

2011: The Year Ahead

MV Capital Management Annual Market Outlook, January 2011

Navigating the New Reality

*If a quantum calculation predicts that a particle might be here, or it might be there, then in one universe it **is** here, and in another it **is** there.*

-Astrophysicist Brian Greene, "The Hidden Reality"

"Reality" is a relative term. Things that appear solid and permanent – all the material objects in the world around us – are mostly empty spaces when viewed at sub-atomic levels. If an atom – consisting of a nucleus of protons and neutrons at its core and electrons orbiting in space around the nucleus – were the size of a football stadium then the nucleus itself (containing over 99% of the atom's mass) would be the size of a grain of rice. Our very ability to perceive the world around us is determined by the specific way the human visual cortex processes images of reflected light, and thus our "reality" looks vastly different from that of a frog, a dolphin or a fruit fly. And we won't even begin to get into how weird reality becomes when we contemplate the quantum world, or how quantum mechanics supplies evidence for possibilities like the existence of multiple universes. Things that were once the province of fanciful science fiction are turning out to be entirely plausible theories of "reality" in complete accordance with the laws of physics. Brian Greene's is one of the latest books to come out over the last couple years addressing these various theories (Steven Hawking, among others, is a recent contributor to the literature). These are as fascinating as they are unsettling (and well worth a read).

This brief *tour d'horizon* of recent scientific theories may seem far removed from the world of investment markets, but we think the metaphysical question "what is reality?" is actually a fairly good segue into the strange landscape of markets and assets at the dawn of 2011. We operate on a daily basis by calling up our memories, which are repositories of ideas and associations accumulated from empirical evidence gained over time. "Stocks always go up in the long term." "US government bonds are the ultimate risk-free investment." "Perfectly rational behavior is the best assumption for models that make valuation calculations for investments".

These images and associations help us establish a framework by which we can explain the world and our place in it. When confronted with new evidence that conflicts with these stored perceptions our natural instinct is to resist it. It can take a long time for old perceptions to catch up with new realities. For creatures that exist in a world of constant change, who in fact ourselves have successfully evolved over millions of years by constantly adapting to change – for all that, we humans are not particularly fond of change.

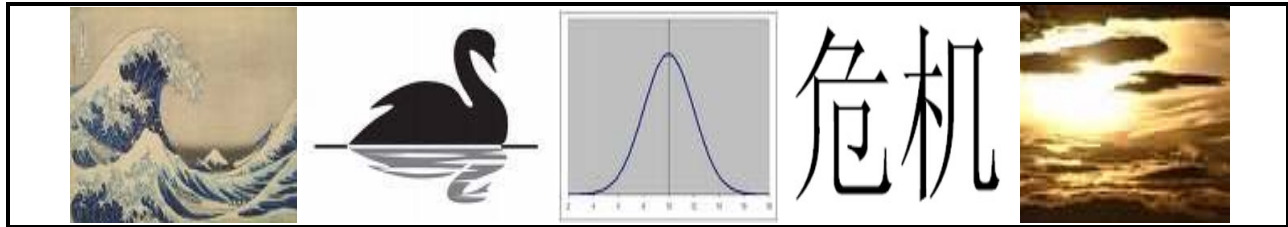
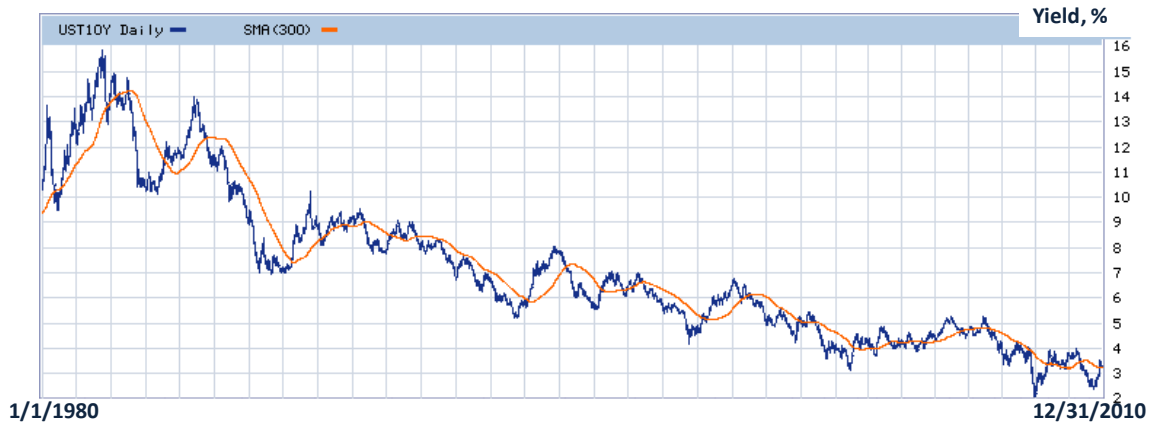


Table 1
Yield on the 10-year US Treasury Note, 1980 – 2010



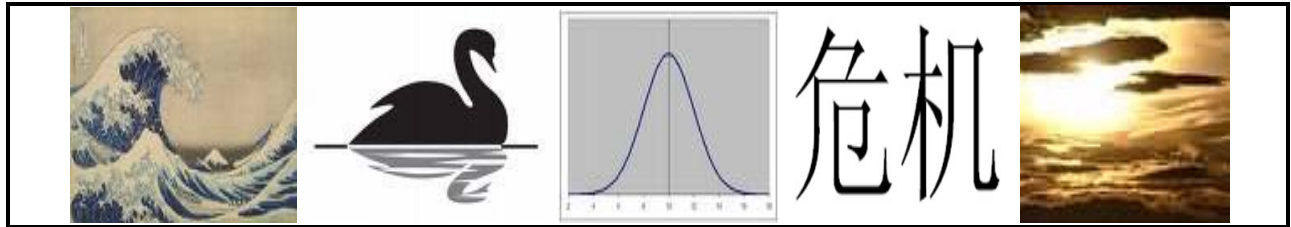
Source: Wall Street Journal Online

Yield on the 10-year US Treasury Note, 1980 - 2010

Blue line represents the 10-year Treasury Note
 Orange line represents the 300 day moving average

Which brings us to the weird reality of capital markets at the beginning of 2011. If there is one image that perhaps more than any other expresses the reality to which we have grown accustomed in the market over the last thirty years it is that of declining interest rates. This long-term decline, as illustrated by the US 10-year Treasury note in the chart above, is arguably the most important context in which all other investment trends over this period have played out. Not only has it been a good thirty years to be a bond investor, but an environment of declining interest rates helps other asset classes as well. They stimulate the creation of credit, which results in capital investment by businesses and more purchasing power for consumers. Think of how much easier it became over this period to obtain financing to buy a house, a car or a major home appliance. Think of how many more businesses, even those without sterling credit ratings, could obtain debt financing by tapping the high yield bond market. Credit creation stimulates economic activity, which in turn improves the prospects for businesses and thus makes investing in their common stock desirable – hence the longest bull market in history from 1982-2000.

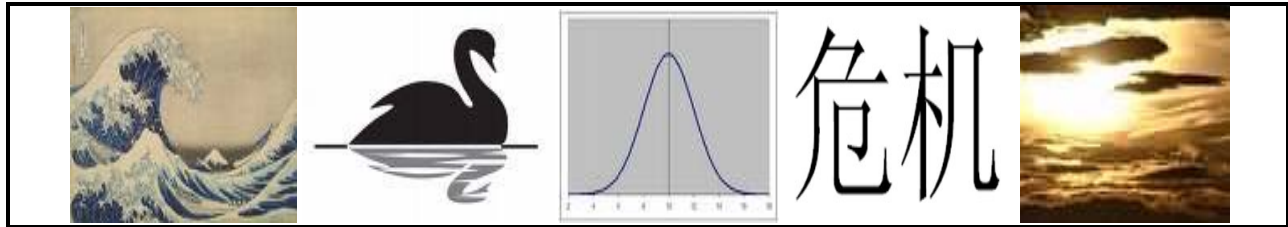
This observed reality of structurally low interest rates is really the touchstone of this report – because we believe that this period is coming to an end, probably sooner rather than later and for a variety of sometimes unrelated reasons. When we speak of a “new reality” we mean that we expect credit markets over the coming years to look quite a bit different from what we are used to. That may at times be good news for other assets, and at times it may be challenging. As we will discuss in a later section of this report, we think that the particularly strong performance of the bond market over the last decade relative to stocks and other risk assets is likely to reverse in the coming year and perhaps farther ahead.



But there are inherent risks as well. Periods when interest rates rise over a multi-year period are typically not good for investment markets in general – witness the stagnant environment of the 1970s.

