility, coupled with high levels of skew and forward pricing, suggest a market still concerned with "tail-risk." Tail-risk is the market's reaction, often in extremes, to events which are typically shrouded in uncertainty as to cause and potential impact. Not only is the potential negative impact of these events a concern, but a rise in cross correlations among asset classes and markets in diverse geographic areas have added difficulty in adequately diversifying global portfolios against this type of risk.

Bond markets benefited during the second quarter due to a flight to quality caused by the equity market sell-off and concern with Eurozone debt. The Barclays Capital U. S. Aggregate Bond Index earned 2.29% for the quarter, although it lost 0.29% in June as fears eased regarding the European credit crisis. The second quarter performance, primarily earned in April, May and the first half of

June, accounted for most of the Index's performance of 2.72% for the first six months of 2011. Default risk dominated the mindset of bond investors, although inflationary concerns and the projected shift of the Federal Open Market Committee to a less accommodative monetary policy raised the specter of other fixed income market risks. Modest yields provide little offset to the negative price impact of rising rates, so that returns for investors in the bond markets remain at knife's edge.

## GATEWAY INDEX/RA PERFORMANCE

The second quarter provided an excellent case study for the value of a low volatility equity product. The Gateway Index/RA composite earned 0.16%, net of fees, for the second quarter, slightly higher than the return for the S&P 500 Index. In a similar fashion, the trailing ten-year performance comparison shows the total return for the Gateway strategy at 39.51%, net of fees, while the S&P 500 Index earned 30.74% for the same ten-year period with the Gateway Index/RA composite having significantly less volatility and downside exposure.

Premiums from the sale of index call options, which had provided a solid return in the first quarter of 2011, provided an effective offset to the subsequent market decline, particularly in the month of May and the first half of June. Gateway's management continued a steady approach of riding through the market turbulence and allowing the option positions to have a smoothing effect. The volatility spikes which occurred during the period provided opportunity for further premium to earn, while the overall lower level of volatility, as measured by the VIX, permitted the Gateway strategy to maintain a reasonably priced position in index put options equal to the entire notional value of the portfolio. Index put options offer the potential to offset more extreme market risk events such as had been threatened in connection with, for example, the Japanese tsunami/nuclear crisis or an escalation of the Eurozone debt crisis.

## MARKET PERSPECTIVES

Much discussion has arisen regarding the concept of tail-risk in the marketplace. Particularly since 2008, major developed markets have been exposed to extreme leverage which has considerably magnified the potential impact of, and reaction to, market events. As developed nations attempt to unwind that leverage, their economies simultaneously remain vulnerable to political shocks, natural disasters and economic crises.

Equity investing has been based on the long-term upward trend in markets, which allows for the recovery of value lost during

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# GATEWAY INDEX/RA CALMS A TURBULENT EQUITY MARKET IN THE SECOND QUARTER OF 2011 (CONTINUED)

downturns. On the other hand, equity market volatility creates issues for investors, both emotional and economic, as those investors who draw current income from their portfolios or have shorter investment horizons may not be able to recover lost value. Tail-risk adds another complicating component — in that severe market losses exacerbate those issues, especially at a time when markets are already vulnerable.

With bond yields at low levels, and credit risk becoming problematic for fixed-income investors, the search for a viable alternative to traditional stock and bond investing becomes crucial. As depicted in the quarterly and trailing ten-year performance above, a lower volatility equity investment, such as Gateway, offers that attractive alternative.

Gateway Investment Advisers, LLC (“Gateway”) is an independent registered investment adviser and a successor in interest to Gateway Investment Advisers, L.P. as of February 15, 2008. Gateway Index/RA performance in this document is an asset-weighted composite of discretionary accounts under Gateway’s management which share the same investment objectives and hedging strategies.

The composite was created in January 1993. Prior to January 1, 1993, not all fully discretionary portfolios were represented in composites. Results shown for 1988 through 1992 are those of one representative account.

Gateway Index/RA performance results reflect the deduction of investment advisory fees and the reinvestment of dividends and other earnings. Past performance is no guarantee of future results. A more detailed description of Gateway’s fees is included in Form ADV, Part 2.

The Annual Disclosure Presentation for Gateway Index/RA is available on the “Literature” page of this website or by calling 513.719.1100 extension 443.

AVERAGE ANNUAL TOTAL RETURNS AS OF JUNE 30, 2011			
	GATEWAY INDEX/RA (NET OF FEES)	Barclays Capital U. S. Aggregate Bond Index	S&P 500 Index
One Year	12.10%	3.90%	30.70%
Three Years	0.39	6.46	3.34
Five Years	2.53	6.52	2.94
Ten Years	3.39	5.74	2.72
Since 1/1/88	7.83	7.31	9.84

The S&P 500 Index is a widely recognized measure of performance for the U. S. stock market. The S&P 500 Index figures represent the prices of a capitalization-weighted index of 500 common stocks and assume reinvestment of all dividends paid on the stocks in the index.

The Barclays Capital U. S. Aggregate Bond Index is an index comprised of approximately 6,000 publicly traded bonds including U. S. government, mortgage-backed, corporate and Yankee bonds with an average maturity of approximately 10 years. The index is weighted by the market value of its bonds and represents asset types that are subject to risk, including loss of principal.

Data Source: Gateway Investment Advisers, LLC and Thomson Reuters