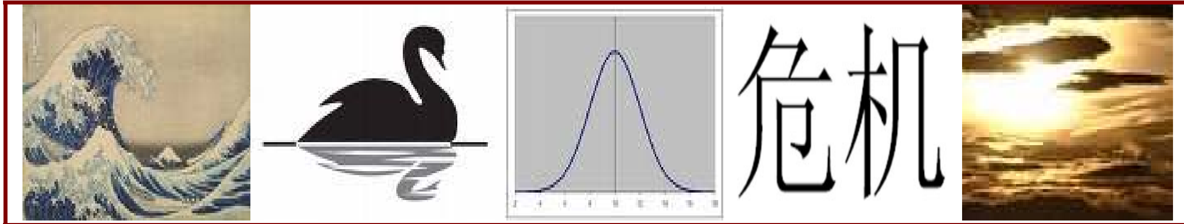

The Year Ahead, 2009

MVCM Annual Market Outlook

Note to readers: Our executive summary outlook for 2009 (a summary of the more detailed commentary found in the rest of the report) can be found on pages 4-6

Nel mezzo del cammin di nostra vita
mi ritrovai per una selva oscura
chè la diritta via era smarrita.

Midway in our life's journey
I found I was in a dark forest
For I had strayed from the straight path.

-Dante Aligheieri "La Divina Comedia" Inferno, Canto I

Tectonic Plates, Colliding

More than a few people today are no doubt feeling like Dante in those memorable opening lines of "The Divine Comedy": lost, looking for the way back home, and fearful of what lies in store. The good news, of course, is that after descending to the depths of hell Dante then ultimately ascends to a glorious vision of heaven and winds up back in his native Florence much the better for the whole experience. We can all hope for a similar outcome *après le deluge*.

What began in the summer of 2007 as a disruption in the credit markets brought about by the effect of falling real estate prices on collateralized debt instruments turned into a full-blown pandemic in 2008 that not only triggered a worldwide crash in asset prices but in fact shook the very foundations upon which the global financial marketplace as we know it was built. For the perquisites and propensities of this global financial marketplace – we use the shorthand "Wall Street" although in reality the geography of this market long ago ceased to have any one single terrestrial epicenter – have for the better part of the last 30 years dictated the contours of our lives in far-reaching ways.

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MVCM 2009 0006
DOFU: February 2009

Wall Street hours for Wal-Mart wages – Americans now work longer, earn less and get fewer vacation days, fewer benefits and no job stability – but all the while we borrow more, consume more and thereby feed the insatiable Beast of the Quarterly Earnings Announcement, and the totality of this arrangement was supposed to be good, patriotic even. The American citizen somehow morphed into the American consumer, the reliable Borrower of Last Resort. The world economy depended on our incandescent desire for more stuff and Wall Street lined its coffers helping us find ingenious ways to spend more money we don't actually have.

And then there was no Wall Street. The preening, chest-thumping Masters of the Universe turned off the lights and either closed up shop or settled into the déclassé status of regulated bank holding companies. The cops on the beat – the SEC whose charge was to protect Mr. & Mrs. Plain Old Investor from becoming chum in the feeding frenzy of the Sharks N Da Street – stood around slack-jawed and dazed as yet another shameless tale of malfeasance – a $50 billion fraud whose perpetrator, Bernard Madoff, once sat among the Valhallan gods of Self-Regulatory Organizations as chairman of the Nasdaq Stock Market – served as the sad coda for a miserable year.

Gotterdämmerung – the twilight of the gods – reigned in all places. The policymakers whose apparent genius was breathlessly celebrated by earnest middlebrow journalism over the years – think of Alan Greenspan and his sidekicks on the Committee to Save the World chronicled by Time Magazine in the late 1990s, steeped in their Chicago School mantras of efficient markets and Rational Man – turned out to be shocked, shocked, that when you figuratively give gluttonous drunkards the keys to the liquor store they will, to be perfectly blunt, get extremely drunk and bloated, and then die. Or, at the very least, cease being Masters of the Universe and become Quasi-Civil Servants instead, clinging obsessively for one last time to the toys of their bygone days – the corporate jets with Hermès silk pillowcases, the $35,000 antique commodes as office furniture, and of course the bonuses rewarding them for value they destroyed rather than created. Fitting is the title to a forthcoming book by Newsweek financial correspondent Daniel Gross called *Dumb Money: How Our Greatest Financial Minds Bankrupted the Nation* (Simon & Schuster, February 2009).

For three months in the fall of 2008 the tremulous arias of this vivid opera frightened and fascinated us, with the Dow Jones Industrial Average falling by 800 points one day and then rising by the same amount the next, with auto loans disappearing from the reach of all except the most perfect credit ratings, with economists' dour references to the decade of the 1970s giving way to bleaker still comparisons with the 1930s. The final two months of the US presidential campaign played out against the sharp clarity of our economic deluge, and Americans went to the polls to take a chance on the candidate, Barack Obama, who over the course of a long, brutal campaign had seemingly come into possession of the trade rights to the words "hope" and "change", words in which most of us desperately wanted to believe.

Now, six weeks into 2009, the opera continues. The Dow Jones Industrial Average and the S&P 500 both closed more than 8% down for the year to date at January month-end. That's supposedly an ill portent for the year, at least according to that particular strain of market kibitzer which touts the "January effect", a dubious but mildly entertaining prognostication that places undue weight on performance during the first calendar month of the year. More likely than not, though, the fate of popular nostrums like the January effect will be to gather dust in the attic as memories of a different time – the once bright, fluffy and cheerful festoonery of a 25 year bull run, the longest and the most profitable since the outset of the 20th century.

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But whatever the stock market does for the rest of 2009 – and very plausibly that could be a rally, another crash or a jerky sideways corridor – will not change the enduring effects of the tectonic collision that in 2008 sank the World Made by Wall Street. The economy of the past three decades, a creature of debt-fueled US consumption bankrolled by Asian and petrodollar savings, will not reassert itself any time soon. Something else is going to generate whatever growth we are capable of achieving in the coming future, and figuring out what that "something" is will be the key to successful long-term investing. The regulatory and policymaking institutions, and the legal and academic theories that support them, will be different. We believe there will be significant socio-cultural changes as well, including the rather existential question of what it is exactly that nation-states and their individual citizens expect and demand of one another.

So 2009 really is a new beginning. To commemorate this we have chosen as our decorative panel at the top of the first page of this report several images that we think are appropriate. At the center of these five images is a familiar representation – the Gaussian (normal) distribution that underlies so much of our probability-based theories about risk and return in investment markets. 2008 showed us the practical limits of these risk management approaches and we discussed this in a commentary to our clients last year called "The Limits of Analysis".

To the left of the Gaussian distribution graph is the image of a black swan. This refers to a term popularized by the mathematician Nassim Taleb, author of "The Black Swan: The Impact of the Highly Improbable". The essence of Taleb's *Weltanschauung* is that conventional risk measurements (like Gaussian distributions) are useless in that the only risks that really matter are the ones we cannot anticipate and thus cannot measure – the eponymous "black swans".

