

# GATEWAY INDEX/RA MEETING THE CHALLENGES OF A VOLATILE MARKET IN THE FOURTH QUARTER

## EQUITY MARKETS

The final quarter of 2011 saw U. S. equity markets rebound from a third quarter slump. Coupled with recovering corporate loan demand, improving economic indicators provided support for the S&P 500 Index as it posted a strong fourth quarter return of 11.81%. However, for the year 2011, only its dividend yield allowed the S&P 500 Index to remain positive at 2.12%, as its price level was virtually unchanged from 2010. Fear surrounding the European debt crisis and domestic political gridlock, which had weighed heavily on the market in the third quarter, seemed less problematic in the fourth quarter given improved employment and manufacturing data and continued positive (even if declining) year-over-year gross domestic product growth. Against the backdrop of nearly flat annual performance and continued lighter-than-normal trading volume, investors could well question whether the fourth quarter rally was a recovery from an oversold market or a springboard for further advance.

Equity market volatility, as measured by the Chicago Board Options Exchange Volatility Index (the “VIX”), declined from 42.96 on September 30, 2011 to 23.40 on December 30, 2011. While the fourth quarter rally restored the price level of the S&P 500 Index to where it began the year, the VIX remained in a range well above the below-average levels sustained for much of the year’s first half. From the beginning of the year until July 31, 2011, the VIX averaged 18.21. From August 1 through December 30, 2011, it averaged 32.33. During the fourth quarter, the elevated VIX levels continued to benefit strategies which rely on generating cash flow from the sale of index call options, such as the Gateway strategy.

## FIXED INCOME MARKETS

Fixed income markets received two elements of support during the fourth quarter. First, the yield curve compressed, especially on the long end, potentially due to the effects of the Federal Open Market Committee’s program designed to lower long-term yields. Secondly, the credit sector of the bond market benefited from the equity market rally. The fourth quarter return for the Barclays Capital U. S. Aggregate Bond Index was 1.12%, capping a 2011 return of 7.84%. In earlier quarters, a “flight to quality” supported the bond market and provided a solid base for the fourth quarter performance. Overall, inflation seemed contained as earlier spikes in food and energy prices abated by year-end. However, potential debt defaults in Europe and rising interest rates in Asia, together with the looming federal deficit in the United States, would seem to suggest caution with regard to fixed income markets.

## GATEWAY INDEX/RA PERFORMANCE

The elevated volatility level translated into a strong fourth quarter return of 5.53% for Gateway Index/RA, net of fees. For the year, Gateway Index/RA earned 3.16%, net of fees — 104 basis points more than the S&P 500 Index at 2.12%, owing to the benefits of a hedging strategy. Furthermore, the incremental annual return was achieved with a significantly lower level of volatility (standard deviation for 2011 was 5.43% for Gateway Index/RA, net of fees, versus 15.94% for the S&P 500 Index). No doubt the risk-adjusted performance of the Gateway strategy was comforting to investors during an extremely turbulent year in both domestic and especially international markets.

As often occurs with sideways markets, portfolio management made only modest option position changes during the fourth quarter, ending the quarter slightly in-the-money due to the S&P 500 Index finishing the last two weeks of the year nearly as strongly as it began the final quarter. Management remained disciplined as market volatility unfolded.

During the first half of 2011, Gateway’s management team focused on being opportunistic in accruing call premium and maintaining reasonably priced put protection in the face of a “skew” in equity index-option pricing which drove up hedging costs. During the first six months of 2011, Gateway Index/RA earned 2.66%, net of fees, versus 6.03% for the S&P 500 Index, not an atypical relative outcome despite the challenging environment. Skew, which is a measure of disproportional implied volatility between at-the-money and out-of-the money contracts, receded in the second half of the year. During the last six months of 2011, call premiums benefited from the elevated level of volatility and, as skew decreased, index put options became a more effective hedging tool. While the S&P 500 Index declined 3.68% in the second half of the year, Gateway Index/RA earned a positive 0.49%, net of fees.

## MARKET PERSPECTIVES

The prevailing 2011 theme in the capital markets was “tail risk,” particularly in the first half of the year. Events with difficult-to-predict impacts, such as the debt crisis in the Eurozone, a tsunami and nuclear crisis in Japan and U. S. debt downgrades, created uncertainty and volatility in worldwide markets and across the spectrum of asset classes. Compounding these economic events were widespread geopolitical uncertainties. As equity markets reacted to countervailing forces, the persistent lower levels of volume, particularly during rallies, indicated a lack of conviction by investors,

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# GATEWAY INDEX/RA MEETING THE CHALLENGES OF A VOLATILE MARKET IN THE FOURTH QUARTER (CONTINUED)

## MARKET PERSPECTIVES (CONTINUED)

but no shortage of concern for the potential downside. Hence, “tail risk” is a term that has become more integrated into investment thinking.

Reinforcing the lack of equity market certainty is the continuing depression of the yield curve in fixed income markets. With the traditional safe haven becoming overcrowded, prospects have potentially diminished for a continuation of the performance achieved over the last 30 years by high-quality fixed income investments.

Despite the problematic performance of traditional asset classes, they continue to dominate the investment landscape. Therefore,

the challenge for non-traditional investment strategies is to demonstrate proven ability to assume a role in a larger portion of client portfolios. This is the challenge Gateway has successfully met throughout its long-established history. Recognizing the need for investors to gain equity exposure while being able to mitigate downside risk, Gateway has steadfastly focused on hedging using index options for a steadily growing asset base. The 2011 performance for Gateway Index/RA illustrates its ability to potentially serve as a core asset for investors who demand stability, yet growth, in volatile and problematic markets.

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.

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

|              | AVERAGE ANNUAL TOTAL RETURNS<br>AS OF DECEMBER 31, 2011 |   |                  |
|--------------|---|---|------------------|
|              | GATEWAY<br>INDEX/RA<br>(NET OF FEES)                    | Barclays Capital<br>U. S. Aggregate<br>Bond Index | S&P 500<br>Index |
| One Year     | 3.16%   | 7.84%   | 2.12%            |
| Three Years  | 4.98  | 6.77  | 14.11            |
| Five Years   | 1.46  | 6.50  | -0.25            |
| Ten Years    | 3.64  | 5.78  | 2.92             |
| Since 1/1/88 | 7.68  | 7.37  | 9.45             |