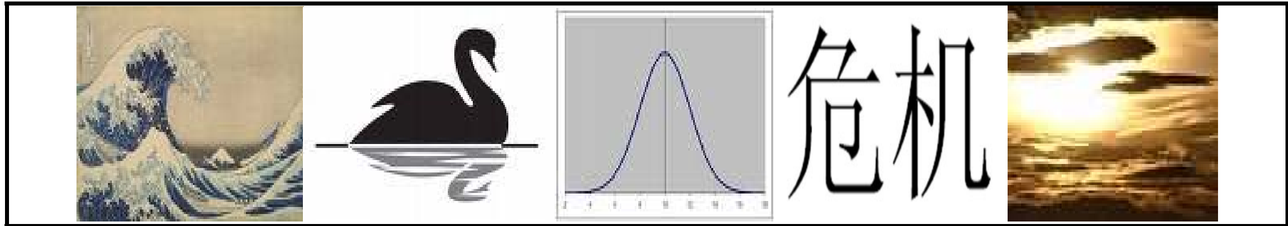


2010: The Year Ahead

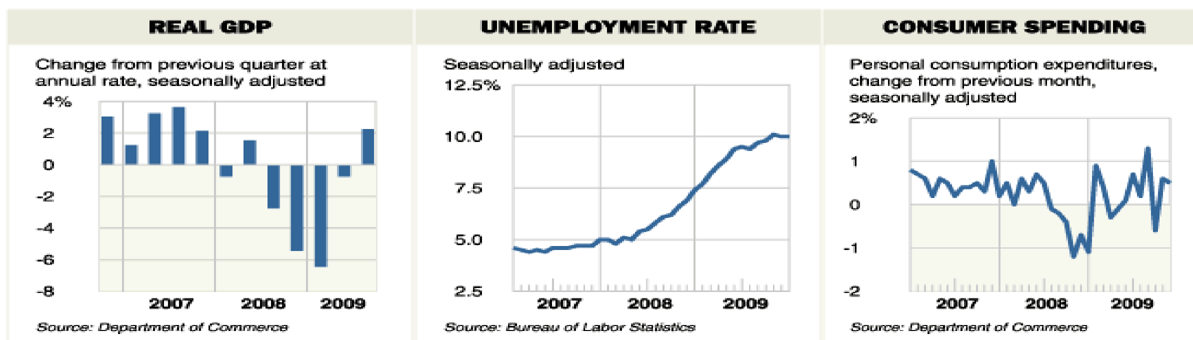
MV Capital Management
Annual Market Outlook, January 2010

Dawn of a New Decade: Fits and Starts

Apocalypse (Not) Now

One year ago the world economy teetered on the edge of the abyss as the financial system upon which it was built appeared headed for systemic collapse. Instead, the system was (at least for the time being) saved by the hundreds of billions of taxpayer dollars committed to the preservation of its largest, most systemically critical (and most politically influential) institutions. As the financial system stabilized businesses cautiously came back to life, conditions in the housing market stabilized and even the eviscerated American consumer continued to buy enough stuff to keep retail sales from falling through the floor. However whether this relative stability will be able to create jobs in sufficient numbers to bring unemployment down from its highest level in 30 years remains to be seen. The economy is precarious. So far the evidence from the steady stream of monthly data points can best be described as "fits and starts" – two steps forward, one (or one and a half) steps back. "Fits and starts" was good enough for world investment markets in 2009 as stocks, bonds and pretty much everything else came roaring back from the low points hit last March. Investors interpreted the lack of truly terrible news as the year wore on as a sign that those 10-15 year lows in March represented a substantial overselling and that we would not be nearing those waters again anytime soon, if ever.

Table 1: Fits and Starts: No Armageddon, but No Elysian Fields Either



Source: The Wall Street Journal Online

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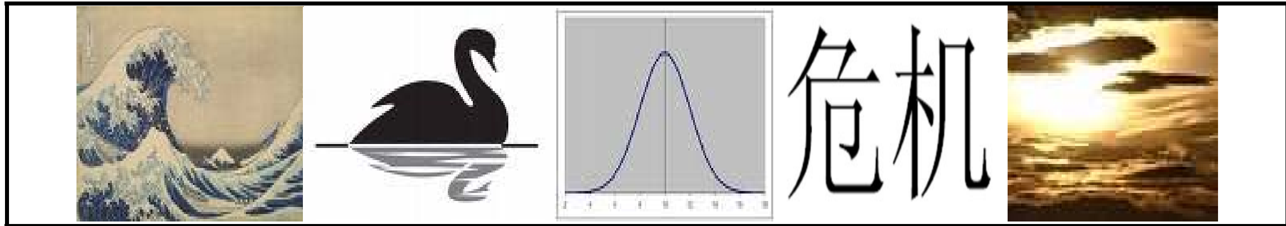


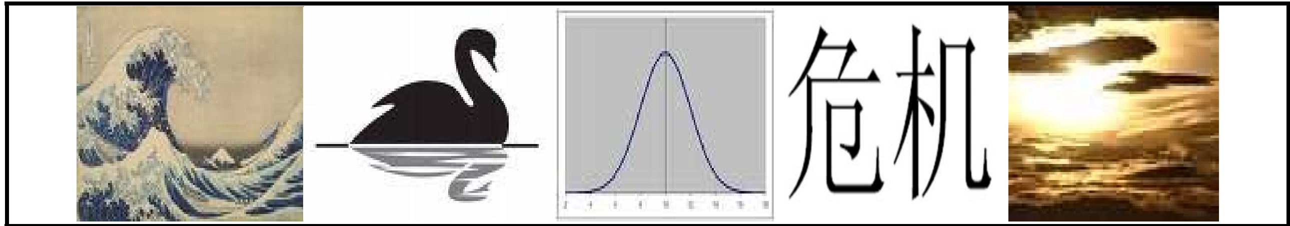
Equities in 2010: Sustainable?

So much for 2009. "Dow 6,000" is no longer a staple of cocktail party conversations. The question now is whether "fits and starts" is a sustainable state of affairs for continued market success in 2010. Stock prices, after all, do not simply move according to their own whims – they are an attempt to reflect the true value of enterprises. That valiant quest for "true value" often misses the mark, but sooner or later the minute details of what generates potential cash flows, upon which that perceived "true" value rests, will necessarily factor into the equation. Enter the Price-Earnings (P/E) ratio, perhaps the most widely-used valuation metric for common stock. It's easy to focus on the "P" – that number flashes before us every day on CNBC (often without much useful information as to what it means). But the fate of the "P" side of the equation depends to a great extent on what happens with the "E". In 2010 that presents an interesting dilemma about what to make of the market's prospects for growth.

At present valuation levels the S&P 500's 12-month trailing P/E is up in the mid-high 40s while the 12-month forward estimate based on analysts' consensus earnings forecasts clocks in at a more reasonable-seeming 14.8x (note: when we say that a P/E is "14.8x" we mean that the current price per share of the company is 14.8 times the current earnings per share of the company). What does this mean? Bear in mind that there are two valid ways to look at P/E ratios. The 12-month trailing number tells you how today's stock prices relate to corporate earnings generated over the past 12 months. There's nothing mysterious about this – those earnings are already historical facts, so the trailing P/E number is grounded in knowable reality. Not so the 12-month forward P/E, which analysts will tell you is the really important number, because it reflects how present stock prices look compared to *future* earnings (and presumably we are more concerned about what is to come than what has already been).

The problem, of course, is that nobody actually *knows* what those future earnings will be. So here come the Wall Street analysts with their complex discounted cash flow models to show us what they *think* earnings will be. Actually, they tell financial data services providers like I/B/E/S, and the estimates are thus compiled and presented to the investing public as a "consensus". The more accurate the analyst consensus estimates, the more precisely the 12-month forward P/E informs us whether stocks at current prices are too hot, too cold or just right, like Goldilocks' porridge. The caveat is that securities analysts are human like the rest of us, and their estimates are subject to human weaknesses (like trimming their own figures to follow the herd and thus not risk sticking out like a sore thumb if they are wrong). Analyst estimates tend to be particularly vulnerable to missing the mark at sharp market turning points (for example they tended to be overly optimistic just ahead of the 2008 market crash and overly pessimistic heading into the post-March '09 rally).