We cannot predict how the credit markets of the new reality are going to look. Are we going to see a steady rise in interest rates over a multi-year period even as long as ten or more years? What are the implications for the broader market of further declines in the credit quality of leading developed sovereign nations, including the US but almost certainly the Eurozone and Japan? With structural weakness in both the dollar and the euro, and trillions of dollars of stimulus money flowing through the credit markets, is runaway inflation a major near-term threat? What is to become of the Eurozone and the US municipal markets? The answers to these questions will likely have a major impact on markets over the coming years. All we can do now is be mindful of their potential influence and diligent in our analysis of what threats and opportunities are manifesting at any given time.

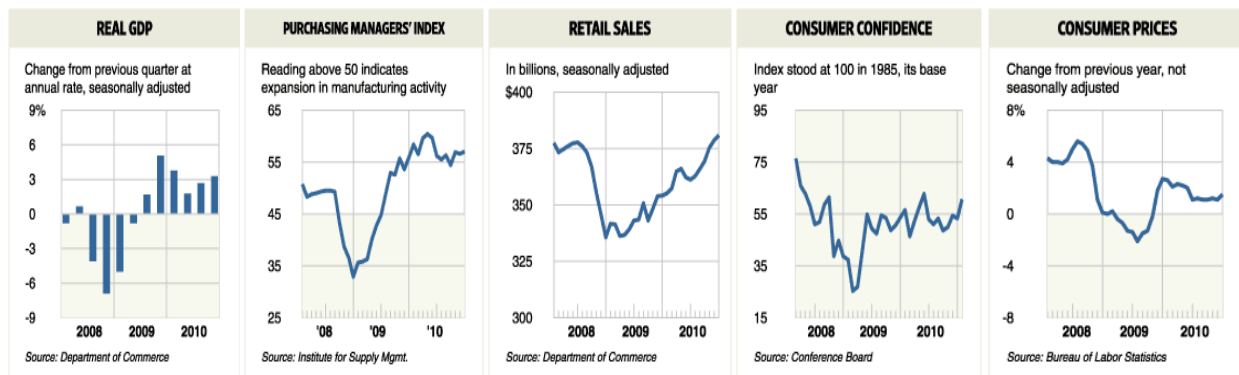
Things may be here, they may be there, and they may confound the limits of human abilities to reason and make logical, fact-based decisions. The wheels are already in motion for this new reality. There are tremendous opportunities, we believe, but at the same time no shortage of potential risks to be encountered in navigating the new terrain. Welcome to 2011.



Investment Thesis

Good Outlook for Risk Assets, but Expect Higher than Average Volatility

Table 2
Selected US Economic Indicators



Source: Wall Street Journal Online

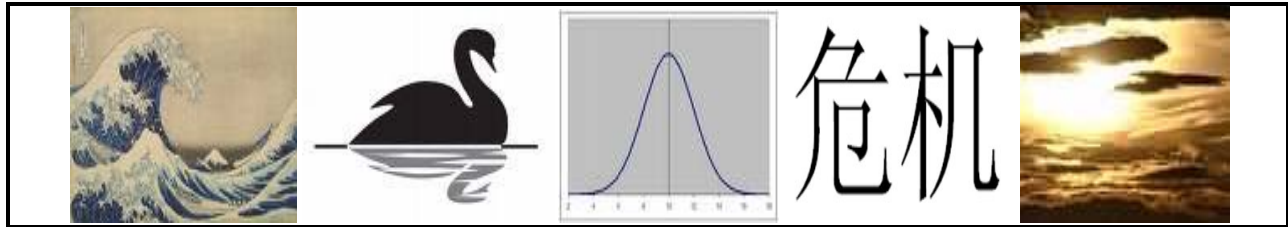
Stronger economic foundation in US; continued growth in Asia and Latin America

Our outlook for 2011 reflects a generally more positive assessment of economic and market trends than has been the case for the past three years. Last year our theme was “fits and starts”, with the economy moving gingerly out of the darkness but encountering some major potholes along the way. This year the tone is considerably firmer. Four solid quarters of economic growth have been helped along by healthy levels of retail sales, a very strong performance in the manufacturing sector, measured improvement in consumer sentiment and a generally stable price environment.

Global growth prospects continue to appear strong in the dynamic markets of Asia and Latin America, while in the US a consensus view towards higher than expected GDP growth is emerging as well – perhaps as high as 3-4% for 2011. *Our recent allocation decisions reflect that more optimistic tenor – increased weightings among risk asset classes including equities, commodities and real estate, relative to fixed income classes. We see higher than average risks in fixed income and seek to complement exposure among fixed income asset classes with lower-volatility alternative strategies.*

Volatility likely to be a major issue this year

That positive economic and market assessment is somewhat tempered by a prevalently high level of volatility that we are already seeing as the year begins to unfold. Here is an example: in the first week of 2011 the MSCI Spain stock market index fell by 6%, but by market close on January 14th it was up 6% for the very brief year to date, and surged another 5% the week after. There was a time when multi-



percentage point gyrations like that would have been jaw-dropping. Now they are just a regular part of the new reality.

The case of the Spanish stock market is a good illustration of a distinct valuation challenge we have today. In this case there is a school of thought out there that sees Spain on the brink of a massive sovereign default, which would be potentially catastrophic for the Eurozone. Another school of thought says, no, this will not happen because the European Union policymakers have already committed massive funds to avert just such an outcome, in which case equities valuations in Spain should look very attractive now. And so here we are with a crisply defined set of two eigenvalues: *either* Spain is an imminent basket case *or* it is a screaming buy opportunity.

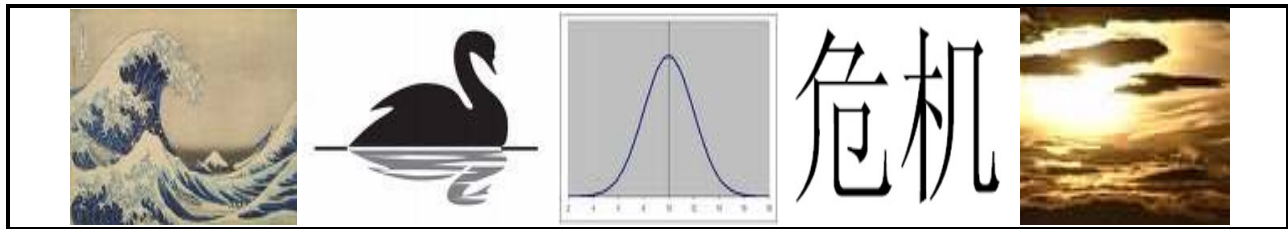
Why is this a valuation challenge? Well, which of these vastly different, but also very immediate, scenarios do you believe? If the EU manages to smoothly guide all its member states through the crisis so that nobody defaults and bondholders get their 100 cents on the dollar, then Spanish stocks really are a screaming buy. And if the country goes into default on its debt, then share prices will most likely fall considerably from their present levels. There is a high probability we will know the answer to this before the end of 2011, so depending on what view you take, the consequences will be very near-term. Here we can't just split the difference the way we do sometimes. "Scenario A has XYZ Company's earnings growing at 5%, Scenario B says 7%, so let's split the difference at 6% and feed that into the model."

In more "normal" times we have a greater preponderance of valuation decisions like that second example. That is not to say that there are not always significant risks lurking behind the valuation models – there are. But in the new reality of today's environment those risks have higher potential for actualizing in the near term. And we cannot properly address them simply by splitting the difference and going with the resulting Net Present Value. That is a key reason why we see so much volatility today.

Fixed income markets: potential trouble ahead

While equities and other risk assets face the prospect of higher than average volatility this year, deeper concerns lie in the fixed income markets. This is the traditional safe haven preserve of portfolios, where you put money not because you expect turbo-charged returns, but because you want a peaceful sleep at night. The last decade, though, was a go-go period for the usually staid bond market. Bonds not only were **far less volatile** than stocks, they were **far more profitable** investments in and of themselves. From the beginning of 2000 to December 31, 2010, the Barclays US Aggregate Bond index returned 6.4% on an average annual basis as compared to 0.41% for the S&P 500 (on a total return basis, including dividends). At the same time the average annual standard deviation, a common measure of investment risk, was only 3.8% for the bond index versus 16.4% for stocks. Put another way, over the course of the 00s investors took on **more than four times as much risk** going into equities as they did for bonds, and still came out losers in the end. That's the investment equivalent of a free lunch, and the history of free lunches is that they don't last forever (read more about this in our "Selected Thematics" section below).