On the other side of the bell curve image there is a depiction of the Chinese phrase "wei ji", commonly translated as "crisis" but actually consisting of the two characters for "danger" and "opportunity". We would elaborate on this except that it seems blazingly self-explanatory given our present circumstances. Yes – to quote a tried and true Old Russian proverb, those who don't risk anything will never drink Champagne.

But for those who prefer their images to be a bit more tangible and down-to-earth, well, there's a tempest at sea girding the left side of the panel and a calming sunrise as its twin bookend on the right. The confusion and violent passions of the storm, these things pass and yield to the clarity and serenity of the morning light. It has always been thus, and always will be. In the meantime settle in and buckle up – we're in for the ride of a lifetime.

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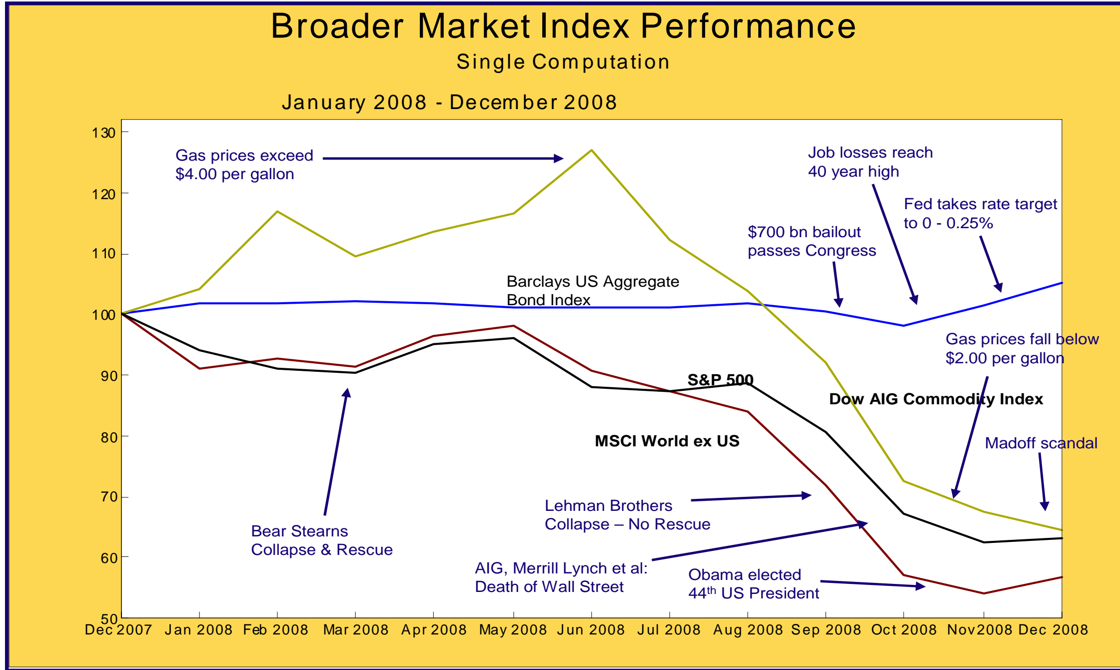
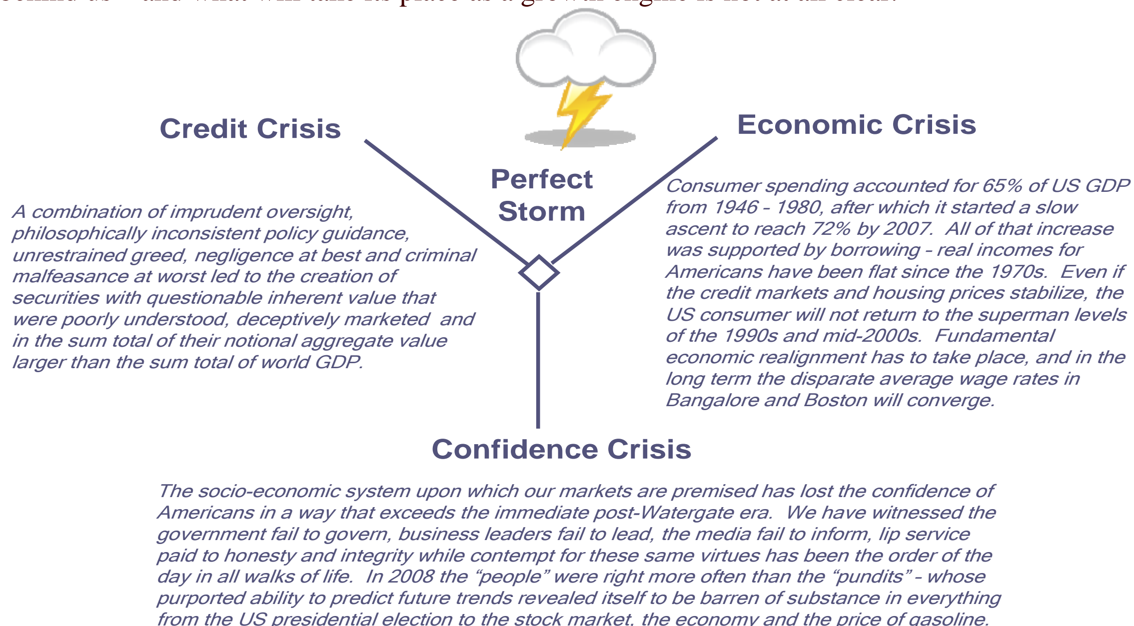
2009 market thesis: Surviving the perfect storm



Source: Zephyr & Associates LLC. Indexes are not directly investable. Past performance is not a reliable indicator of future returns.

In 2009 investment markets will have to weather the unusual confluence of three disruptive forces, each of which could be damaging in its own right but together make for a perfect storm: a *credit market crisis*, an *economic crisis* and a *confidence crisis*. Well-intentioned but ultimately misguided policies over the past 20 years have sought to eliminate the downside of natural business cycles, which involved a near-continual build-up of leverage in our system, ultimately to unsustainable levels. The dominance of debt-fueled consumer spending as an economic driver is behind us – and what will take its place as a growth engine is not at all clear.



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US Equities

- We look for 2009 to be another difficult year for US equities as considerable downward pressures exist to temper the market's upside potential. At a P/E ratio of 19.4x 12 month trailing earnings and 12.2x forward estimates (as of February 3) the S&P 500 is not exactly cheap (it was 18.2x TTM a year ago). The four-month freefall in the "P" of P/E has been commensurately matched by the fall in "E", as evident in the dismal stream of earnings numbers being revealed now. ***Recommendation:*** Retain underweight allocation to domestic equities but maintain sufficient exposure to participate in any possible uptrends. For core portfolios maintain roughly equal weight between growth & value and allocate more to large cap than to small-mid cap. Tactical overlays weighted towards growth/technology may prove opportune, but also likely to carry higher than average volatility and not appropriate for more income-dependent portfolios.

Fixed Income

- Fixed income markets that were *not* US Treasuries suffered in 2008, with yields on high-grade corporate and municipal bonds at historically high spreads to the risk-free rate. We look for that to change in 2009 as the credit markets grope their way towards a return to normalcy. In our opinion there is reasonable potential for diverse classes of fixed income securities to outperform stocks this year – with a high level of probability to do so on a risk-adjusted basis but also with potential to do so outright. ***Recommendation:*** Maintain overweight positions in core fixed income with focus on investment grade corporates, municipals and agency mortgage-backed securities, and default weights for high yield and non-US plus.