So what can we make of current valuation levels? Regarding the 12-month trailing number (47.0x as of 1/27/10) we have a pretty straightforward answer. The 12 trailing months from January 2010 extend back to the first quarter of 2009, when corporate earnings were dismal and consumer confidence was at its worst levels. That in significant part explains the bigness of 47.0 – a high numerator and small denominator (the 12-months trailing P/E was actually much, much higher than that one or two quarters ago). What turns that big number into a small (and economically sustainable) number like 14.8x is "E inflation", i.e. the growth in the denominator of the equation. But to live up to the expectations embodied in that 14.8x number, corporate earnings will need to be growing at brisk, low-double digit rates over the



rest of the year. So the message here is that conventional analyst wisdom today has corporate earnings producing a nice long string of pleasant surprises (or "exceeding expectations" in their own vernacular) for the rest of the year.

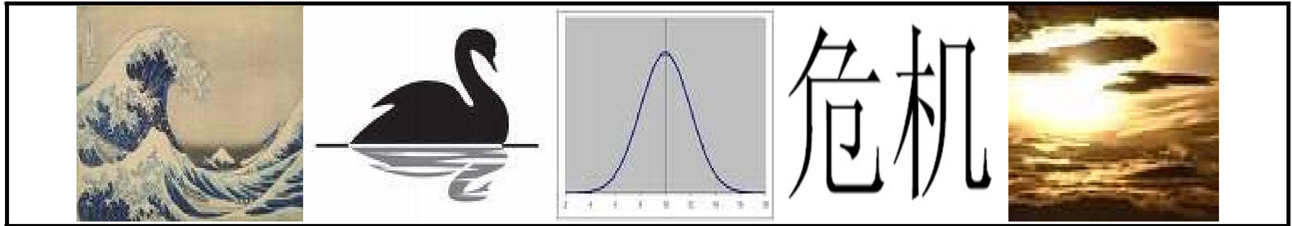
That view seems to us to be at odds with the most likely (in our opinion) story for the economy this year: that there will be some growth in the U.S. but of a decidedly modest nature, with persistently high unemployment and under-employment, a still-high burden of household debt, languishing income and lackluster housing prices keeping a lid on the amount of growth the private sector can attain. In 2009 we saw that the worst-case scenario did not play out, and while that was certainly grounds for a collective sigh of relief we believe there is still a structural realignment of the global economy that is only in its early stages today. The roller-coaster cycles of boom and bust, asset bubble and market crash, are unsustainable as an ongoing economic model. What is to come in their place is still not clear.

Those Wild and Crazy Fixed Income Markets

Stock markets are of course not the only object of interest and scrutiny. Much of the wild action over the past two years has been in that traditional safe haven known as the bond market. In 2008 U.S. Treasury securities enjoyed double-digit returns, while in 2009 some classes of non-investment grade U.S. corporate bonds returned their investors upwards of 80% - far more than the S&P 500 or other stock indexes, and with equity-like volatility levels to boot. There's no such thing as a free lunch, though, and today the bond market is fraught with potentially unappealing outcomes. At the short end of the curve there is literally no money to be made. The Federal Reserve brought interest rates down to zero percent in trying to bring the economy back to life. Through its open market operations the Fed is able to exert a direct influence on short-term rates, and as long as the 0% doctrine remains in effect putting money into short-term fixed income instruments will differ little from shoving wads of cash under the mattress. On the other hand, moving out the duration curve to obtain more attractive yields has its own set of risks. The main risk is that if the economy does start to kick into high gear faster or stronger than appears likely, the specter of price inflation will likely prompt the Fed to begin raising rates again. The relationship between interest rates and bond prices is mathematical: when rates go up bond prices go down. It really is as simple as that. Moreover (and again with mathematical certainty), when bond prices decline, the rate of decline is greater for bonds with longer duration. So the price of obtaining yield benefits at the longer end of the maturity curve may be steep indeed.

Our 2010 View in Summation

In a "fits and starts" economy the most perilous trap into which one can fall is to see a couple isolated data points, extrapolate those into a sustained trend and go overweight in a concentration of higher-risk asset classes thought to be the most likely beneficiaries of that imagined trend. Yes – the decade-long performance of the U.S. stock market over the past ten years was significantly below average and the traditional methods of probability and statistics would bolster the case for better results in the years to come. But there is no guarantee that 2010 will be the year that happens, or even that this decade will witness a full-on reversion to the mean. Japan's Nikkei 225 stock index reached its all-time high of just over 39,000 on the last day of 1989. Twenty years later – twenty years! – it was languishing just above 10,000, or less than a third of its all-time high even before adjusting for inflation. These are things we don't expect, but sometimes they happen. Do we think the S&P 500 is another Nikkei 225 in the making?



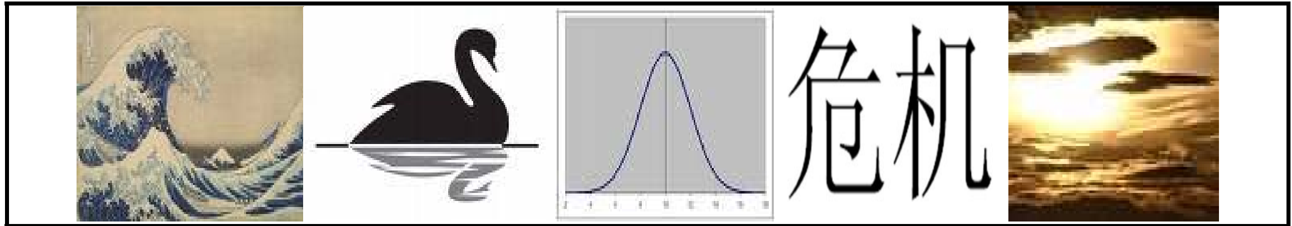
No, we don't. That is not what we consider a high-probability outcome. But is it a possible, albeit very low probability outcome? Absolutely – and our investment approach has to balance the discipline of optimizing portfolios for expected high-probability outcomes with the presence of mind to recognize that low-probability events do happen, and when they do it is necessary to be agile and nimble. *Discipline and agility are our watchwords for 2010.* We can't say whether this is going to be a good year or a bad year, but we feel quite certain that it is going to be an interesting one.

Market Tectonics: 2010 and Beyond

Our investment thesis is not a simple outlook for the coming calendar year, but rather a collection of observations we believe will have an impact over a longer period of time. For the past decade market conditions have been mired in what we refer to as a "gap market" environment, with stocks demonstrating annual average returns over the period significantly below historical norms. As we have described in other market commentaries (see for example our Periodic Market Outlook of May 2009), gap markets tend to persist because of a widespread lack of conviction in or understanding of the existence of a compelling market narrative for growth. Of course this narrative is never clearer than when in hindsight, and any view about the actualization of future trends has to take into account the probability that they will in fact not materialize. Nonetheless, we see certain threads of a fabric coming together, and this is informing not only what we do in 2010 but where we see our asset strategies migrating over the coming years.

- The first decade of the 21st century is behind us, and for many Americans it was a lost decade. The number of nonfarm private sector jobs at the end of the decade was roughly the same as at the beginning, but since the population grew by 9% job creation was effectively negative. Incomes were stagnant, household debt piled up and the S&P 500 was negative on an annual average total return basis. Investors chant the mantra of mean reversion in hopes that things will fare better in the coming ten years, but the challenges and obstacles to a sustained, broad-based, inclusive recovery are still very much with us.

- For much of the world though – especially the so-called "emerging" parts of it – the 2000s were not at all bad and in fact the last ten years witnessed a more massive global rise out of poverty than at any time in recorded history. If your native language is Mandarin Chinese, Hindi or the lilting Portuguese dialects of Sao Paolo, chances are that you are much better off at the dawn of 2010 than you were at the end of 1999. The locus of economic power has shifted. We see considerable economic growth in the decade ahead – with most of it happening in places other than North America, Western Europe and Japan. If, say, you work in some professional services capacity in Boston (e.g. graphic design, financial analysis, journalism, even law), ask yourself what the differential is between your basic hourly unit of compensation and that for a professional doing the same job in Bangalore, India. Then consider who will benefit – and who will suffer – from the Boston-Bangalore compensation convergence resulting from widespread promulgation and adoption of global best practices. This we believe to be a meta-theme of the coming decade.