There are two components to the fixed income troubles we see on the road ahead. One has to do with interest rates, the other with credit quality. As for interest rates, they have nowhere to go but up. The result of three years of crisis-fighting action by the Fed is that short-term rates remain effectively at

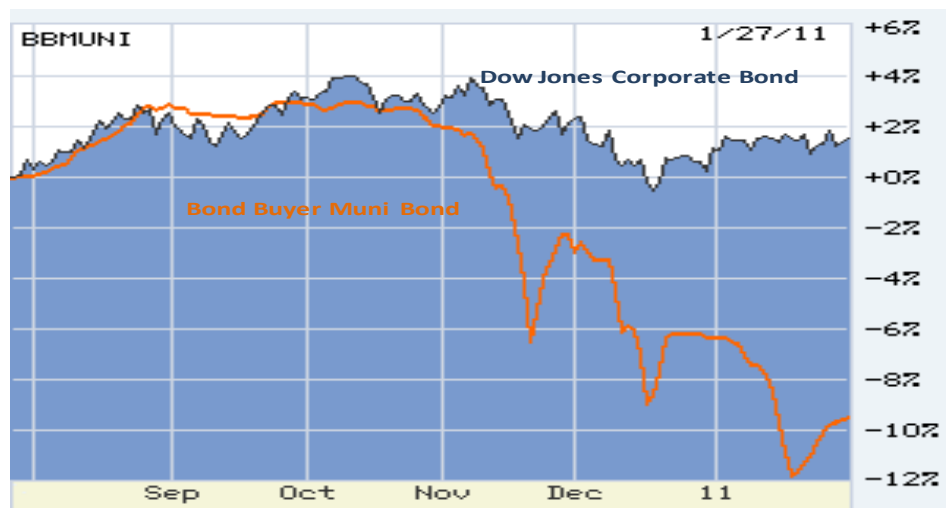


zero, while for much of 2010 mid-long term rates also hovered around historical lows. A brisker pace of global growth is likely to stimulate further upward pressure on rates, a trend that began in autumn last year. In particular the voracious appetite of high-growth economies for commodities ranging from oil to copper, zinc and corn could bring high inflation out from the cold and back onto center stage.

The credit quality issue has two main potential flashpoints: Eurozone sovereign debt and US municipal debt. In 2010 we watched three acts of a drama play out: first with Greece, then Ireland, and finally Portugal as the year headed to a close. EU policymakers reacted briskly as the Greek crisis threatened to spill out into the broader market in May, and those efforts at least provided a foundation to keep market reactions tempered as the other two crises played out.

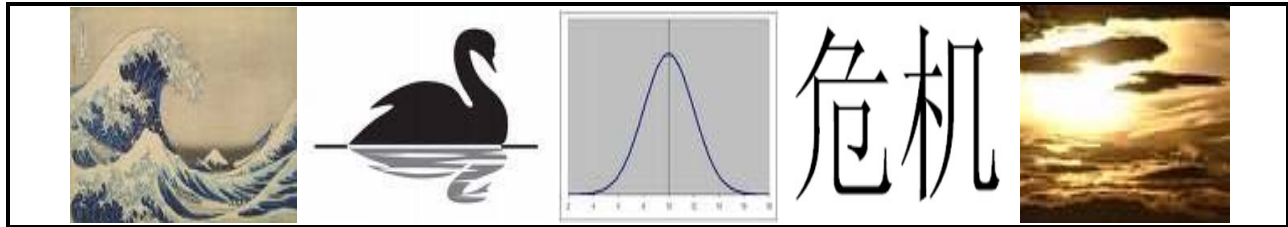
One of Europe’s great gifts to the world are the plays of William Shakespeare, and as the Bard’s fans among us know, these timeless tales play out in five acts. So the question at hand now is whether there is going to be an Act IV or an Act V to the Eurozone drama, and the two names that swirl around as possible *dramatis personae* are Spain and Italy. An Act V to this play would likely be as unhappy as the final stanzas of *Macbeth* or *Othello*, not just for the Eurozone but for broader credit markets. As we recall from what was then called the “subprime crisis” in 2007, seemingly contained segments of the market have a way of spilling over into much larger swathes of territory.

Table 3
Six month performance of municipal versus corporate bonds



Source: Wall Street Journal Online

The second flash point is US municipal debt, indicated in Table 3 above. US state and local municipalities are in a difficult and dangerous position. They got into the same trouble during the illusory boom years of the 2000s as did households and financial institutions – running up bills on the assumption that the income would always be there when needed, taking on undue risks in pursuit of a few extra basis points, and generally letting their balance sheets run amok. Now, in a new age where fiscal austerity measures have to start somewhere, many eyes in Washington are focused on more and deeper cuts in federal aid



to municipal programs. States ranging from the immense (California) to the impoverished (Alabama) are on the edge of a financial abyss that in many ways looks as unnerving as the subprime loan market did three years ago.

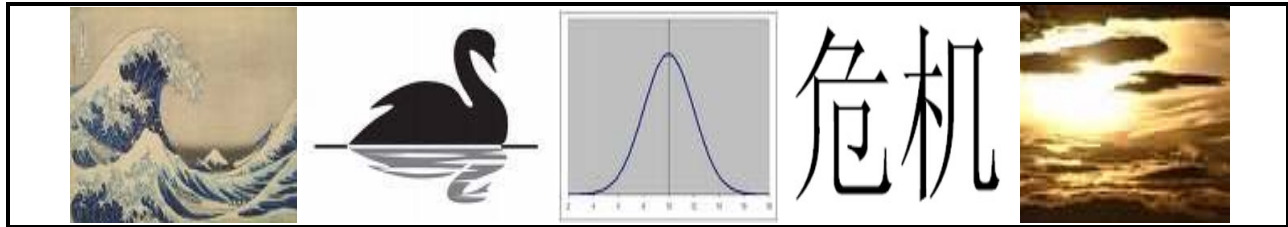
Producers, consumers, investors and creditors: the Great Realignment continues

The market crash and recession of 2007-09 brought into stark relief the transformation taking place in world markets with the evolution of mature and growth economies into new alignments of providers of goods and services (producers), buyers of those goods and services (consumers), and providers of the funds needed to facilitate the efficient exchange of these goods and services (creditors and investors). We call this the Great Realignment, because it is indeed turning the global economy into something vastly different from what it was twenty or thirty years ago. The important question for 2011, as we are still in the somewhat fragile early stages of recovery from the recession, is what the metrics show in terms of how smoothly this realignment is proceeding.

The realignment has a couple overriding premises. The first of these is that the mainstay of future global growth should consist of something other than, or at least in addition to, developed market consumers (mainly US) buying tons of stuff from growth market producers (mainly Asia). A handy metric for measuring this is the comparative contribution of consumer spending to GDP in the US and in China. Personal consumption expenditure accounts for about 70% of GDP in the US and about half that – 35% – in China. We don't expect these figures ever to converge completely – at least not in the next couple of decades – but they should move towards each other.

The second overarching premise is that the flow of capital to facilitate the efficient exchange of goods and services will no longer be a one-way street between rich individuals and institutions in New York and London and recipients of their investment funds in other parts of the world. Even as capital markets become more truly global in how they operate, they will become more local in that, for instance, Asian wealth will tend to fund Asian investment projects, Islamic financial instruments will convey wealth from the Gulf States, Malaysia and Brunei into *halal* global infrastructure projects, and entrepreneurs who live in the more cash-strapped and debt-burdened nations of the West will seek new forms of investment structures to pick up the slack from a still moribund market for traditional venture capital.

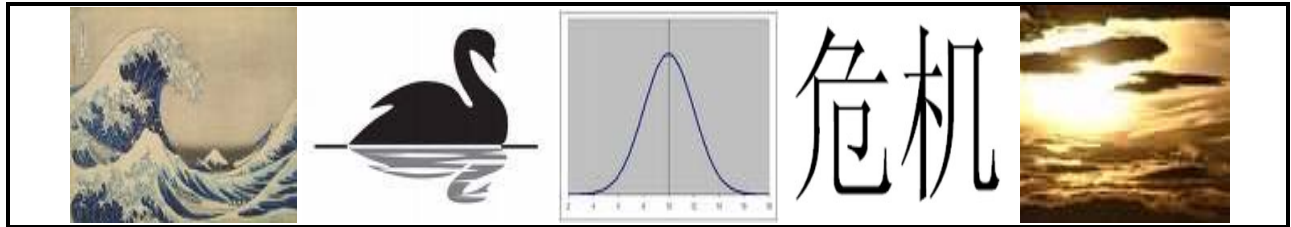
This is the recipe for – to somewhat paraphrase one of the catch-phrases of the 2008 US presidential election campaign – global growth we can believe in. The good news, at the outset of 2011, is that many of the signals we detect in the market today show evidence of firmness where there were just fits and starts a year ago. In particular the US, by producing higher than expected GDP growth, can provide a very necessary stability to world markets. The US remains by a large distance the world's largest economy, and it cannot be emphasized enough how important US economic health will continue to be for the Great Realignment to be a smooth transition, and not the Time of Troubles we see in some historical examples of transition from one *regime* to another.