Non-US Equities: Developed

- Most of the developed world is in recession. European economies face an ongoing reckoning in the financial and related sectors, with the United Kingdom and Spain being particularly vulnerable along with the Nordic countries. Although further outright failures along the lines of Iceland are not a high probability event in Western Europe they are not inconceivable either. Japan continues its depressing 17 year road to nowhere. The downturn may prove to be shallower for developed Asia/Pacific ex Japan. Currency trends will favor the US dollar barring a worst-case scenario of Treasury dumping by foreign central banks – but this will likely reverse later on when the cost of the stimulus and financial bailout programs come due. ***Recommendation:*** Retain underweight allocations to developed international equities.

Non-US Equities: Emerging

- Emerging economies in 2008 showed that global capitalization – the decoupling of regional and national economies from the fates of North America and Western Europe – is an idea whose time has not yet come. However what these economies *have* done is to decouple regionally from each other. Emerging Asia, led by China, suffered most directly from the downturn in US consumer spending. Russia was dragged down by plunging commodities prices while Eastern European economies caught the Iceland disease and are variously susceptible to further weakness or outright collapse. Latin

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America's heavyweight economies – Mexico, Brazil and Chile – appear to be in better shape. ***Recommendation:*** Maintain strategic weightings for emerging markets equities with no explicit overlay positions. Also note that Israel, Taiwan and South Korea are likely to be reclassified (including by MSCI, our primary international benchmark) as "developed" within 1-2 years.

High Volatility Alternatives

- As bad as it was for equities in 2008 commodities performed even more poorly as measured from peak to trough. Most of that was due to the sudden collapse of oil prices in late summer and the acceleration of futures bets against recovery in the wake of global economic contraction. China's real GDP for 2008 plummeted to half its 2007 pace (though still quite healthy when compared with much of the rest of the world). We look for ongoing softness in oil and industrial materials, though precious metals, natural gas and other commodities could provide stability. As for REITs, we assess the downside vulnerabilities to continue to be more impactful than near-term upside potential. REITs primarily reflect commercial, not residential real estate trends, and in important sectors like tourism, malls and business offices in major urban areas the trends are not attractive. ***Recommendation:*** Retain default strategic allocation to commodities for low correlation purposes. Maintain strategic exposure to REITs for diversification and income-generating properties, though slightly less than long-term default weightings would be appropriate.

Low Volatility Alternatives

- Equity market neutral and various arbitrage strategies did better than long equities in 2008 though generally fared more poorly than the broader bond market. Hedge funds experienced liquidity risk problems and remain an ongoing concern for structural and regulatory reasons. Registered low volatility mutual funds should continue to provide a partial hedge against long equity positions. ***Recommendation:*** overweight registered investments with traditional low volatility exposures e.g. market neutral, covered call, event arbitrage. Avoid hedge funds, fund of funds and private equity.

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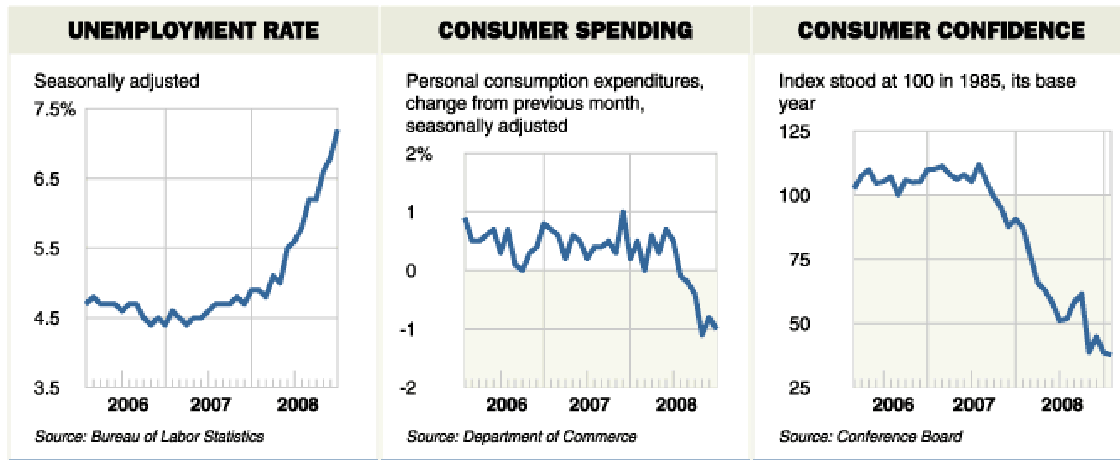
The economy: The long, deep plunge



Source: The Wall Street Journal; Bureau of Labor Statistics; Dept. of Commerce; Conference Board

The era of the hyperconsumer

Ours is a consumer economy – it is in fact the most consumer-centric economy the world has ever seen at any point in the history of civilization. Historically personal consumption reliably accounted for about 65% of our total real GDP: it was this amount give or take a few basis points virtually every year from 1946 to 1980. Even that was high relative to other world economies – personal consumption in France, for example, accounts today for about 55% of total GDP. So we're a nation of catchy ad jingles and product-pushing hucksters – it's in our national DNA and probably always will be.

But from 1980 to 2007 US consumer spending went on a tear, steadily rising from 65% to just under 72% of GDP over that period. Consumer spending has been *the* growth engine for the last 28 years of our economic history. That's what makes the charts shown above so unsettling. The debt crisis of 2008 pushed into hyperdrive what would have been a longer term trend in any case – the diminishing of consumer spending power brought about by stagnant incomes, overstretched budgets and maxed out credit cards. Now the question is – how fast does our economy fall back to that long-term norm of 65% personal consumption? And the more important follow-on question: what will fill the growth vacuum left by debt-driven discretionary spending?

The asymmetric punchbowl

It all seemed to happen so fast. One minute we were happily running up the tab for every imaginable piece of consumer frippery and remodeling our kitchens and bathrooms in such a determined fury that one would think the future of civilization depended on the number of gold-plated shower faucets we owned. The next minute we couldn't even get a used car loan without a perfect credit score. In fact, it is not all that surprising to witness the speed at which this all happened when one thinks about the financial policies that governed our economy since the late 1980s – a little bit after the time that Paul Volcker left his post as chairman of the Federal Reserve Board of Governors and was succeeded by Alan Greenspan.

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Not that we wish to pin the whole story on poor Mr. Greenspan, who has endured much maligning in the recent public discourse. But the Fed's policy during this time was a big part of the story, namely, the belief evolving to consensus wisdom that the natural business cycle could be manipulated in a way to essentially eliminate recessions – or at the very least smoothed into a mild "soft landing" that would last a couple months before the economy went back into growth mode. This led to an asymmetric approach to using the levers of monetary influence, primarily short-term interest rates. The approach was to leave the punchbowl (i.e. low interest rates) around as long as possible until the party really started to really get out of hand, then take it away just long enough to let things quiet down a bit, then bring back more punch to let the good times roll all over again.