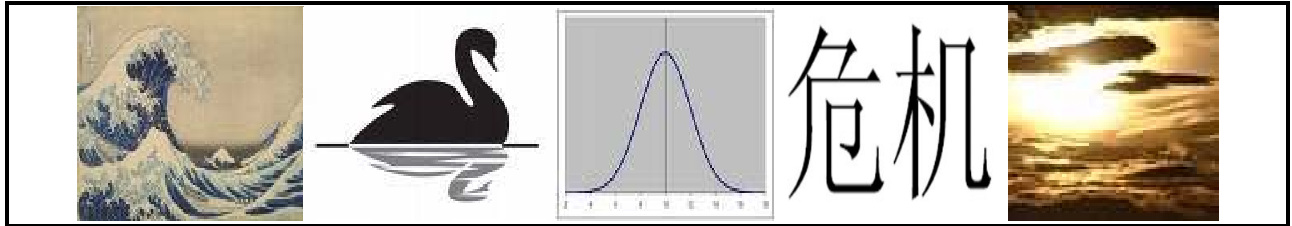


- We also believe that economic growth in the next ten-plus years will be powered by a different model than the one that has held global sway for the past 25 years. In the old model, New York and London served as the axis of a system, the main purpose of which was twofold: (a) to dream up innovative new credit financing vehicles for people (aka "consumers") to borrow and spend more money, and (b) to employ a variety of accessible capital markets instruments like junk bonds to encourage businesses (that in times past would have found it hard to obtain sufficient levels of capital) to invest in making more stuff for those consumers to buy with their borrowed funds. Over and over the spiral went, accompanied by ever more leverage. Consumption as a percentage of U.S. GDP grew to 72% while household debt rose to 133% of household income. Essentially a vast amount of the money raised in the capital markets was put to one of its least productive uses – consumption of goods and services that did little to improve the physical or intellectual infrastructure of the country.

- In the new economic model we see the geographic locus shifting from the New York – London Axis of Leverage to the Cash Triangle, a region loosely running from China and Korea in northern Asia to the southeastern Asia Pacific Rim and then westward to the Indian subcontinent and perhaps the Gulf States (the more prudent ones like Abu Dhabi and Qatar rather than flamboyant Dubai). In a deleveraging world cash is king, and this part of the world contains a significant amount of unleveraged cash. In the Cash Triangle region three critical economic markets are growing in lockstep: consumer markets made up of those billions of humans emerging out of poverty into the middle class; production markets containing some of the world's most advanced manufacturing and services providers imbued with state-of-the-art global best practices; and capital markets to mobilize the high level of savings generated by the citizens of the Cash Triangle and employ them towards productive ends.

- If the U.S. is to be an economic growth laggard rather than a leader, does that mean that U.S. stock markets will have another lackluster decade? Not necessarily. Perhaps 30 years ago it was true that buying the Dow or the S&P 500 meant "buying American" – but those days are long gone. The companies that top the market cap tables on these indexes – the likes of Intel, Microsoft, Procter & Gamble, IBM and Citigroup – these companies obtain an ever-increasing percentage of their revenue and profits from places outside their homeland. Opportunities in the Cash Triangle beckon for these companies. This makes for an interesting – perhaps a disturbing – possible meta-trend for the decade. We see it as entirely plausible that U.S. stock markets could do very well indeed even if the U.S. economy remains mired in intractable problems for years to come. While that may sound comforting to investors, such a trend would inevitably widen the already gaping chasm between Wall Street and Main Street, reinforce a growing conviction that the critical machinery of our system is fundamentally broken, and lead to the unpredictable X-factors of widespread social and civic unrest.

- Of course, not all national companies can achieve success in foreign markets. This could lead to an interesting tiering of stock markets worldwide, where the so-called large cap indexes like the S&P 500 or the U.K.'s FTSE index, the French CAC-40 and the German DAX essentially serve as a proxy for the global economy at large, while smaller cap and micro-cap indexes provide more of a pure play on domestic markets. This has profound implications for asset allocation

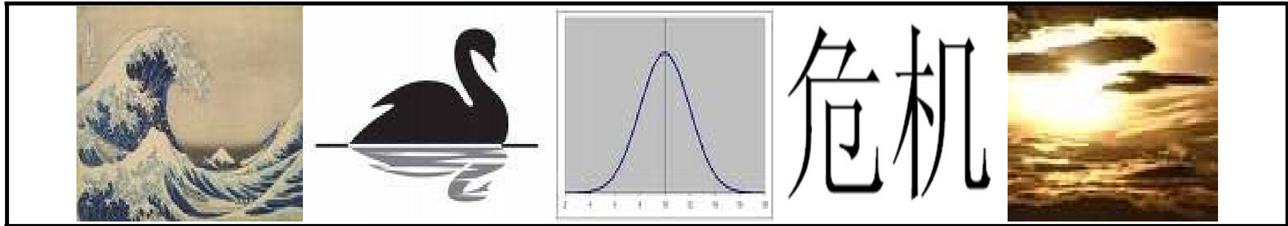


policies, which traditionally have clearly divided percentages allocated to domestic and non-domestic exposures. Low-correlation benefits from non-domestic exposures have been on the decline for years anyway, a trend we expect to continue and which will require a more surgical approach to selecting and managing international asset classes in the context of diversified portfolios.

- Speaking of low-correlation benefits…these are the Life-Giving Force upon which portfolios of diverse assets rely for their sustenance. And they are increasingly hard to come by in an age of geographic convergence, up-to-the-nanosecond trading technologies and the continual lurking presence of volatile, high-impact events that tend to affect nearly all risk-based assets in a similar manner. It is somewhat ironic: today we have a proliferation of investment alternatives about which investors and asset managers in years past could scarcely have dreamed, and yet it is harder than ever to engineer the positive value that derives from portfolios made up of assets that have low levels of correlation with other assets in the portfolio.

- Another significant challenge facing investors in today's investment climate is what to do with the fixed income investment category. We are used to thinking of bonds and other fixed income investments as the boring old safe haven for portfolios, where we sacrifice a bit of upside in exchange for more predictability. That formula, in fact, is absolutely intrinsic to the evolution of investment management practices, like the strands of DNA that survive from prehistoric times to which we regress when primitive instincts like fight-or-flight scenarios flash in front of us. Basic tools of valuation like the Capital Asset Pricing Model live or die based on the predictable gradation of risk from risk-free investments like Treasury bonds to higher-risk assets. And yet…say what you will about the bond market in the last several years, but "boring" and "predictable" are not words that come to mind. Double-digit returns (both positive and negative) for Treasury bonds and equity-like volatility for mid-quality corporate bonds are facts of life in the new world, and demand a radically fresh approach to managing this portfolio component.

- The trends we describe here are what we call "market tectonic shifts" – they are not events that happen overnight but unfold and take shape over a longer time period. Every so often tectonic plates collide and create spectacular, frightening displays of pyrotechnic upheaval. We saw such a collision in 2008 and the realignment from that collision will continue to unfold over, we believe, a number of years. We think that the best way to manage portfolios in the context of market tectonic shifts is through deliberate migration from structures of asset holdings that served us well in times past to other structures that we believe will work better in times to come. We may have a reasonably clear sense as to where that migration will lead us in terms of asset allocation and investment selection decisions five or ten years from now, but we do not intend to get ahead of ourselves. For example the relocation of international financial influence from New York to Shanghai does not mean we plan a massive overweighting in China and Asia Pacific stocks for 2010 – far from it, in fact. But we recognize that investment markets are complex ecosystems whose characteristics are dynamic and not predictable in a precise linear fashion. Larger patterns of rationality emerge from the chaotic complexity of these markets, and as they emerge our job is to be in the best position to benefit from those emergent properties.