Economic Watch: What to Keep an Eye On, and Why

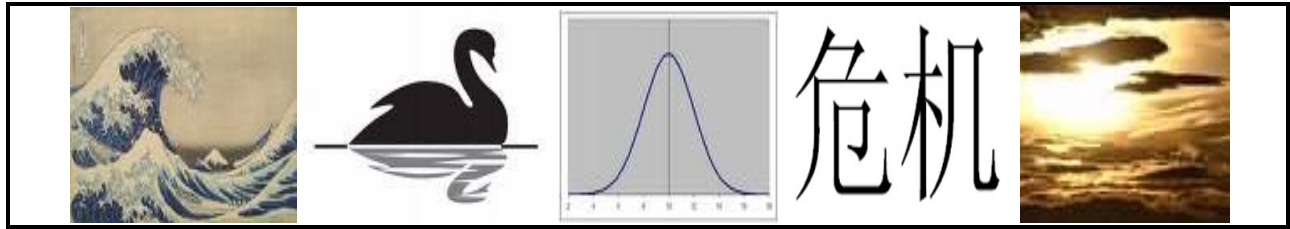
This will be an important year for paying attention to the economic signals – as noted above, there is a higher than average amount of volatility in the market currently, and outcomes will likely turn on some combination of the following factors:

- **US GDP:** We have noted several times already that the emerging case for a higher than average growth rate for the US economy could have a major impact on market performance. At first glance it may not seem like there is much difference between a range of 1-2% GDP growth and 3-4%. But the difference is significant, because once you clear a threshold around 2.5% (based on observed experience) the resulting increases in **private sector job creation** start to make a meaningful dent in unemployment – and that in turn bodes well for sustained economic health. On a related note, keep a close eye on the Conference Board’s consumer sentiment index. This has started to trend up recently, and is an indicator of whether the good economic news is being felt at all in middle America.
- **Commodities Prices:** There are a couple factors at play when monitoring commodities prices, which have been on an upswing since the middle of 2010. The first is that price firmness will signal continuation of the high growth rates of industrial powerhouses like China and Brazil, who consume vast quantities of commodities from petroleum products to industrial metals and agricultural products. That’s good news for global growth. The second factor, though, is the specter of high inflation, and that is not good news (see more about this in our “Asset Class Review” section below).
- **Inflation Indexes:** As discussed in the previous bullet point, commodities prices have been heading back towards (and in some cases already surpassed) their pre-recession levels of 2007 and 2008. When corn prices and oil prices skyrocket on commodities bourses, prices also soar at the gas pump and in the supermarket. Middle class households spend a pretty good chunk of their monthly budgets at those two places. These households have just started to gingerly open their wallets again to discretionary spending purposes. Any significant inflation in core monthly staples like gas, milk and cereal threatens to choke off the recent improvement in consumer spending, which in turn will necessarily throw cold water on sustained GDP growth.
- **Japanese Debt-to-GDP:** While we’re worried about the levels of debt here in the US, at least we’re not running at levels of 200% of GDP. But Japan is – and in recent weeks several Japanese policymakers have broken the usual polite silence around this subject. Now, what makes Japan different from either Greece or the US is that the overwhelming majority of debt is held domestically, as opposed to European financial institutions (Greek Eurodebt) or the People’s Bank of China (US Treasuries). So it has not been viewed as susceptible to massive waves of panic selling. For Japan to get out of this debt hole is going to require a level of growth that does not appear visible on the horizon. Keep an eye on Japan’s share of the export market to other Asian countries, particularly China and the richer nations of the Pacific Rim like Taiwan, South Korea and Malaysia. So far it has been underwhelming to say the least.
- **US dollar/Euro Rate:** The hard thing about making sense of currency movements in the current environment is how many different variables are at play. The US dollar is generally reckoned to



be in a weak secular trend for a combination of reasons related to our overall economic competitiveness, low interest rate environment, high debt levels and others, but none of this is evident when you look at the trajectory of the dollar versus the euro. What that exchange rate does tell you is the pulse of sentiment in Eurozone credit markets. The euro fell in 2010 to levels around \$1.19 / €1.00 before rising back to \$1.40, and currently it is trading around the \$1.35 level. The dollar/euro rate will tell us much less about the US economy in 2011, and much more about the resilience of the European currency in the face of all the sovereign debt challenges.

- **Flight of the Renminbi:** Watching the dollar/yuan rate (the Chinese currency is known both as the yuan and the renminbi) is like watching grass grow. You never really see it change, but after awhile you notice that it has indeed moved a little. The rate was \$1.00 / RMB 6.69 in September last year, and now it is 6.58. A couple years ago it was over 7.0. Contrary to much popular opinion, the Chinese do not enjoy keeping their currency below its putative natural level of valuation, but this has been seen as the price of keeping their economy on a brisk enough growth trajectory to avoid major social problems at home. It would be hard to argue with the success of that strategy up to now, but the Chinese economy is showing signs of real overheating, and that could result in a combination of higher domestic interest rates and, yes, a greater willingness to let the currency do its own thing. Of course “slower Chinese growth” is a phrase that has a lot of impact on global capital markets – and usually not for the better.



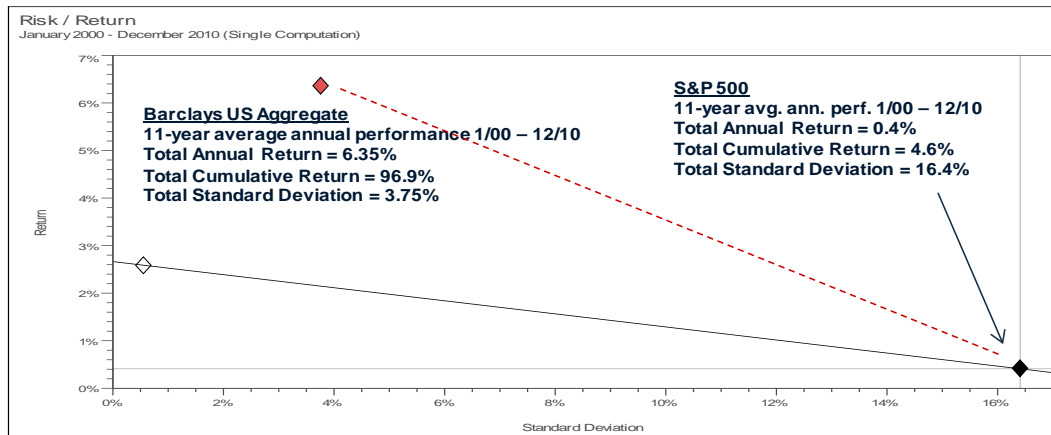
Selected Thematics for 2011 and Beyond

In this section we identify a small number of themes that we believe have potential significance to influence markets beyond the next twelve months.

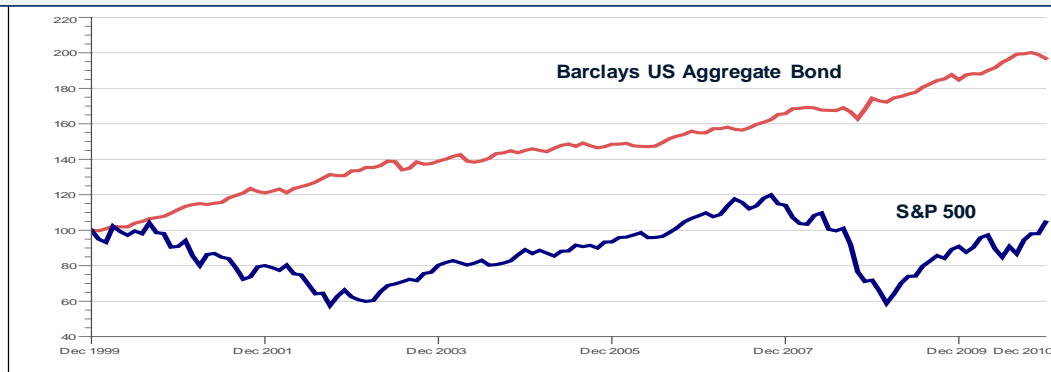
Goodbye to the Great Free Lunch

The Great Free Lunch is a story best told with pictures:

Table 4
Comparative performance of stocks and bonds, 2000 – 2010

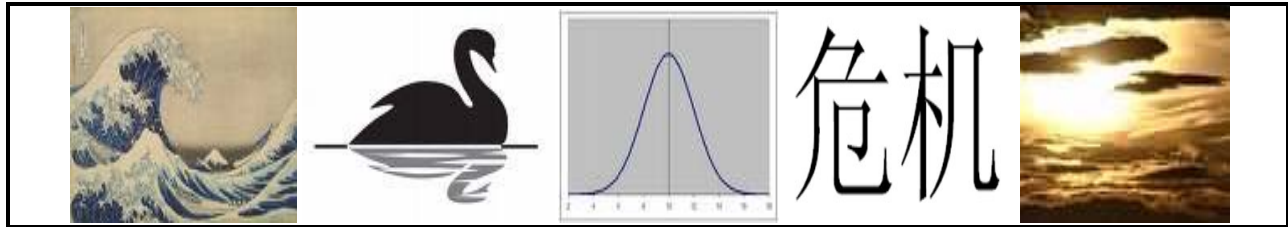


An investor in bonds nearly doubled his or her investment over the course of the decade, while an investor in the broad-based stock market got nearly nothing for all the extra risk assumed



Source: Zephyr & Associates LLC

At some point in our lives we have undoubtedly all been told (with serious intonation of voice) that “there is no such thing as a free lunch”. For the past decade, though, bond investors have enjoyed something remarkably like a free lunch. That is to say, an investor going into bonds at the beginning of the 2000s would have just about earned double on the investment by the end of 2010, while an investor



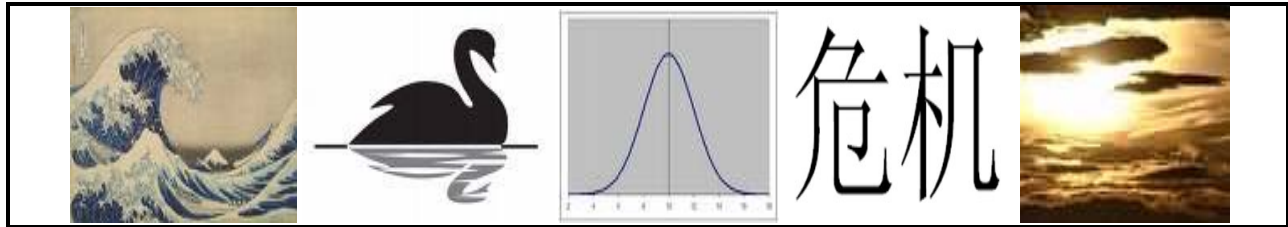
who went into the stock market at the same time would have essentially nothing to show for all the added risk that investing in stocks entails. It's hard not to think of that iconic Dire Straits song of the early 1980s: "Money for Nothing" (playing your "gee-tar" on MTV, investing in Treasury bonds, it's all the same!).

Here's the thing, though – when you look at that chart and contemplate just *how much better* bonds performed relative to stocks over that period, it is hard not to have something like the following thought nagging at the back of your mind: is it conceivable that this could happen two decades in a row? Now, we should quickly answer this by saying: yes, it is certainly *possible*. But is it *likely*? We would say no. The last decade was bookended by two disasters in risk asset markets – the collapse of the tech bubble in 2000 that led to recession the next year, and the meltdown in the subprime lending market in 2007 that begat the Great Crash of '08 and the worst recession since the Great Depression. There are real reasons why bonds were such a better place to be than stocks for those ten years, for sure. But the more likely case we see going forward is a return of growth led by the engines of the new reality – China, India, Brazil and the dynamic smaller nations of those regions, with good enough (though not stellar) growth in the US to maintain overall stability as the global economy goes through the realignment of wealth and influence towards the growth markets. This scenario lends itself to an environment where risk assets deliver healthy returns and performance in the bond market is more subdued, with perhaps even years in which bond indexes turn negative (something that tends to happen only very rarely).

Of Nation-States – Their Companies, Their Citizens

The new reality has dimensions above and beyond the characteristics of investment markets that touch on issues of a more socio-political nature. When we think of markets we still have a tendency to think in traditional terms of "national" markets. That's what our brains are anchored in – we live in the United States, or Germany, or Japan, and we think of our home markets as consisting of national companies that employ *us* to make things to sell to *us*. This, of course, is another example of how old perceptions of reality can linger around in our brains long after conditions have actually changed. American companies, in fact are AINOs – Americans in Name Only. Bellwether names like General Electric earn more than 60% of their operating profits outside the US. Technology and communications giants like Cisco and Microsoft have huge physical investments in markets like China and India. We are not talking simply about call centers where low-end employees perform relatively menial tasks. We are talking about advanced research, operations and marketing facilities. Cisco operates a second headquarters in Bangalore, India. The work being performed in these foreign centers is the kind of high-end creative and analytical output that has traditionally endowed college- and graduate school-educated Americans with six figure (or higher) salaries and a commensurate lifestyle.

This is why one of the most peculiar metrics in the economy today is what we call the "Twin Doubles" – double digit earnings growth for US companies and double digit unemployment for US citizens (the official rate of unemployment currently is 9.4% but the broader measure including underemployment hovers around 17%). American companies are doing well for many reasons that have nothing to do with American workers or American consumers. The same is true – to a greater or lesser extent – in other mature markets as well.



For companies this may be a recipe for success in the short term, but we have to believe that it cannot be sustainable as a long term model. Companies can move quickly in and out of markets as opportunities present themselves. Human beings are not so nimble – most of us do not likely relish the idea of a life of perpetually racing around the world to live where the jobs are, even if that were possible in a practical sense (and it is not – labor markets are nowhere near as frictionless as capital or production markets). Private enterprise unquestionably has a very large influence on government policy in the US, and yet there is a growing sense that they are not truly “in the game” with us regular folk. Companies may depend on the US for less than half their earnings, but most of us who work in the US get pretty much *all* our earnings from here. It may not yet be the stuff of regular debate in our present (sadly, woefully shallow) public discourse, but at some point the arrangements as they are today are not going to be viable without something changing. This is a time bomb that at some point is going to go off if not handled in an intelligent, farsighted way sometime in the very near future.

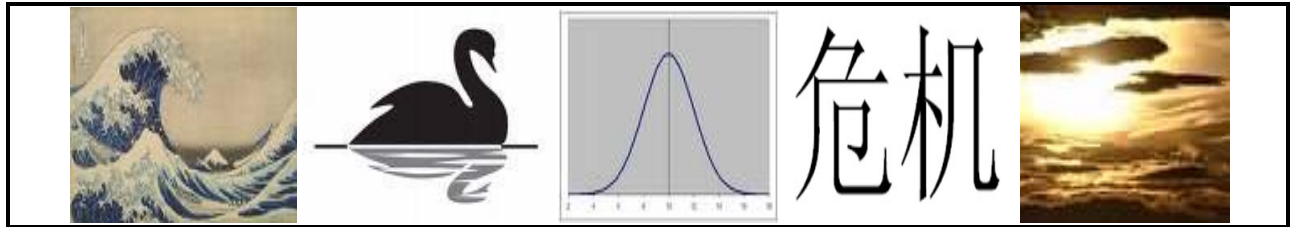
The Era of the Machines

Table 5
 “Flash crash” in the S&P 500, May 6 2010



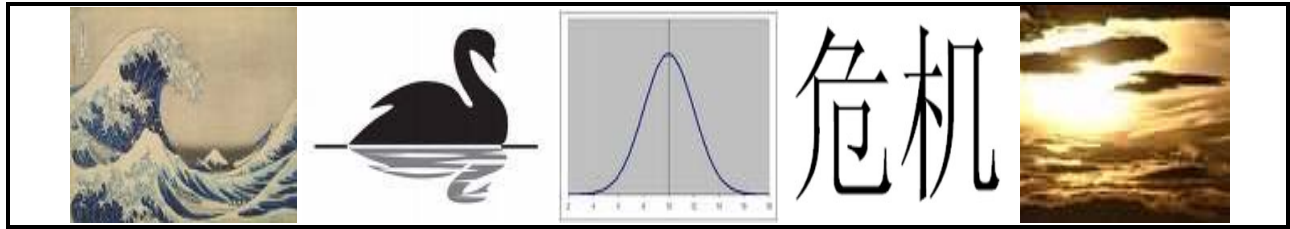
Source: Power Financial Group, Inc.

It was one of those classic “where were you when X happened?” moments. On May 6 2010 the market was having a bad day – Greece and the Eurozone crisis were in the news of late and the recent spring rally was having trouble sustaining its pace. But we went about doing our usual routines, including a 2.00pm conference call. With an eye intermittently on the market data flashing on the screen in real time, it suddenly dawned on us that something extraordinarily bizarre was happening. The Dow was dropping literally hundreds of points right before our eyes – seemingly in an unstoppable freefall collapse. We got off the call in a hurry to man the battle stations – and then, just as quickly as it began, the freefall bounced back up like a bungee jumper. The market still closed down for the day, but nowhere near the depths to which it sank during what was to be dubbed the “flash crash”.