Mr. Greenspan and his likeminded policymakers professed to be devotees of the Efficient Markets Hypothesis – the idea that economic markets are always priced perfectly to reflect the true value of goods and services (including financial services) based on all known information relevant to price formation. Yet the practical manifestation of their dogma seemed to be that the EMH worked only when prices were going *up*. When things went the other way somehow the markets were "wrong" and they, the policymakers, knew best how to fix it. And the fix was always the same thing: more borrowing – more consumer, business and municipal credit sloshing through the system.

In 1990-91 that approach made a potentially severe credit crunch much milder. In 1994 it seemed to beautifully navigate a possibly overheating economy into that fabled "Goldilocks" state – not too cold, not too hot. In 1998 Greenspan, Larry Summers and Robert Rubin apparently "saved the world" (according to *Time* magazine) by bailing out the failing hedge fund Long Term Capital Management, ensuring that the financial system would still have plenty of liquidity to keep us on our daily rounds of mall visits and Disney World holidays. In 2001 the Fed quickly made liquidity very available in the wake of the 9/11 terrorist attacks, then kept interest rates at those historically low levels until 2004. In effect the Fed plunked down the punchbowl, said "party on" to Wall Street and left the room.

Goldilocks and the trillions of derivatives

In 2004 it was time to engineer another "soft landing" in the spirit of 1994 – Goldilocks *redux*. The housing bubble was in full swing and a plethora of brand new financial innovations – mostly derivative debt instruments linked to underlying cash flows from mortgages and a variety of other cash flow sources – had flooded the debt markets such that the cost of borrowing at nearly any point along the duration curve was extremely low. One of the most popular innovations was the technique of pooling long-dated assets – mortgages, student loans, municipal obligations and so forth – and selling securities backed by these assets to investors in the short-term debt markets. Short-term debt investors look primarily for liquidity and safety and traditionally didn't venture further than Treasury bills, bank money market funds or high-grade commercial paper. But they were attracted to these new instruments that promised the same liquidity with better yields. Erroneously, these securities were marketed to investors as cash equivalents – an error that became all too apparent in mid-2007 when these markets froze and that promise of certain liquidity turned out to be a hollow promise indeed. Auction Rate Note holders know exactly what we are talking about.

Thus while the Fed engineered its target Fed funds rate up from 1.5% to the eventual peak of 5.25% in the summer of 2006, rates on long-dated debt obligations remained low and the yield curve turned sharply downward-sloping. Credit spreads on all but the junkiest of junk debt were

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negligible. In 2005-07 more than 5,000 private equity transactions brought more than $1.5 trillion of new debt into the high yield bond market. The notional amount of credit default swaps, a form of insurance against corporate default packaged as a tradable debt security, reached the unfathomable sum of $62 trillion – more than $10 trillion *more* than the sum total of the entire world's GDP. All the while the real estate bubble turned ever more frenetic. The usual *fin de siècle* stories showed up in the press about desperate homebuyers throwing new Porsches into the package along with ridiculous top-dollar bids for prime and not-so-prime properties. The savings rate turned negative and consumer debt as a percentage of household income rose well past 100%. And then it all went bust.

Bernanke, Bernanke, lama sabachthani?

'Why have you forsaken us?' they cried. Listen to an embittered Wall Street survivor or a stressed-out money manager for more than a couple minutes and you'll hear a common refrain – it (the market crash) was all because the government didn't bail out Lehman Brothers in September 2008. In terms of short-term cause and effect there is some truth to that. After bailing out Bear Stearns in March the government's non-action when Lehman came up empty-pocketed spooked the financial markets and probably was the main catalyst for the tailspin of October when the Dow lost over 2500 points and credit markets essentially stopped functioning.

But what if they had stepped in and bailed out Lehman? The Dow might – *might* have closed above 10,000 for the year. But the banks would still be on the edge of insolvency and the consumer would still be tapped out. It might have taken longer to get to where we are, but the trajectory was not going to change. The banking system itself was careening towards insolvency, and the pass on Lehman Brothers simply focused laserlike attention on just how bad it really was.

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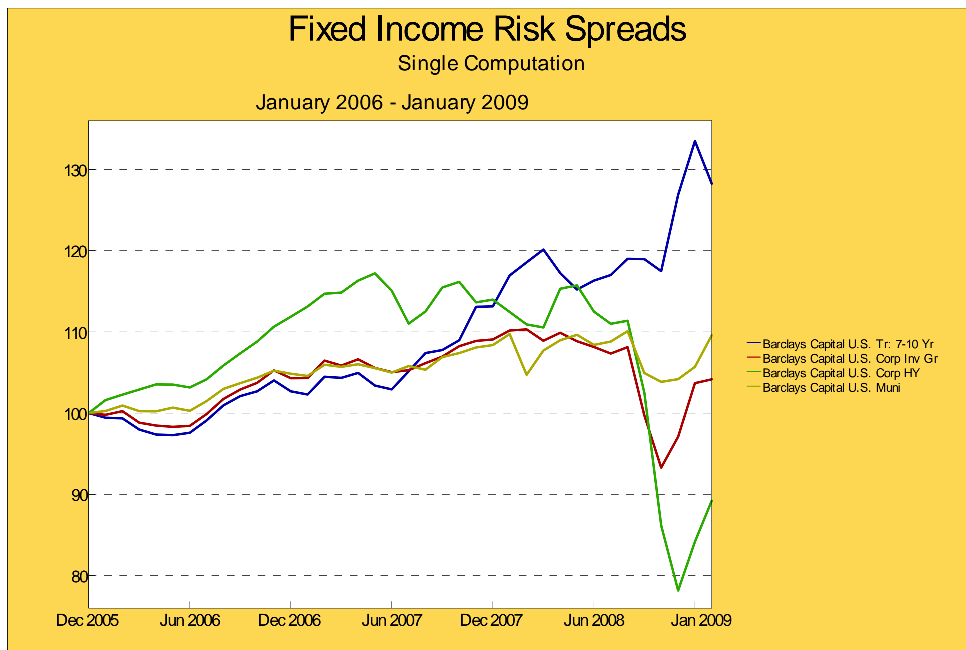
The long road back: Markets in 2009

We believe the economy is not going to revert to its former ways anytime soon, and even when the daily flood of bad news abates we are not going to see a swift resumption of debt-fueled binge consumption to lead the way. Real economic re-alignment is going to take time and is going to be fraught with challenges along the way – not the least of which will be the ability of public sector policymakers and private sector business leaders to rise to the challenge in a responsible fashion.

But that is a debate for another venue. Here we are concerned about what the economy is likely to do in 2009 and what that means for the investment markets. There are alternative possible outcomes depending on how the following scenarios play out.

Stability in the credit markets



In our view the *key determining factor that will influence market performance in 2009 is the extent to which credit markets recover to a reasonable equilibrium of borrowing and lending*, which in turn depends a great deal on how effective the government's various programs are going to be.