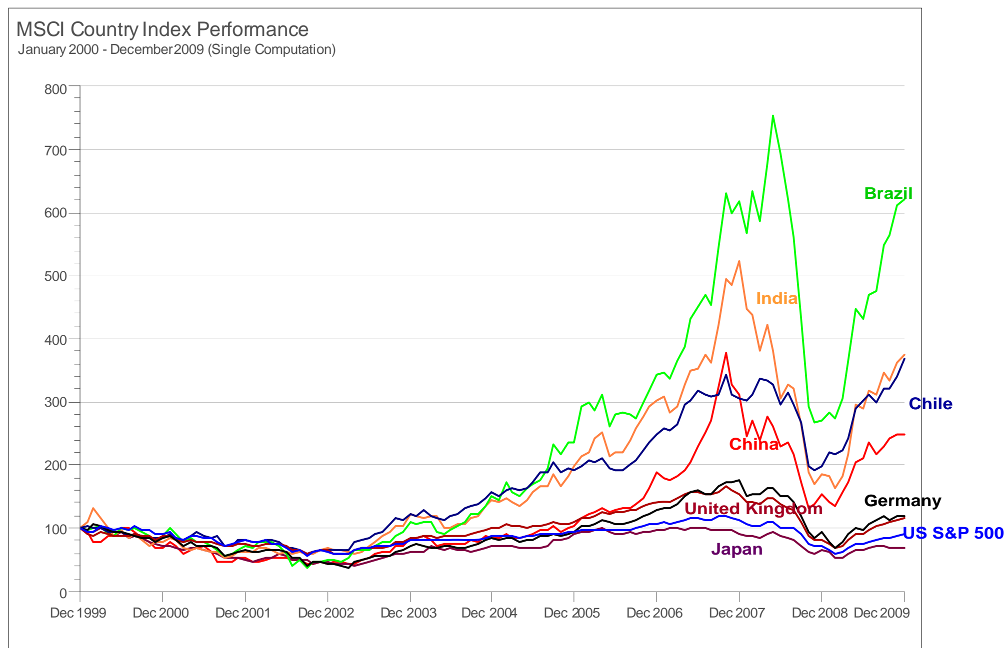


The Global Economy and Long-Term Asset Migration

One Decade, Two Stories

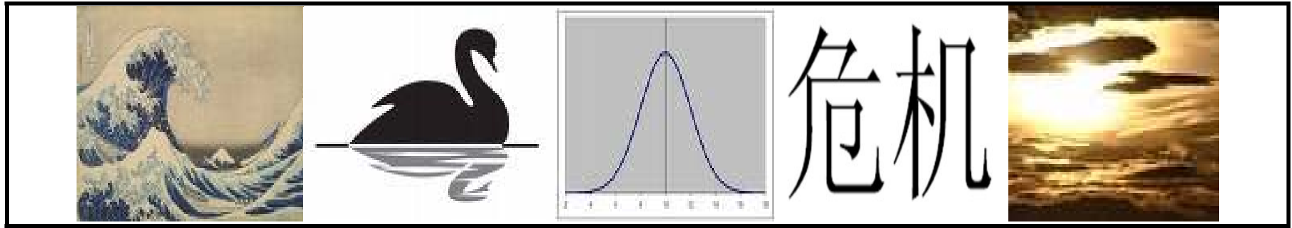
Bees go where the honey is. Animals on the savannah gravitate towards the watering hole. Investors follow their instincts to where the growth is (or more accurately, where it is likely to be in the not too distant future). Increasingly that appears likely to be somewhere other than the United States, the world's largest capital market. The good news, and what makes today different from any other historical post-deep recession/market crash environment, is that there are plenty of ways to take advantage of that – to go where the growth is via liquid, transparent, tradable investment vehicles. In this report we give you the world – and explore in-depth some of the major trends and opportunities we see as likely to have a defining influence on the forthcoming investment climate. For those who prefer not to read on but would like to take away the distilled essence of our argument it is simply this: *we expect the world's economy will grow in the coming years, and we expect most of that growth will not be here at home. Our portfolios intend to reflect this.*

Table 2: World Equity Markets Relative Performance 2000-2009



Source: Zephyr & Associates LLC

The message of this chart can really be described as One Decade, Two Stories. The national equity markets of the so-called developed world, including as shown here the U.S., Germany, the United Kingdom and Japan, would up the end of the decade largely where they were at the beginning. The story was quite different in the so-called "emerging" markets world (a term that really needs to be retired by the



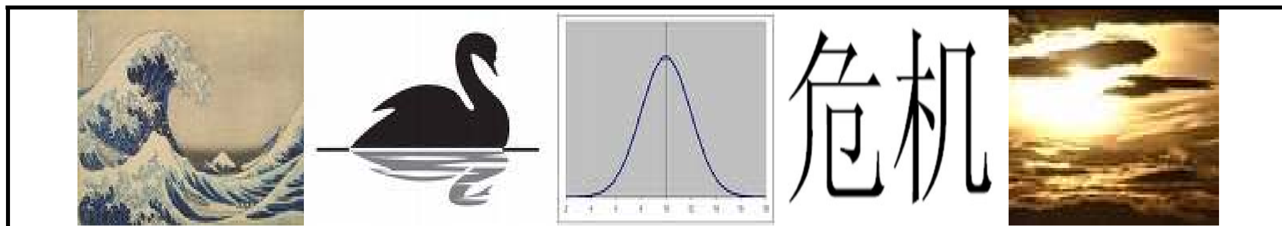
financial world as it no longer carries a relevant meaning). In Chile, for example, the stock market at the beginning of 2010 is at all-time record levels. The losses of 2008-2009 have been completely erased. Other major emerging markets have also recovered substantially more of that lost ground than their developed-market counterparts. Now, the important thing to understand about this picture is that it is not some short-term phenomenon. This divergence, this Tale of Two Markets has been going on for the better part of the past ten years. This is not just about stock markets; it is about real economics. It is about a new paradigm of global growth.

The Cash Triangle Leads the Way

The U.S. consumer has been the world's engine of growth for the past 25 years. The U.S. economy, the world's largest, had a gross domestic product (GDP) of $14.3 trillion at the end of the 3rd quarter of 2009. Personal consumption expenditures accounted for $10.2 trillion, or 71% of total GDP, a level largely consistent with the role consumer spending has played in our economy for the last 10 years or so. As the U.S. consumer spent the world grew – this is the story of globalization as it has played out since the early 1980s. Now we are faced with the distinct possibility of a long period of decline in the spending power of the U.S. consumer as unemployment rises, real income shrinks and the sorry accumulation of years of out-of-control borrowing dominates household budget decisions. The question at hand: in the absence of the American shopper leading the way, what force or combination of forces will lead the world economy back to a sustainable trend of long-term growth?

We think the answer to this question is actually rather simple: personal consumption. Although the 71% level of consumption-to-GDP that the U.S. maintains is significantly higher than the global norm (it is 56% in the Euro area) nonetheless consumption is the catalytic driver of economic activity the world over. As far as we can see, the most likely scenario for the world economy to grow at something like the pace of recent experience would be for that consumption-to-GDP ratio to dramatically increase in growth-engine countries like China, India and Brazil that collectively make up the world economy's most dynamic area. Currently that metric is 41% in China, 61% in India and 56% in Brazil. If each of these countries were to increase value-added consumer activity such that consumption-to-GDP in each one rose by 3-4% that would nicely offset the gap left if, perhaps, the trend in the U.S. reverses towards the 65% PCE-to-GDP that prevailed for much of the post-World War II period up to the early 1980s.

What is the likelihood that such a scenario will play out? Pretty decent, in our opinion. First of all, there is the demonstrated ability of these countries to grow at a faster rate than the developed economies of North America, Western Europe and Japan. Coming off the sharp recession of 2007-08, the growth outlook for the developed world in 2010 is remarkable only in being anemic: 0.4% in Japan, 0.9% in the U.S. and 1.2% in the Euro area. By contrast India is expected to grow at 7.2% and China at 9.0%. Fast-growing economies engender the possibility for the increased purchasing power of a growing middle class and the formation of demand for high value-added goods and services. The story is well-known and seemingly eternal: people aspire to have more, they look at the materially well-off citizens of developed markets and see themselves with just a bit more effort and income. Three billion souls in the middle of the world's economic gradations want to live like the one billion at the top.