Sadly, the chances are pretty high that we have not seen the end of anomalies like the flash crash. The fact is that an overwhelming majority of the trading that takes place on asset markets every day is not made by human beings barking buy and sell orders to each other, but by computer algorithm-driven programs executing trades when some piece of external data – an economic report, a share-volume calculation, whatever – triggers a call to action. These algorithms all work largely independently of each other – thousands upon thousands of them doing as they have been programmed to do in this complex Petri dish of activity that is the modern global capital market. It would be impossible to predict when and how some unfortunate, random combination of variables could trigger another massive wave of selling, which then begets more selling as new tipping points are breached – but it is likely that it will happen again.

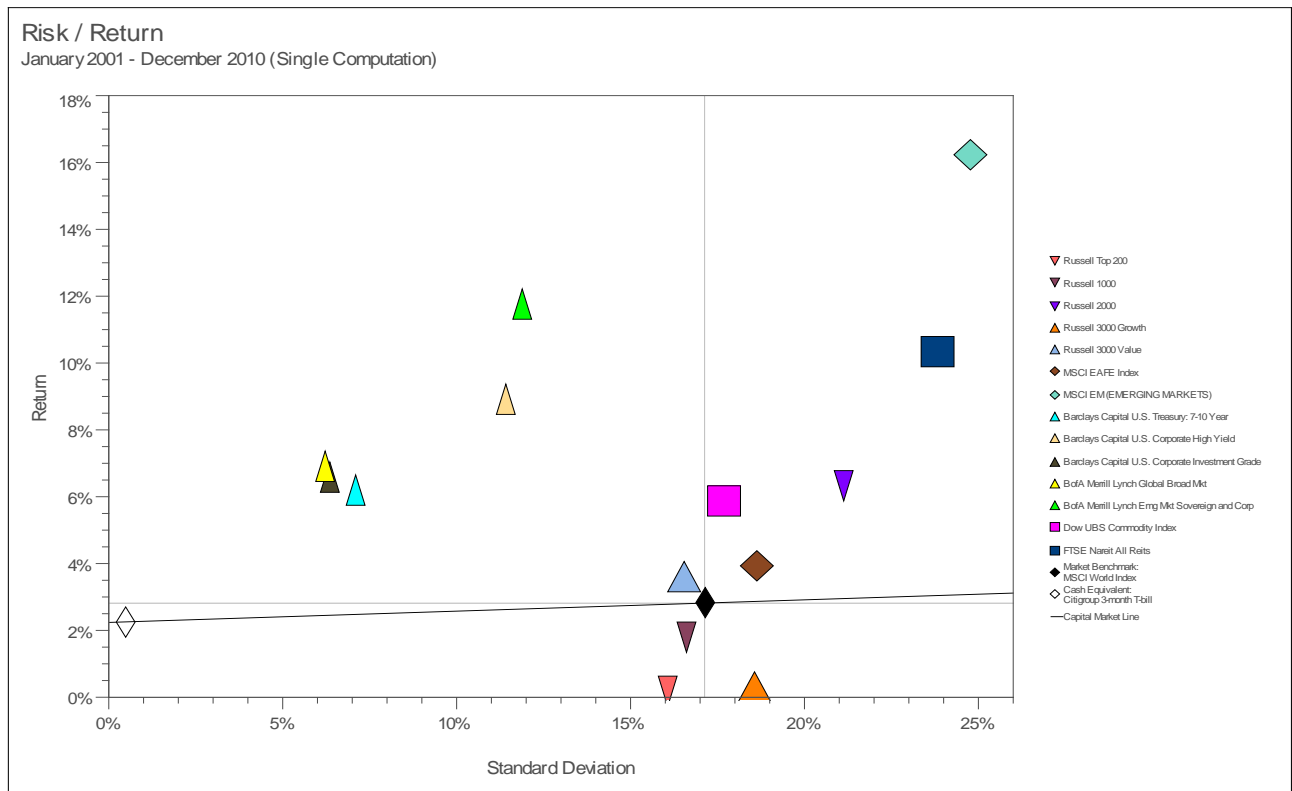
Securities regulators are of course aware of the dangers of massive program trading-led selling: those old enough to remember that far back can recall Black Monday in October 1987, and the considerable hand-wringing that followed as policymakers and regulators digested the impact of the portfolio insurance programs that were such a factor that day. Just about all exchanges today have elaborate mechanisms in place, such as “circuit-breakers”, to contain the damage in the event of a market rout. But unfortunately regulators can only do so much in the way of preventative measures without attacking some very fundamental premises of the 24/7, liquid, globally interconnected markets that exist today. Whether the will and the political climate exist for this to happen is far from clear.



Asset Class Outlook

The Big Picture

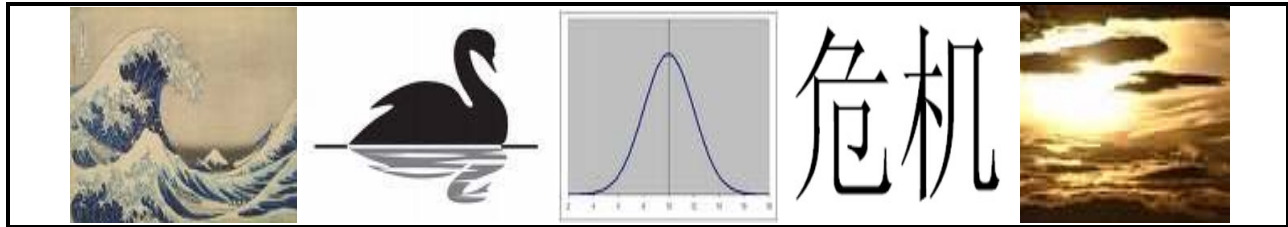
Table 6
Comparative Asset Class Performance 2001 – 2010



Source: Zephyr & Associates LLC

This chart presents a comprehensive view of the winners and losers of the past ten years: fixed income asset classes performed well across the board, while among risk asset classes the only standout performances were from emerging markets equities and real estate investment trusts (REITs). Small cap equities generally did better than the broader stock market. Growth stocks, which had a strong rebound in 2009 and 2010, still performed below average for the period as a whole given their underperformance after the technology bubble and through the mid-decade rally.

As we have discussed elsewhere in this report, we expect to see the “fixed income free lunch” dissipate on account of the events and trends we have described. In the realm of US equities, in the near term we see a strong case to make that large cap equities (for example as represented by the Russell Top 200 or



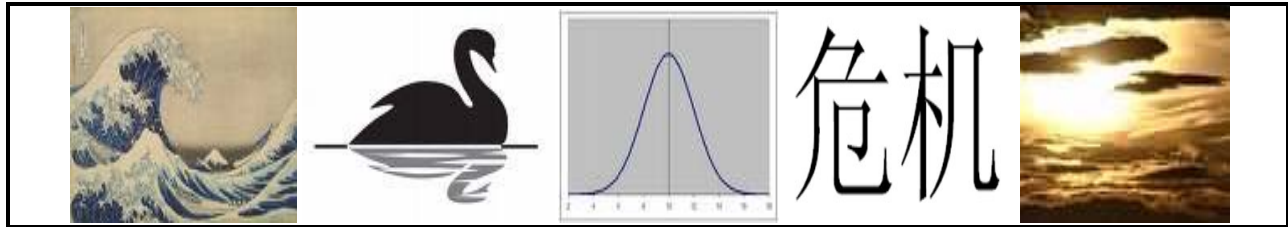
the Russell Top 50) may exhibit outperformance over small cap stocks after a long run of dominance by small caps. With regard to non-US stocks, we see a couple different emergent possibilities.

Among mature market regions and countries we believe the US could demonstrate broad outperformance over Europe and Japan. The latter (Japan) we regard with particular concern as it is very difficult to make a strong economic case for growth given the combination of the massive debt burden, ongoing deflation, demographic challenges (including a shrinking workforce population) and political dysfunction. In Europe we believe the Eurozone problems are not over and that there may be a significant realignment of some form to take place in the coming years, if not sooner. Second-tier European economies are among the most volatile risk assets in the market currently, exhibiting the type of daily and weekly fluctuations one would expect from erratic, fragile frontier markets, rather than from mature and established nation-states.

In emerging markets we do not necessarily believe that the returns gap will be as profound in the coming ten years as it was for the previous decade; rather, we are already starting to see a convergence in the risk differential between emerging and developed markets. While we still expect emerging markets to offer risk-adjusted outperformance due to the ongoing economic realignment, there should be a smaller magnitude of incremental risk for emerging markets exposures – and with that, a smaller magnitude of difference in normalized returns as well.