Let's stop here for a moment and just briefly take stock of what exactly the government is planning to do. We hear "bailout", "recovery program", "stimulus" and a bunch of other terms thrown around and after awhile they start to blend together. In fact the financial recovery program and the economic stimulus are two different things. Of the two, the one more important to the health of the financial system is the financial recovery program. This really isn't one "program". It includes the Troubled Asset Recovery Program (TARP) that was signed into law last October and half of which is yet to be distributed. It is also the upcoming Obama administration plan for helping the banks to restructure their balance sheets and capital adequacy, the details of which are slowly emerging. Finally, it is all the unusual monetary policy levers that the Fed has been pulling to stimulate growth in lending markets. Economists are putting a price

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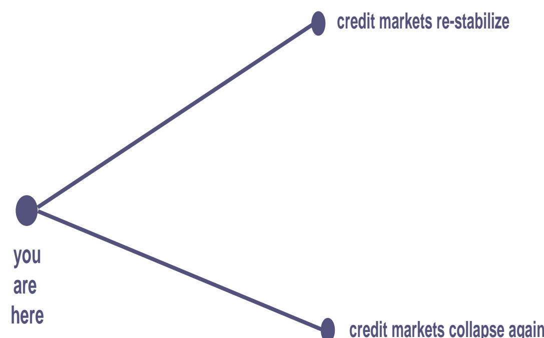
tag of around $2 trillion on the total sum of these measures. That does *not* include the $800 billion or so that makes up the current version of the economic stimulus package still being run through Congress.

Credit markets will not recover to anything remotely like their frenzied level of activity in the middle years of this decade. But that is not our threshold for "reasonable equilibrium". Reasonable equilibrium simply presumes the following features:

- Financial institutions are making loans to creditworthy businesses and individuals,
- The relationship between lending rates for basic financial products – such as mortgages, commercial paper, rated corporate bonds and municipal debt – and underlying benchmarks like Treasury notes are closer to long term norms than to the spreads prevailing for much of the past six months or more,
- Financial institutions have demonstrably adequate levels of Tier I and Tier II capital (as set forth at minimum by applicable BIS capital adequacy ratios) to provision against their risk-asset portfolios.

In our scenario analysis for 2009 this is the first critical juncture.



Our base case scenario assumes that this equilibrium will reappear. How the financial sector gets back to that position – whether via a good bank/bad bank structure, or quasi (or even outright) nationalization of banks, or some other mechanism is of less concern than the simple fact of that equilibrium being restored. That brings us to fixed income investments – the first port of call in our assessment of prospects for investment markets this year.

Fixed income as performance driver

In most years the fixed income category is an afterthought – that big lump of 20% or 50% of a portfolio that results from an investor's risk tolerance. In most years this big lump serves as the brakes on otherwise-achievable returns from equities. But this year is not like other years. ***In our opinion, this year meaningful achievable returns for the overall portfolio may derive in large part from fixed income positions – moreover, from fixed income positions that are higher in credit quality (and therefore usually not very exciting) like investment grade corporate bonds and municipal debt.***

The government appears fully ready to throw as much money as it can at every problem it can perceive. That money will get thrown at long-term Treasury bonds, government agency

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obligations (particularly agency-backed mortgage securities) and all manner and variety of bank debt, which the government will likely continue to own more of as the year progresses. Now, this is not money that we currently have sitting in our coffers. Most of what we throw at the debt markets is money that we are either going to borrow from our usual overseas suppliers (China, Japan and the Gulf petrostates) or simply going to print. Printing money is something that never happens without adverse consequences – but those consequences are for another day. For this day, the most likely result of throwing money at numerous classes of high quality debt is that the value of these debt classes will appreciate in the aggregate. *We believe these massive spending proposals – in the US and also in other markets – are more likely than not to restore stability and functionality to the credit markets and avert a total collapse of the financial system.*

In view of this belief one of our key allocation decisions made for 2009 has been to seek optimal positioning among diverse high quality debt classes, including the aforementioned agency-backed mortgages, bank debt and (particularly for more risk-averse portfolios) long and very long-dated Treasuries, as well as investment grade corporate bonds. We have done this in two ways. First, in our core portfolios, we have allocated weightings into these asset classes. Second, we have reallocated part of our cash positions, built up before and during the market meltdown in autumn last year, into flexible overlay positions in these asset classes.

We are not taking overly aggressive positions in more speculative areas of the fixed income market like US high yield debt or emerging markets bonds, as we believe many of the risks that caused underperformance in these sectors in 2008 remain in place. Credit spreads for private equity debt – the massive amount of borrowings that fueled the leveraged buyout boom in the middle of the decade – were averaging over 1000 basis points at the end of 2008, a level that indicates the market's expectations that the issuer will default. Despite this, *we think it is prudent to maintain exposure levels here roughly in line with longer-term strategic allocation weightings.* US high yield debt could be a leading indicator of the equity market's eventual return. A sustained improvement in this market, perhaps indicated by a revival of private equity activity, would send us a signal that recovery in the equity markets may be not far behind.

So credit markets stabilize – what next for equities?

So if our base case is correct for that first node on the decision tree, what happens next in the equity markets? At some point, we expect that a good portion of all the cash sitting on the sidelines will find its way back into stocks. However that is less likely to be a steady flow than a series of fits and starts. There are a number of factors on the near-term horizon that we believe

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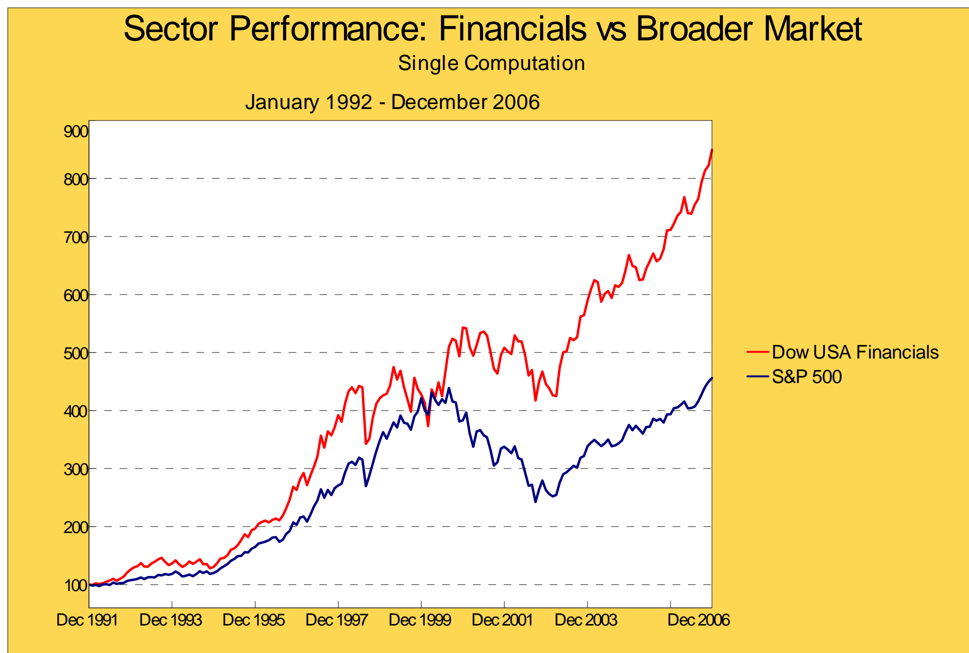
will tamper any wild exuberance in equities and keep intermediate rallies short-lived rather than indicative of a longer-term bear trend. Here is a description of some of the key factors:

Corporate earnings are likely to remain bleak for some fiscal quarters ahead as companies continue to deal with the realities of diminished consumer spending and high unemployment. Since earnings are the "E" of P/E and since despite the market crash last fall P/E ratios are not ridiculously cheap (compared with those prevailing in the mid-1970s, probably the most appropriate basis for comparison) we expect rallies in equities to be brief with a tendency to revert to lower levels.