Equities: The Dow Follows the Tao

The Chinese-originated belief system called the ‘Tao’, represented by the character 道, literally means ‘way’ or ‘path’ (in its correct pronunciation it is also basically indistinguishable from ‘Dow’, for those who like us enjoy wringing every possible iota of amusement out of our metaphors). The essence of Taoism is a holistic recognition of all named and nameless things and concepts in the universe. Without digressing too far into the depths of ancient Eastern philosophies it is worth observing that the holistic, nondualistic nature of Tao provides an apt context for the integrated complexities and emergent properties in our modern global economy. It is often said that the Tao cannot be expressed – it is simply too boundless to be confined into the limitations of our vocabulary and grammatical constructions. But it can be known and its principles followed. In a sense that is what we are attempting to do with the vast complexity of the global economy – not to reduce it to a necessarily narrow and ill-fitting reductive explanation, but to discern meaningful knowledge therein and pursue that knowledge with active investment strategies. The ‘path’, indeed, is an appropriate symbol for our continual quest to identify meaningful events and developments and understand how they may impact our clients’ financial futures.

As we have already noted in this report, world stock markets and particularly those in the so-called developing world fared much better than their developed-world counterparts over the last ten years. However, it is neither prudent from a risk-return standpoint nor defensible in the face of supporting evidence to conclude that the core strategy of equity asset allocation should merely be location-based. At MVCM we make asset allocation decisions generally based on three factors: risk, style and location (by which we mean “thematic” as well as “geographic” location). The two charts below underscores the importance of this three-pronged approach:

Table 3: Calendar Year Performance of Selected Equity Markets, 2000-2009

U.S. and Non-U.S. Equity Asset Classes January 2000 - December 2009	**Common Period**	**2009**	**2008**	**2007**	**2006**	**2005**	**2004**	**2003**	**2002**	**2001**	**2000**
MSCI EM LATIN AMERICA	17.59%	104.19%	-51.28%	50.67%	43.48%	50.42%	39.62%	73.66%	-22.45%	-0.39%	-16.57%
MSCI BRIC	14.17%	93.52%	-59.34%	59.06%	56.60%	44.46%	17.12%	91.71%	-12.62%	-14.01%	-21.23%
MSCI EM (EMERGING MARKETS)	10.11%	79.02%	-53.18%	39.78%	32.59%	34.54%	25.95%	56.28%	-6.00%	-2.37%	-30.61%
MSCI PACIFIC ex JAPAN	9.15%	73.04%	-50.03%	31.73%	33.15%	14.84%	29.55%	47.03%	-5.78%	-9.43%	-15.19%
Russell 2000 Value	8.27%	20.58%	-28.92%	-9.78%	23.48%	4.71%	22.25%	46.03%	-11.42%	14.02%	22.83%
MSCI EM ASIA	7.33%	74.21%	-52.77%	41.58%	33.22%	27.50%	15.33%	50.97%	-4.75%	6.19%	-41.79%
Russell 1000 Value	2.47%	19.69%	-36.85%	-0.17%	22.25%	7.05%	16.49%	30.03%	-15.52%	-5.59%	7.02%
MSCI EMU	2.30%	32.79%	-47.09%	20.35%	37.28%	9.58%	22.23%	44.13%	-21.49%	-22.13%	-8.39%
MSCI EAFE Index	1.58%	32.46%	-43.06%	11.63%	26.86%	14.02%	20.70%	39.17%	-15.66%	-21.21%	-13.96%
S&P 500	-0.95%	26.46%	-37.00%	5.49%	15.79%	4.91%	10.88%	28.68%	-22.10%	-11.88%	-9.11%
Russell 2000 Growth	-1.37%	34.47%	-38.54%	7.05%	13.35%	4.15%	14.31%	48.54%	-30.26%	-9.23%	-22.43%
Russell 1000 Growth	-3.99%	37.21%	-38.44%	11.81%	9.07%	5.26%	6.30%	29.75%	-27.88%	-20.42%	-22.43%
Common Period: January 2000 - December 2009											

Source: Zephyr & Associates LLC

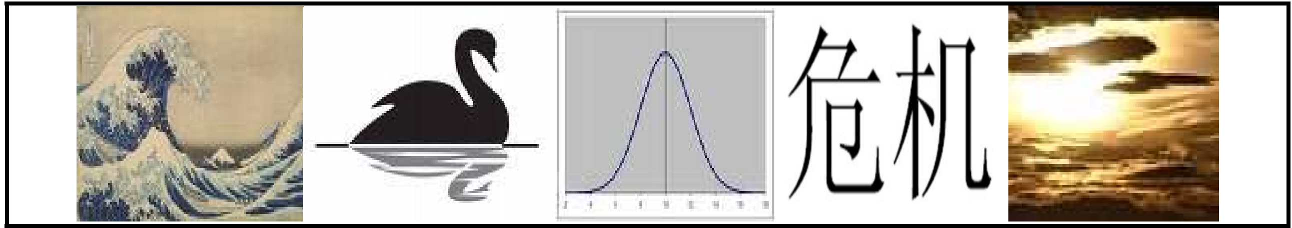
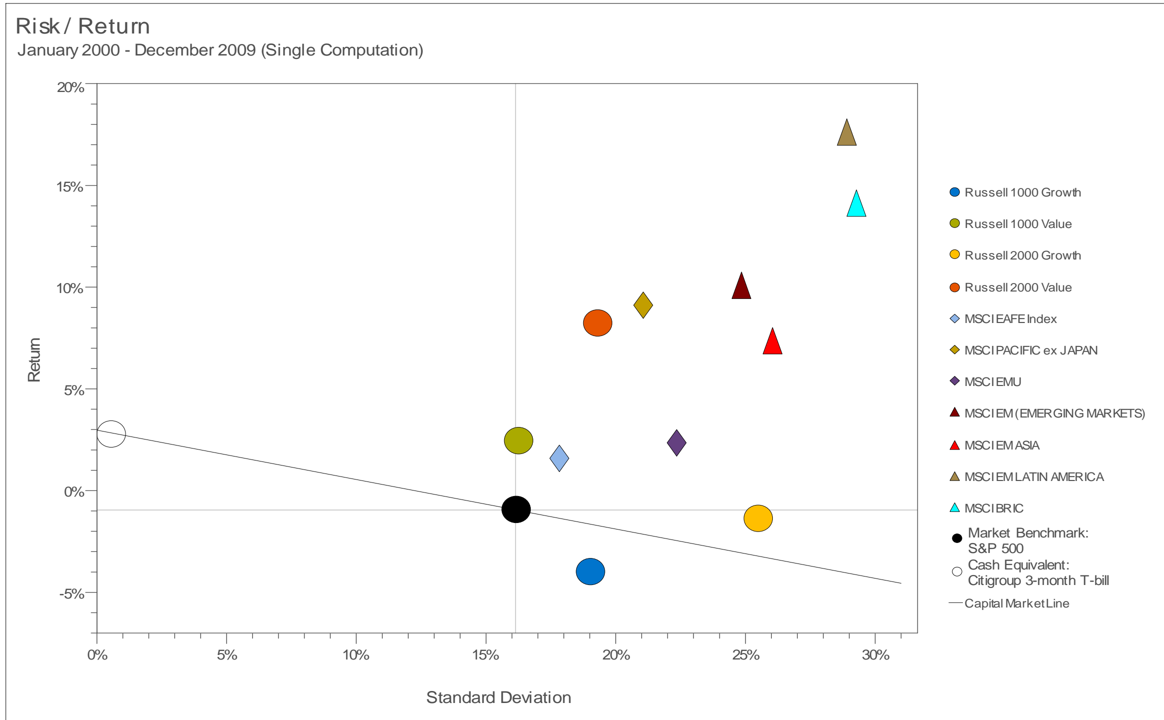