Alternative assets come in a variety of flavors, and play distinct roles in diversified portfolios. One role is to provide low-correlation benefits: this has been the province of higher-volatility alternative assets like commodities as well as hedging strategies like long-short directional, market neutral or event-driven arbitrage whose risk characteristics are closer to fixed income than to equities. These low-correlation benefits have been in scarce supply in recent years; even commodities, which over long periods of time have tended to show almost no correlation with equities, have exhibited correlations of 0.50 or more with broad stock market measures like the S&P 500. Correlation between two asset classes can range from 1.0 (perfect positive correlation) to -1.0 (perfect negative correlation).

Another role for alternatives, in particular the low-volatility variety, is to help reduce overall portfolio risk in environments where fixed income allocations are below target weights. Given all that we have talked about the negative tenor of fixed income markets in this report, we believe that various prudent hedge strategies can play an important role in reducing undesirable fixed income risk while still managing volatility at levels consistent with our more risk-averse clients.



US Equities

Table 7
Mega Cap versus Small Cap Performance: 2001 – 2010

| as of 31 December 2010 | 1 Year | 2 Years | 3 Years | 5 Years | 7 Years | 10 Years |
|--------------------------------------|-------------------------|---------|---------|---------|---------|----------|
| | <i>all figures in %</i> | | | | | |
| Russell Top 50 Mega Cap Index | 9.48 | 14.84 | (4.45) | 1.59 | 2.01 | (0.51) |
| Russell 2000 Small Cap Index | 26.85 | 27.01 | 2.22 | 4.47 | 6.36 | 6.33 |

Source: Russell Investments Index Return Calculator

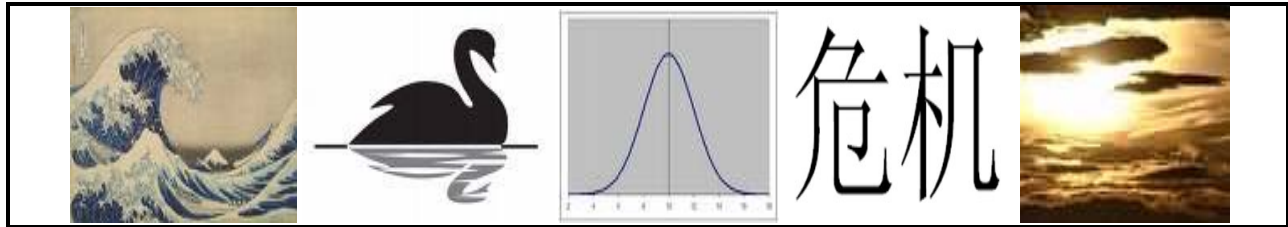
The above chart shows very clearly the dominant advantage small cap stocks have had over the largest US equities over the past decade. What the “10 Years” figure says is that on an average annual basis for ten years, small caps have outperformed the 50 largest (by market capitalization) companies in the Russell database by an *annual average of just under 7%*. Expectations of a turnaround in mega cap fortunes have foundered on the shoals numerous times over the course of the decade. We believe, however, that the case for the largest-cap stocks is particularly strong at the present time. The case boils down to the following: (a) large cap companies are in a better position due to their more extended sales, marketing and operations footprints to prosper in the growth markets of Asia and Latin America where a dynamic and fast-increasing share of global wealth resides; (b) their balance sheets are extremely cash-rich with minimal debt obligations (those obligations reflecting the very cheap borrowing costs of the past few years); and (c) those cash surpluses are being invested in the type of advanced operations technology that will enhance productivity and supply additional strength to operating margins.

Non-US Equities

Table 8
Risk and Return Metrics for Selected National Markets

| 1 year ended 12/31/2010 | Standard Deviation (%) | Total Return (%) | Sharpe Ratio (x) | Cash-Adj. Beta (x) | Cash-Adj. R-squared (%) |
|-------------------------|------------------------|------------------|------------------|--------------------|-------------------------|
| Japan | 14.2 | 15.6 | 1.09 | 0.64 | 74.4 |
| Malaysia | 15.6 | 37.0 | 2.36 | 0.51 | 38.8 |
| Chile | 15.7 | 44.8 | 2.85 | 0.32 | 15.3 |
| China | 17.1 | 4.8 | 0.28 | 0.68 | 59.5 |
| S&P 500 | 19.2 | 15.1 | 0.78 | 1.00 | 100.0 |
| Hong Kong | 19.3 | 23.2 | 1.20 | 0.72 | 51.1 |
| Canada | 20.4 | 21.2 | 1.03 | 1.01 | 90.6 |
| United Kingdom | 23.4 | 8.8 | 0.37 | 1.08 | 80.0 |
| India | 24.1 | 21.0 | 0.86 | 0.91 | 52.6 |
| Germany | 27.6 | 9.3 | 0.33 | 1.27 | 78.7 |
| Brazil | 27.7 | 6.8 | 0.24 | 1.32 | 84.1 |
| Sweden | 29.9 | 34.8 | 1.16 | 1.36 | 76.9 |
| Spain | 42.2 | (21.1) | (0.50) | 1.59 | 52.8 |

Source: MSCI Barra; Zephyr & Associates LLC



This table offers a glimpse of how the future may be shaping up to look in terms of risk-return relationships between so-called developed and emerging markets. We rank this table by standard deviation, a common measure of absolute risk in asset evaluation. Low standard deviation is a desirable quality as it means that your investment has a more moderate range of fluctuations up and down around the average return. The interesting thing about this chart is that of the top five least risky (by this measure) markets, three (Malaysia, Chile and China) are considered to be “emerging” markets while among the bottom five – in other words the most risky – markets are three (Germany, Sweden and Spain) that are deemed “developed” markets.

Put another way, if you consider how traditional investment institutions like pension funds and endowments manage their investment policy guidelines, they typically permit a much larger allocation to “developed” than to “emerging” markets – up to four times or even more. This chart tells you that such practices are no longer viable. At MVCM we have been saying this in our research and communications since 2006, but here are the data points to show that this is no longer something to anticipate down the road. The monikers “emerging” and “developed” markets do not have meaning today – at least not in the same way that they did 15 years ago.

Fixed Income

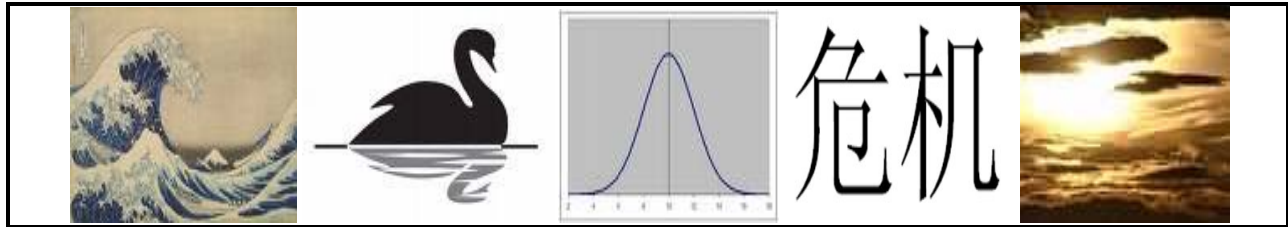
Table 9

Five-year Performance: US Corporate (Investment Grade & High Yield) Bonds versus S&P 500



Source: Wall Street Journal Online

We have spilled lots of ink in these pages about fixed income, but one more point is worth making. There is a significant difference between the prospects for corporate bonds – both in the investment grade and high yield sectors, and those for sovereign and municipal debt (we discussed these sectors in detail earlier in the report). One of the distinguishing characteristics of corporate balance sheets today