2008				**2007**			
Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
-151%	-62%	-36%	-30%	-56%	-24%	14%	10%

Source: Wall Street Journal Market Data Group
Chart shows year-on-year change in aggregate net earnings on continuing operations for all reporting companies: i.e., Q4 2008 shows the change from Q4 2007 to Q4 2008.

Market leadership is likely to be a bit of a mystery going forward. In the 1990s financial institutions, consumer format innovators (such as Gap and Best Buy) and then the technology sector carried the leadership mantle. In the 2000s the financial sector, housing & construction and the energy sector all pulled the market forward. The common thread to both of these sectors was the contribution of financial institutions. However we think that *financial stocks are at the outset of a new macro phase where their contribution to the overall market (measured by market value) will diminish*. That leaves a likely leadership vacuum.



End of the ***value effect***? The question of market leadership plays into a larger question about one of the most enduring anomalies in the market for more than 30 years – the so-called "value effect" where value stocks – those with persistently cheaper valuation measures like price-to-book value – outperform growth stocks over practically all mid-to long-term time frames. The reasons for the value effect have been much debated by academicians and investment

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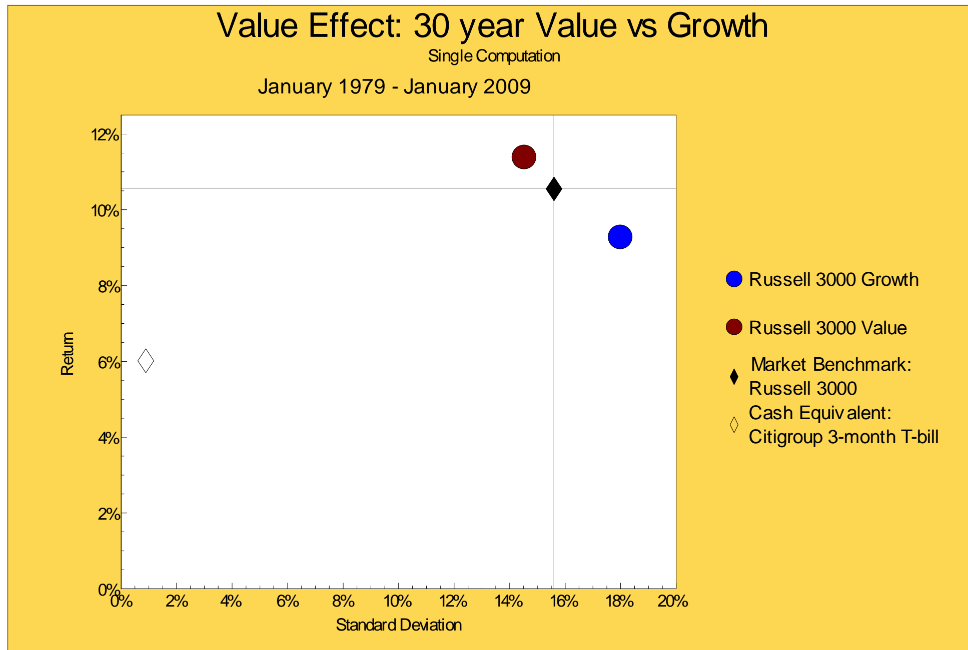
professionals: in theory, continual outsized gains in any discernable asset class should be arbitraged away by rational investors, but on the other hand the accumulated evidence of the past ten years of market performance seems to have delivered the death knell to the time-honored Rational Man theory. It is too early to pronounce the value effect dead, but the traditional sectors that drive value stock indexes – financial services, energy and industrial materials being prominent among them – will be less likely to drive overall performance. We bring this up because our strategic default weightings carry a value bias – and we need to closely monitor the advisability of this.



Can the ***government's massive stimulus plans*** pull up the stock market? To the extent that we see near-term opportunities in equities it is more likely than not to be in areas like technology-related areas like diversified or alternative energy, healthcare IT, broadband technologies and related sectors. We see these benefitting from a combination of two factors: first, they typically rely less than other industries on debt financing (so less likely to experience severe hardship if they cannot raise debt on attractive terms or at all); and second, they will likely be the beneficiaries of the specific areas the Obama administration has targeted for major investment ($10 billion each year for the next five years in healthcare IT alone). We will monitor these areas closely and may engage in tactical peripheral positioning over the course of the year if and when deemed opportune.

Be careful what you wish for: The perils of the upside

Is it possible that the economy actually isn't as bad as the consensus now thinks it is?

The possibility does in fact exist. Some economists have looked at the ISM non-manufacturing numbers for January and seen in the result – a reading of 42.9% – a scenario with upside surprise. The ISM reading is a gauge of the broad services sector, which comprises about 2/3^{rds} of the economy. 42.9% indicates a slight contraction but pre-release expert estimates had been for a lower number. This does not translate into a widespread belief that the economy is poised for a quick rebound – that is a distinctly minority viewpoint. The argument behind this idea, though, is

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that expectations for a quick turnaround in the financial markets are causing businesses in the service sector to position themselves for an upturn in demand.

We don't think that is a high-likelihood outcome: however, it is possible. Here's the peril in that scenario, though – a quick rebound in the private non-financial economy, combined with the expansionary effect of an estimated $2-3 trillion in stimulus – could send the economy into inflationary hyperdrive. We do not think this scenario is going to play out because there are far more numerous indicators of prolonged slump and deflationary rather than inflationary pressures – but if it were to occur then it would warrant a rapid adjustment in tactics: inflation hedges like TIPS, commodities, energy and technology stocks would be the destinations for tactical overlay positions.

The US and the world

In late 2006 we at MVCM issued a research paper on "emerged markets", arguing that the age of global capitalization was upon us. This was to be an age when global regions – the Asia Pacific Region being foremost among them – would attract the co-location of capital, consumer and production markets within a close geographic configuration, reducing and eventually eliminating the old adage that emerging markets catch cold when the US sneezes. It turns out that our idea – while still compelling for a number of reasons and likely to prevail over time – has been put on hold by the global economic crisis.

While we remain optimistic on the long-term prospects for ***emerging markets stocks*** we do not think that 2009 will be a year when significant gains are made in most of the major markets. China's real GDP growth, while at 6.8% still enviable when compared to most of the rest of the world, is half of its recent trendline performance. China is going to continue to need to deal with the effects of a US consumer spending slump, and it also faces a serious potential social crisis at home in the form of dealing with the literally millions of workers who migrated from rural villages to work in large industrial centers like Shenzhen and Shanghai. Managing any kind of a massive safety net for displaced workers could present an extreme challenge to the government's much vaunted stability. One school of thought we have seen is that anything less than 8% growth implies a potential social disaster for China – this bears close scrutiny as China is the world's second-largest economy as measured by purchasing power parity.