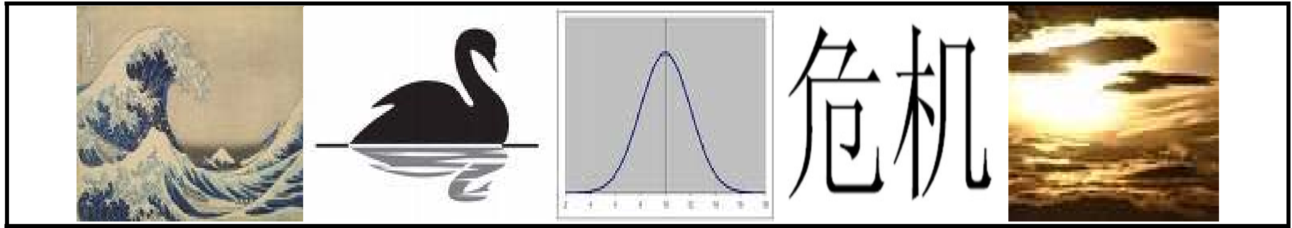
Table 4: Risk-Return Positioning of Selected Equity Markets, 2000-2009



Source: Zephyr & Associates LLC

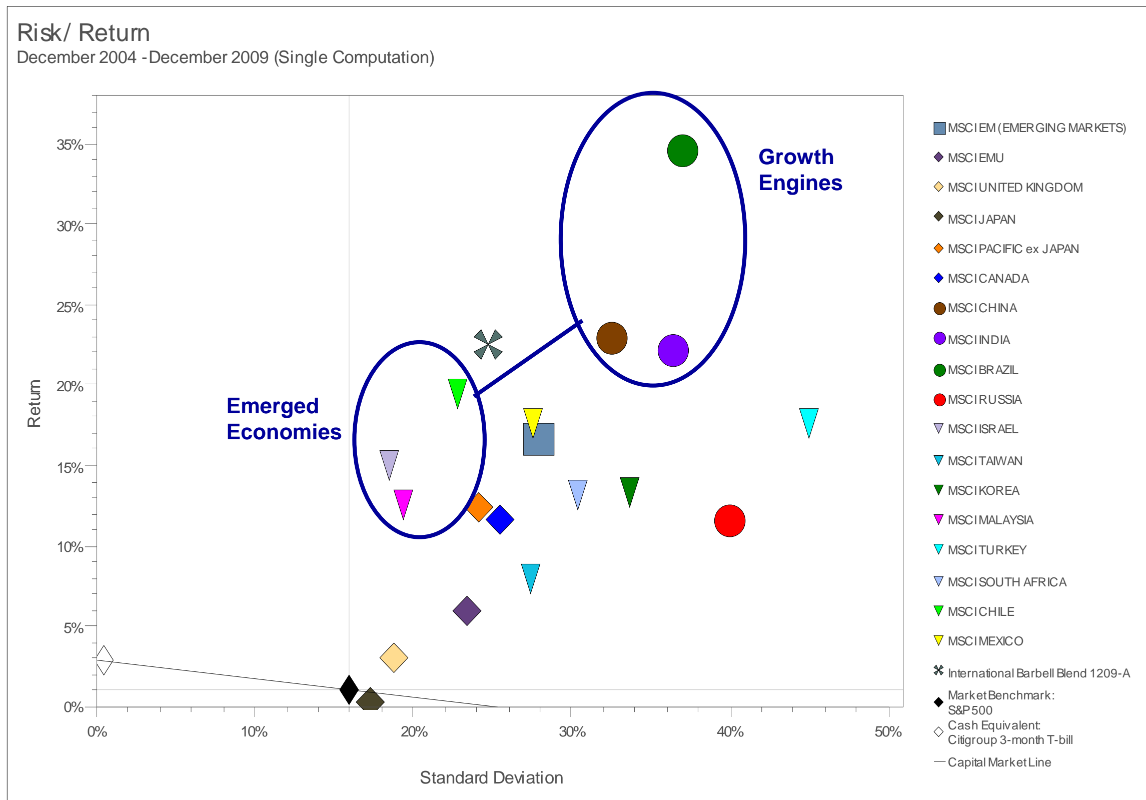
Style Still Matters…More Active Decisions to Make

These two charts contain quite a bit of important information. Perhaps the first thing that seems glaringly obvious is that a strategy of "buy and hold" (in relation to the S&P 500, the most widely-used proxy for the U.S. equities market) was clearly not the way to go in the Aughts decade. From a risk standpoint the broad-based U.S. stock market generally offers the lowest levels of volatility among all countries, and this was true for the past decade as well as demonstrated in Table 4 above. But it is also clear that combining assets with different risk properties changes the complexion of available returns. In Table 3 the top five average annual returns for the decade (as shown in the column "Common Period" included three emerging markets exposures, one non-U.S. developed market exposure (Pacific ex Japan, which comprises Australia, New Zealand, Singapore and Hong Kong), and one U.S. style exposure (the Russell 2000 Value index of small-cap value stocks). Style investing remains important to our asset allocation decisions. The number of active allocation choices that present themselves can be daunting – and the methodology for the allocation decisions must take into account the rapidly evolving characteristics of equity markets at different stages of growth and maturity. What seems intuitively clear to us, looking at these figures, is that "buy and hold" is simply not an adequate substitute for a disciplined, agile active allocation process based on the risk-style-location metric.



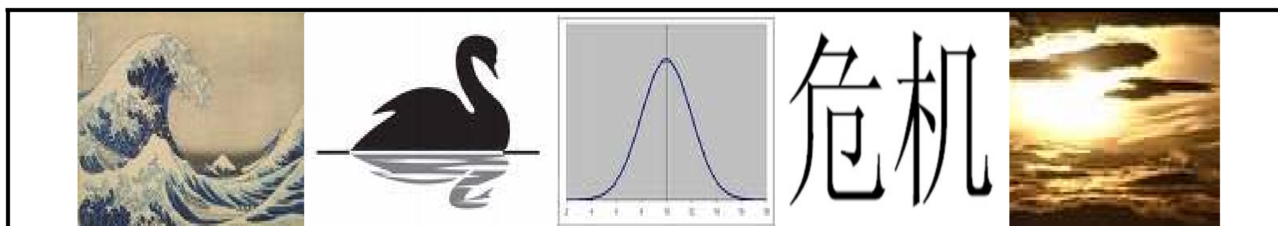
Looking at those previous tables it is hard to avoid the importance of considering the place of emerging markets in the portfolio (we reluctantly continue to use the term “emerging markets” because it continues to be the currency of the realm, though in our own view it is seriously outdated). Table 5 below provides one example of how our thinking has evolved in this regard.

Table 5: Emerging Markets “Barbell” Strategy



Source: Zephyr & Associates LLC

The core of our emerging markets strategy can be thought of as a barbell, with each end of the barbell indicated by the two circles in this table. The purpose of the barbell strategy is risk positioning. At the left side there are certain markets still classified as “emerging” that for all intents and purposes are fully functioning economies with developed infrastructures. The risk-return positioning of Malaysia, Chile and Israel, for example, puts them at a lower risk profile than that for the European Monetary Union, Canada or the developed economies of the Asia Pacific Rim like Singapore and Hong Kong. These markets may not always command the same return premium that they did for the past decade (indeed we expect that premium to narrow over time), but from a risk-return standpoint we see them as portfolio mainstays.



On the other side of the barbell are the growth economies: primarily Brazil, India and China. These are much more volatile assets when viewed in isolation. Indeed we have concerns about China's prospects for 2010 given present valuation levels and a handful of X-factors we believe have the potential to materialize at some point over the next twelve months. However, when viewed not in isolation but as one component of an integrated strategy the picture changes. The "X"-shaped icon in the middle-left of the barbell (just above the connecting line) is a hypothetical basket containing equal parts of the six countries shown within the barbell circles. The combination of risk, return and correlation properties between these assets produces a composite result, the risk properties of which are still largely in line with certain developed-market exposures. Now, clearly (but we need to emphasize it anyway), there are no assurances at all that this kind of risk-return positioning will be achievable under future market conditions. However, we believe this approach has strategic value. As our portfolios migrate over time, in line with global market tectonics, this type of approach will increasingly surface at the core of our allocation process.