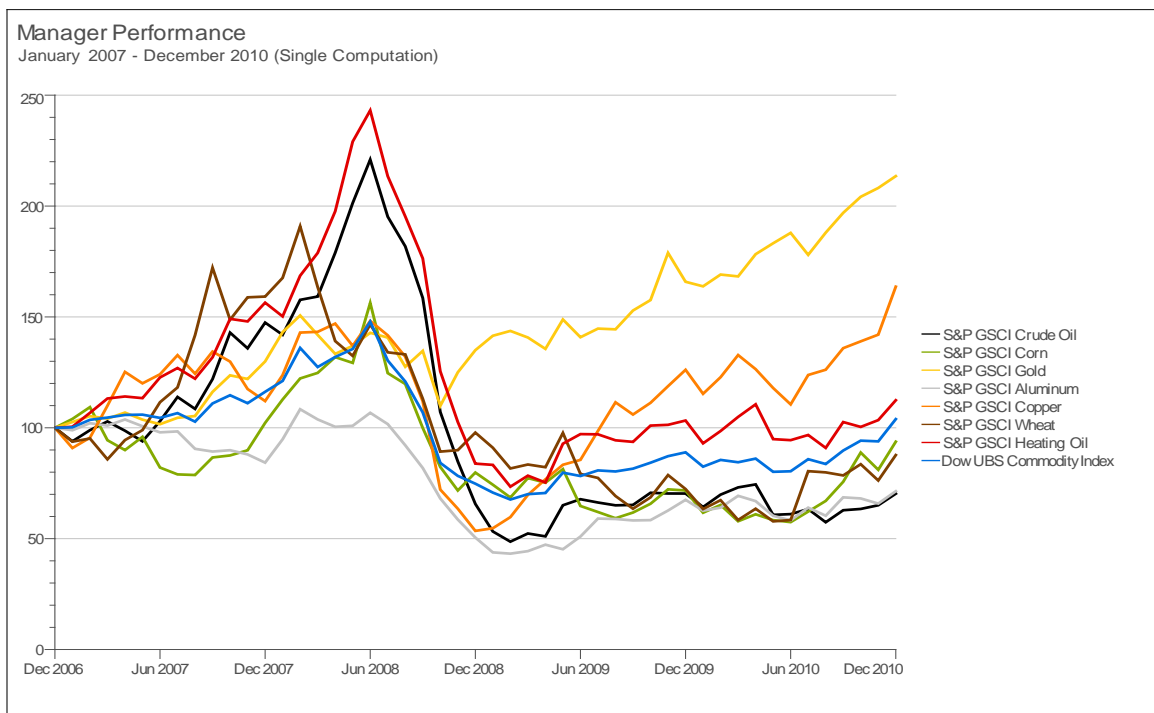


– especially among the largest companies but also among mid and small cap concerns – is an absence of debt. The combination of low debt obligations and the implications of an improving economic picture for cash flow generation provide a healthy view for credit quality in the corporate bond sector. Remember that credit quality is determined by the issuer’s ability to pay its interest and principal obligations in full and on time, and thus avoid default. This is the problem that both European sovereigns and US municipalities are facing. But US (and to a large extent global) corporations are not staring at the prospects of such severe cash flow hiccups.

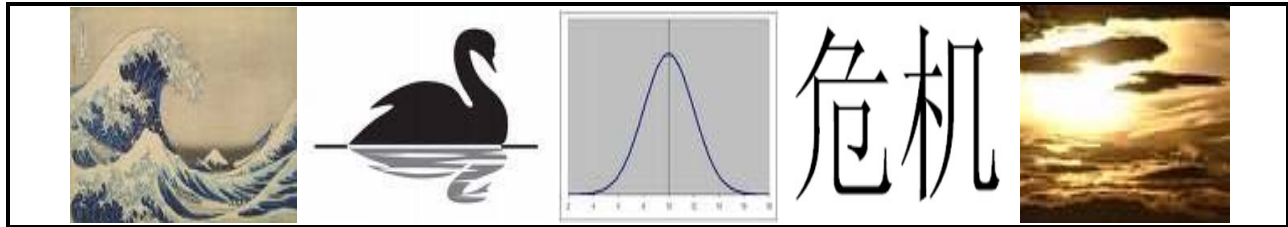
We would expect this to imply that credit spreads between corporate debt and the benchmark Treasury issues will continue to tighten and that the corporate sector may continue to experience good performance (as seen in the chart above). Of course, corporate bonds will also face headwinds if interest rates in general rise, as we expect in 2011. When rates go up prices go down – that is the single most essential characteristic of fixed income assets. But the effect of higher rates can be contained if relative spreads are tightening. Moreover, the high yield sector in particular tends to perform more like equities than like other bonds in many market environments. Of course that also means that volatility questions loom large in the high yield allocation decision – particularly in a year like this with higher than average volatility likely to be a factor.

Alternatives

Table 10
Five Year Performance: Selected Commodities Futures



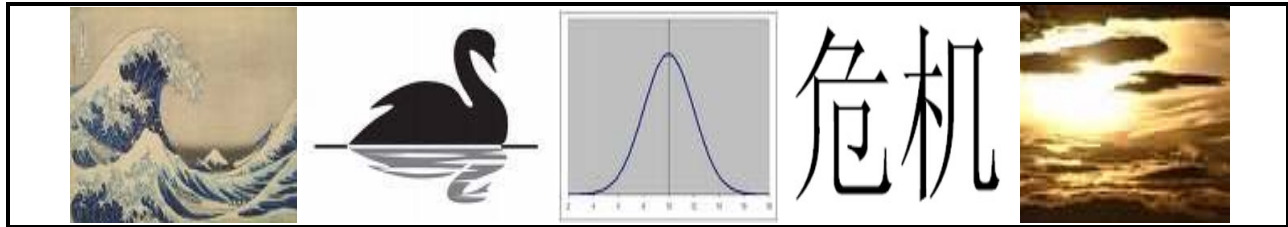
Source: Zephyr & Associates LLC



One of the noticeable factors of 2010 was the resumption of the upwards journey of many commodities prices towards the previous highs reached in 2007 and 2008 before the market crash and recession. Of course the big story in 2010 was gold, which went on a tear for much of the year, seemingly impervious to whatever factors were pulling other assets in different directions. We think the gold fever of last year is likely to abate, though gold prices could still hold up well in a scenario where inflation becomes a large enough immediate concern. But it is other commodities that we think will be the story this year – and in certain conditions could play something of a spoiler role.

Gold and oil are perhaps the “marquee” names in commodities. But the more mundane substances – zinc, corn, wheat, aluminum, copper – these plain Janes are the workhorses of the global economy. They are inputs for the manufacture of value-added goods and the basic elements of the foodstuffs that sustain a large percentage of the world’s population. When their prices go up – and in 2007-08 they went up by quite a lot – economic disruptions can happen. Record wheat and corn prices that year caused rioting in Mexican villages that experienced shortages and price spirals for tortillas – the mainstay of their diets. Higher prices for key raw materials like aluminum and copper mean that companies have to either find efficiencies elsewhere to maintain profit margins, or they have to pass the higher costs onto consumers.

That is where the spoiler role could surface. Households are only just starting to tiptoe back into the market for discretionary goods and services – and the willingness to open the wallet by more consumers gave a big boost to the economy in the second half of 2010. That willingness could come to a screeching halt if prices at the gas pump and the supermarket aisle jump by 10 or 20%. Memories of \$4 gas are not too distant – it was only two and a half years ago. A substantial part of the monthly budget gets spent on gas and groceries, and there is little doubt that households are not in the position to accommodate higher prices there without cutting back on other things. So in an environment where all commodities prices are rising consumer spending could slow and so could business profit margins, because they will find it hard to pass on the higher costs for their value added products. This could be a restraining factor on economic and market performance this year, if such a scenario plays out.



Conclusions

- Overall we maintain a more optimistic view on economic and risk asset performance opportunities in 2011 than we have for the past several years. Economic fundamentals seem to be finding a more solid footing after the “fits and starts” environment of last year. In particular the US could be poised to show higher than expected growth while the real engines of the global economy in Asia and Latin America continue their upward trajectory.
- This optimism is somewhat kept in check by expectations of higher than average volatility. There is a very thin line between the scenarios separating opportunities and threats – for example whether second-tier Eurozone economies will get past their severe debt problems or whether the common currency itself will be in jeopardy. Higher volatility brings with it less confidence in predicting expected outcomes.
- The bond market is poised for a reversal from its recent fortunes as medium and long term Treasury yields have turned up and there is a growing sense that short term rates cannot stay at zero forever. Bonds performed exceedingly well over the last ten years at the expense of stocks and other risk assets, and we see a strong case to make for a change in these fortunes for the year ahead. Among bonds we prefer the corporate sector and are more wary of sovereign and municipal issues.
- US large cap companies could be positioned to benefit after a long run by small cap stocks, helped by their ability to extend their influence in the fast growth markets of Asia and Latin America. Non-US developed economies may be a mixed bag, with second-tier Eurozone and Japanese markets looking particularly fragile. In emerging markets we see a general reduction of the “risk differential” with more mature markets, making emerging markets potentially less risky on a relative basis but also implying perhaps a more modest range for expected returns.
- Lower volatility alternative assets will continue to serve an important function in diversified portfolios to keep risk within prudent boundaries while taking on some of the asset weightings that would otherwise go to fixed income. Among higher volatility alternative assets we think higher commodities prices could exert a big influence on markets this year, with the potential to cause market disruptions that in turn could limit the achievable upside of the growth scenario.



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