Meanwhile two of the other three BRIC components are also dealing with myriad local challenges. India has domestic problems with the Satyam scandal and its outsourcing industry will continue to feel the negative effect from weakness among US financial institutions – a key client source. Russia's economy – as dependent on oil as it ever was and having very little in the way of competitive value-added industries, is in as fragile a state as it has been since the debilitating financial crisis of the late 1990s. The government does have significant foreign exchange reserves – a cushion it did not possess in August 1998 – but is spending these frenetically to try and shore up its domestic financial institutions – a worrying sign of future developments.

Although emerging markets have shown that they are not yet immune from economic trends in the US and Western Europe, they also have demonstrated that they are not a single monolithic asset class. During the successive Asian, Eastern European and Latin American crises of the late 1990s this was not the case – emerging markets generally moved as one. As the emerging markets landscape improved in the early and middle part of this decade the bellwether investment

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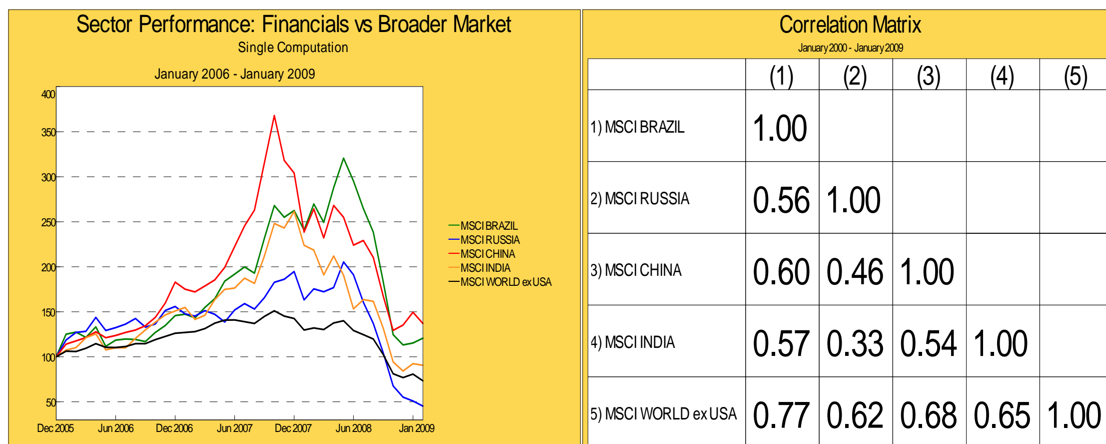
was BRIC. However as we have just discussed BRIC is an amalgam of vastly different influences and variables.



Correlation Matrix

January 2000 - January 2009

	(1)	(2)	(3)	(4)	(5)
1) MSCI BRAZIL	1.00				
2) MSCI RUSSIA	0.56	1.00			
3) MSCI CHINA	0.60	0.46	1.00		
4) MSCI INDIA	0.57	0.33	0.54	1.00	
5) MSCI WORLD ex USA	0.77	0.62	0.68	0.65	1.00

As a proxy for the entire notion of "emerging markets" BRIC does not hold the same validity today that it did in 1998. When we at MVCM pioneered the use of emerging markets baskets with regional and thematic orientations it reflected our thinking on the antiquity of the BRIC formulation, and that thinking appears very appropriate to the market structure today. Our focus has been to segment emerging markets exposures into economic leaders (both by size, such as China, and by infrastructure maturity, such as Chile, Israel and South Korea), mid-transitional countries like Thailand and Mexico, and frontier markets such as Egypt and Turkey. We have pioneered tactical overlays using this methodology and will continue to do so when market conditions warrant.

However we are not emphasizing tactical emerging markets baskets in 2009 portfolio construction. This is a move in keeping with our overall view on equities as an asset category this year.

Troubles in the "developed" world

Non-emerging international markets do not present much of a compelling story today, and indeed we are researching what the optimal mix of developed and emerging exposures should be going forward as the global economy settles into its new phase. In 2007 and indeed for the better part of the decade the MSCI World ex USA index outperformed the US market due in large part to currency-related benefits. In due time this currency benefit is likely to arise again – namely when the bills on our massive spending plans for this year come due. But that is a story for the future, not for today.

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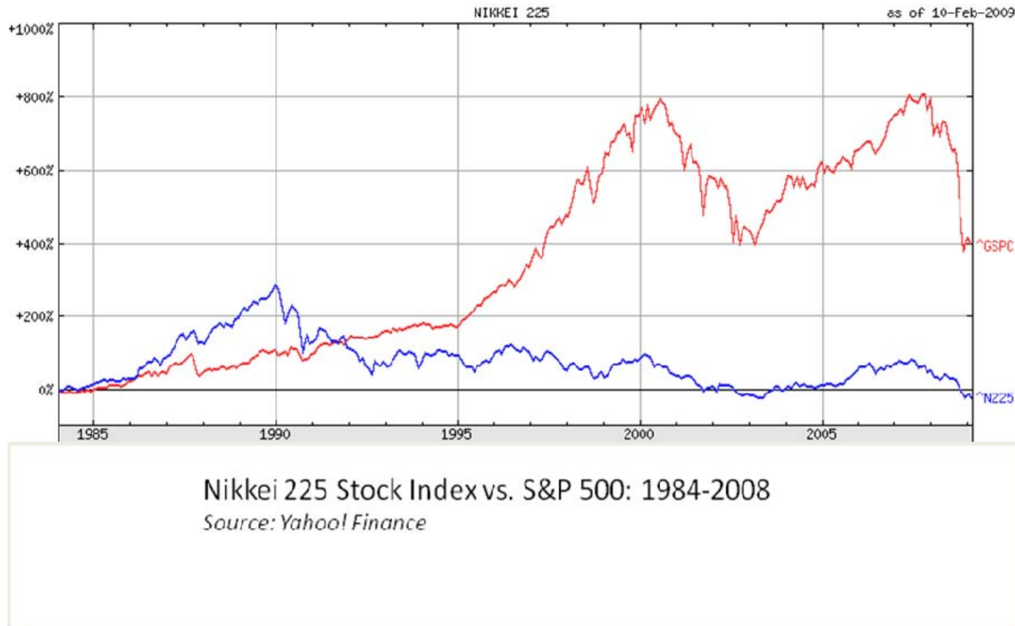
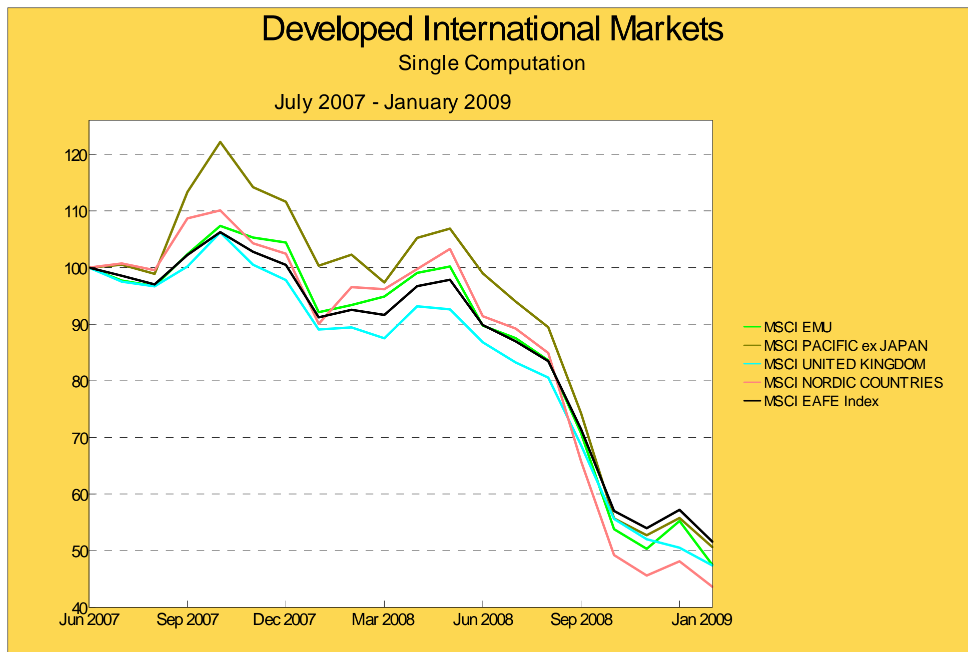