As a final note on this topic we should observe that there is another category of exposure in the emerging markets space: what is becoming known in the common vernacular as "frontier" markets. In Table 5 above Turkey is a good example of a frontier market; others not shown in Table 5 include Indonesia, the Gulf States, and certain emerging North and West African markets among others. Frontier markets today play a role similar to what the original class of emerging markets did back in the early 1990s: offer selective, high-risk, tactical return opportunities for a very constrained percentage of total portfolio allocation. Capital markets technology continues to evolve and bring more liquidity to more markets that were formerly beyond the pale of accessible investment opportunities.

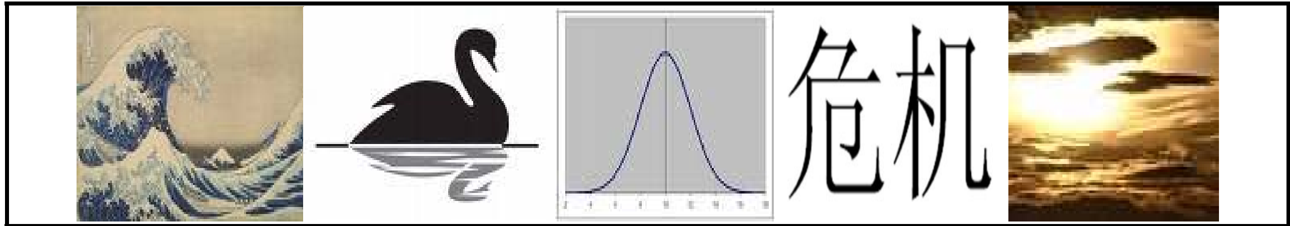
The Fixed Income Conundrum

If there was anything more impressive than emerging market equities in 2009 it could be found in certain corners of the fixed income market. The Merrill Lynch High Yield index briskly outpaced the S&P 500, returning 56.3% on a total return basis, while Merrill's C-rated bond index, at the really speculative end of the junk bond spectrum, brought in a whopping 94.1%, far outpacing even the far-from-demure MSCI Emerging Market Equity index.

Table 6: Selected Fixed Income Performance, 2007 – 2009

Source: Zephyr & Associates LLC

U.S. Fixed Income Asset Class Performance As of December 2009	**2009**	**2008**	**2007**	**Common Period**
Barclays Capital U.S. Treasury: 7-10 Year	-6.04%	17.99%	10.19%	6.90%
Barclays Capital U.S. Corporate Investment Grade	18.67%	-4.93%	4.56%	5.66%
Barclays Capital U.S. Municipal Bond	12.91%	-2.47%	3.37%	4.41%
Merrill Lynch High Yield Master	56.28%	-26.21%	2.17%	5.62%
Merrill Lynch High Yield C-rated	94.09%	-38.23%	0.16%	6.29%
S&P 500	26.46%	-37.00%	5.49%	-5.63%
Common Period: January 2007 - December 2009				



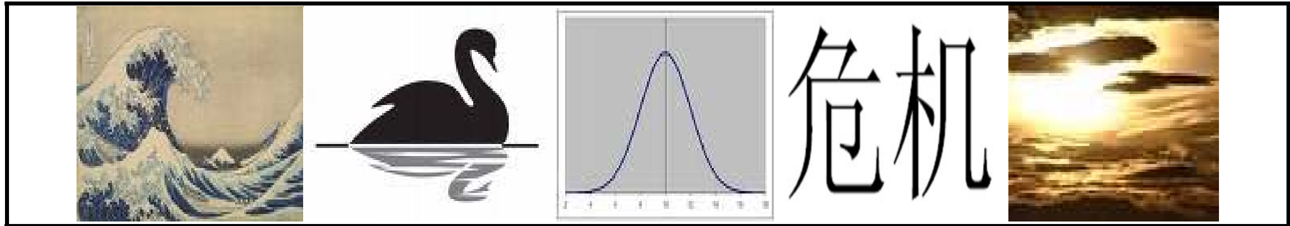
The wild rodeo nature of fixed income markets in 2009 was really a continuation from the crazy months of autumn 2008. As most risk asset markets plummeted during that period, U.S. Treasury securities took on their traditional role as the safe haven asset of choice and returned double digits for the year. In March 2009 risk assets began their sharp upward path and those double-digit Treasury returns turned double-digit negative. If you had completely ignored the equity market and focused only on making tactical moves in and out of the bond market from September 2008 to December 2009 (and actually made the right moves) you would likely be sitting on top of a pile of impressive returns.

Market timing is a fool's game when applied to the traditional high-volatility asset classes like equities, commodities or real estate. It is downright scary when it becomes a staple of fixed income markets. The traditional role of fixed income in diversified asset portfolios is to reduce the overall risk characteristics of the portfolio. The more risk-averse an investor, the higher a percentage of the portfolio will be typically comprised of fixed income securities.

These are not typical times, though. The fact that asset markets recovered substantial amounts of their 2008 losses in 2009 does not change the fact that the investment world has dramatically and irrevocably changed. One of those changes is this: the fixed income category is no longer simply a comfortable place in which to tweak the duration and credit quality composition of bonds in the portfolio from year to year. The total composite risk picture of the portfolio requires much more active inter-management between all investment categories: equities, fixed income, low volatility and high volatility alternative assets. At the outset of 2010 we see lots of potential downside for many of the core fixed income exposures, and not a great amount of potential upside. As a result our fixed income weightings for our different portfolio strategies are below their neutral default weightings.

The big dagger hanging over the fixed income market at the dawn of 2010 is the Fed's interest rate policy. In the wake of the 2008 meltdown the U.S. Fed brought the Fed funds rate, the rate at which banks lend to each other, to effectively zero percent. That continues to be its level today. To understand why this is a serious concern one only has to understand one axiomatic principle of the bond market: when interest rates go up, bond prices go down. That's mathematically certain – you can take that principle to the bank. Now, not all rates go up or down by the same amount. The Fed generally has the most direct influence over short-term rates, because its monetary policy operations are concentrated in the manipulation of the Fed funds rate, which is an overnight rate. Other short-term rates like Treasury bills, certificates of deposit, money market funds and commercial paper will move pretty closely in tandem with the Fed funds rate. You have probably noticed this if you are invested in money market funds, which currently yield barely more than zero.

Long term rates are affected by other factors in addition to the prevailing level of short term rates. Inflationary expectations and risk premiums for instruments of varying credit quality are more pronounced in the longer end of the duration curve. But – and here is another axiom of the bond market – prices of longer-duration instruments react in a more volatile manner for any incremental change in



interest rates. Thus, a 1% increase in rates will result in a larger price decline for a 10-year bond than for a 3-month bill. Again there's nothing magical about that – it is straightforward mathematics.

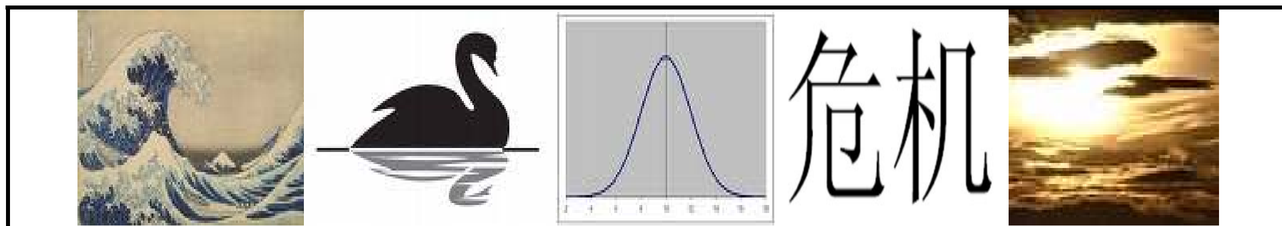
So the question everyone in the market is asking is: will they or won't they? This goes back to the issue we raised at the beginning of this report in regard to the economic outlook for 2010. Simply put, the faster the economy grows this year the more likely it is that the Fed will move more quickly and more dramatically to raise rates. The more tepid economic growth proves to be – in other words the "fits and starts" that we have posited as the most likely path for the year – the less likely the Fed will risk choking off growth with an aggressive rate increase policy. And if the economy falls through the floor (a scenario that is possible but in our opinion the least likely of these alternative outcomes) then the Fed will be likely to not only leave short-term rates at zero but actually venture into new territory by actively buying long-term bonds in the market.