Nikkei 225 Stock Index vs. S&P 500: 1984-2008
Source: Yahoo! Finance

Among the developed markets Japan continues to validate the views of those who see its economy as being in terminal decline. The Nikkei Stock Index trades around a 28-year low (see chart above: by comparison, for the US market to trade at such a long-term low point would imply a DJIA reading below 1,000). The yen's rise of more than 20% in the past two months has dealt a very tough hand to the export sector that still sustains the economy. The currency's rise is a natural outcome of the convergence of global interest rates – as rates have plummeted in other countries the desirability of foreign currency-denominated debt has lessened for Japanese investors, who have repatriated exposures back into home currency instruments. In essence the country never really recovered from its protracted slump in the 1990s – and it is very hard to see such a recovery on any near-term horizon.



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In Europe the Eurozone is a mixed bag. Europe's financial institutions have been no less hard hit by the housing and credit markets meltdown than have their US compatriots. Countries like Spain and the Nordic countries – more prone to mortgage mania than others in the region – are faring generally worse than Germany, France and other central European areas – though Germany in particular is suffering from an export slump. In addition many of the central European territories are those hardest hit by energy disruptions arising from the ongoing natural gas geopolitical warfare between Russia and Ukraine. Outside the Eurozone, the UK economy is in freefall and the pound sterling is at historic lows against the Euro.

Surveying the developed international landscape the only place where we imagine any significant re-weighting upwards in the medium-term horizon is in the developed Asia Pacific region ex Japan. Although markets in this region have suffered along with the rest of the developed world (see chart above) the cornerstones of this region – Hong Kong, Singapore and Australia – will in our opinion continue to serve as the financial backbone of the region – and in the long term we see little to dissuade us from seeing this region as the leader of world growth once the global economy has hit bottom.

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The big picture: asset class allocation strategies yesterday and tomorrow

We conclude this paper by peering briefly into the world beyond 2009. As we have maintained throughout this report, we believe the events of 2007-08 will have far-reaching effects on financial markets and that these effects will continue to be felt beyond the next twelve months. As investment professionals we must ask ourselves: how are these developments likely to affect our strategic planning beyond the decisions we make at the outset of any given 12 month period? These are not easy questions and they don't present us with easy answers.

Our approach at MVCM has always rested on the foundation of strategic returns-based asset allocation. Although one can say much about the details of this strategy the distillation of its essence is simply this:

- Equities offer the potential for higher returns in the long run, but can be subject to intense volatility in the short term, so the equity-fixed income mix is the appropriate starting point for tailoring portfolios to specific risk tolerance levels,
- Both equities and fixed income securities can be further refined into identifiable styles – asset classes with common characteristics that when combined with other asset classes can produce risk-adjusted return as well as low correlation benefits,
- In addition to traditional style benefits it is possible to identify other distinct features of asset groupings for risk-return positioning. Geography, economic sector and theme are examples of what we broadly call "location" positioning.

The cataclysm of 2008 required that we take a hard look at the assumptions underlying our strategic positioning. For example we argue that "in the long run equities should outperform bonds" – but what exactly is the long run? At the end of 1932 the Dow Jones Industrial Average was lower than its level at the close of 1903 – a period of 29 years. As noted earlier in this report Japan's Nikkei Stock Average has suffered a similar fate today. 29 years qualifies as a "long run" in the minds of many – all sorts of financial time horizon events like college educations, starting a new business or retiring from the rat race all can come up within such a span of time.

We may say that the probability a similar fate to the Nikkei befalling the US markets today is quite low – but 2008 showed us that sometimes conventional probability analysis is spectacularly unhelpful while the Black Swan model – the risks we cannot identify and quantify – prevails. Moreover – and this is one of the fundamental tenets of the Black Swan way of looking at things – we cannot say that 29 year span in the first decades of the 20th century is "as bad as it can get" – it is merely as bad as it *has been*. In fact Nassim Taleb, the *Black Swan* author, was quoted during an interview on the *MacNeil-Lehrer News Hour* last October 21, opining that the present economy was – forget the Great Depression – worse than any time since the American Revolution! Now we don't buy that argument – but that doesn't mean that particular Black Swan absolutely could not materialize.

The universe of assets is larger today than it was in the early decades of the 20th century. Even if, freakishly, the US stock market were to take another substantial turn for the worse we have the benefit of access to other assets that under a variety of scenarios should be relatively uncorrelated with US stock market performance – and this gives us a more effective investment toolkit with

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which to work. Over the past eighteen months our portfolios have evolved to reflect a more nuanced understanding of the interplay between different asset classes and sub-asset classes, and also more fluid and flexible means of obtaining and changing desired exposures in the face of the high level of uncertainty our markets and our economy face today.

We are not going to place market timing bets on outcomes before they happen. In the summer of 2008 we thought the risk levels prevailing in the US equity market reflected a downside bias. We believed there was reasonable potential for sharply lower performance. Had we been market timers we could have made a "bet" by going all cash or shorting the market. Had we done so, we would have simply been lucky. Not smart, but lucky – simply a "good guess".

And had we done so only to see the market *not* crash, but rather rise in the 4th quarter, not only would we have been unlucky but we would also have been in violation of our fiduciary investment policy (to invest prudently in accordance with the return objectives and risk tolerance levels of our clients). And that is one outcome we refuse to countenance. When we make tactical adjustments to our long-term strategic default weightings these adjustments are within permissible boundaries – we made such adjustments last year, we are making them this year and no doubt will next year as well. These adjustments are not, and never will be, outright bets on the future direction of the market; a bet that will only ever result in one's being lucky or unlucky. That's a bet we can never afford to make on behalf of the capital with which we are entrusted.

The book is not written on this strange new world of investment management yet – but it is evolving, and you will be hearing much more about it from us as the year progresses.

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We commit to provide unparalleled service, uncommon thinking and uncompromising standards in delivering investment management strategies and solutions tailored to the unique circumstances of each and every client

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