That third (and least likely) alternative is the only scenario in which we see the potential for any meaningful downward pressure on overall interest rates (meaning upward support for bond prices). In other words our outlook for bond prices in general this year ranges from tepid (flat) to down. In alignment with our fits-and-starts outlook we think the Fed will be very cautious about embarking on a rate increase policy, but the risk is skewed towards rate increases sooner than expected, which again would have a negative impact on bonds. As a result we are somewhat below neutral default weightings in our bond portfolios pretty much across the board, and (it goes without saying) keeping a close eye on developments in this area.

What to do if the economy goes gangbusters? Well, on the one hand of course we would expect that to be good news for the equities component of our portfolios (assuming that economic growth is powered by stronger-than-expected corporate earnings to give some validation to current P/E levels). In managing the potential downside to U.S. fixed income exposures we think there are opportunities in non-U.S. fixed income areas. Not all countries' central banks brought rates down to zero in the wake of the crash; in particular both the U.K. and the European Central Bank maintained rates above that level. Within the ECU certain countries that traditionally have adhered to the most conservative, inflation-averse monetary policies (notably the German Bundesbank) may provide a repository for diversifying fixed income positions. The emerging markets are also potentially attractive, in particular countries with sizable capital reserves (such as China and Russia) that are extremely well-cushioned against default as well as countries with strong domestic infrastructures and functioning financial systems such as Chile and Malaysia. We already have positions in these types of exposures as part of our strategic allocation, but also have the potential to execute tactical overlay positions if we deem that to be prudent as the year unfolds.

Alternative Assets: No Portfolio Left Behind

Alternative assets come in two flavors: those with volatility properties more closely resembling equities, and those with more fixed income-like risk characteristics. Here is the good news about life in the second decade of the 21st century: investments are no longer a stark choice between stocks and bonds. High



volatility assets like commodity futures and low volatility strategies like equity market neutral and merger arbitrage add an important value component to portfolios. At different times, under different market conditions, they have the potential to improve returns or reduce risk, and their most important characteristic is the tendency to exhibit low correlation with stocks and bonds – in other words to behave in different ways at different times and thus to hedge against the possibility of really bad things all happening at the same time.

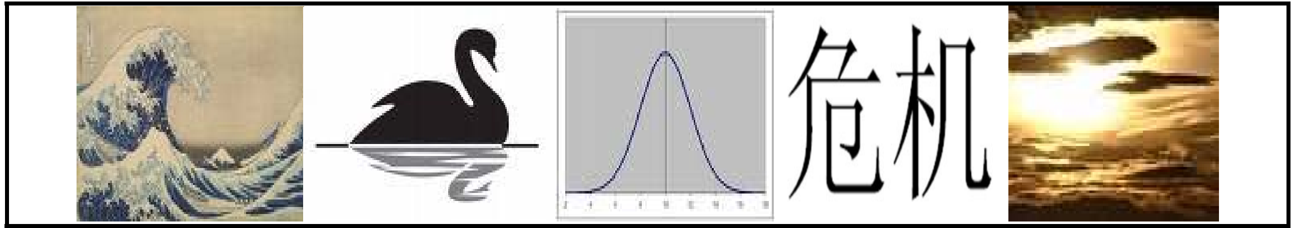
Table 7: Cross-Correlation between Selected Alternative Asset Classes

Correlation Matrix
December 1999 - November 2009

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
1) HFRI Fund of Funds Composite Index	1.00												
2) Dow UBS Commodity Index	0.53	1.00											
3) Wilshire REIT	0.29	0.22	1.00										
4) MSCI World Index	0.67	0.40	0.60	1.00									
5) Barclays Capital U.S. Aggregate	0.05	0.09	0.17	0.02	1.00								
6) HFRI ED: Distressed/Restructuring Index	0.81	0.44	0.42	0.64	0.02	1.00							
7) HFRI ED: Merger Arbitrage Index	0.63	0.39	0.41	0.59	0.09	0.55	1.00						
8) HFRI EH: Equity Market Neutral Index	0.51	0.39	0.03	0.17	0.02	0.39	0.40	1.00					
9) HFRI RV: Multi-Strategy Index	0.78	0.53	0.43	0.64	0.20	0.81	0.56	0.36	1.00				
10) HFRI RV: Fixed Income - Convertible Arbitrage Index	0.63	0.47	0.40	0.53	0.23	0.71	0.55	0.29	0.87	1.00			
11) HFRI EH: Quantitative Directional	0.81	0.34	0.38	0.84	-0.05	0.67	0.58	0.23	0.59	0.39	1.00		
12) HFN Long/Short Equity Average	0.93	0.45	0.39	0.77	0.02	0.73	0.65	0.45	0.69	0.56	0.90	1.00	
13) S&P 500	0.56	0.29	0.58	0.97	-0.02	0.57	0.54	0.08	0.55	0.46	0.80	0.68	1.00

Source: Zephyr & Associates LLC

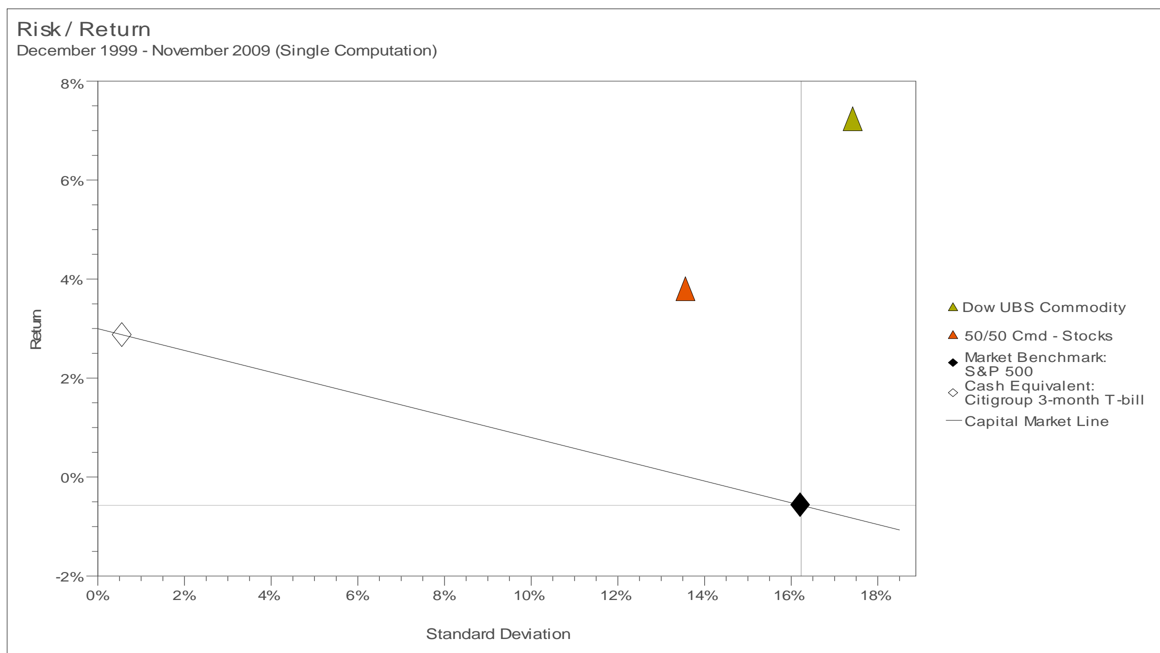
When looking at correlations there is a rule to remember: Zero is Golden. A correlation of zero means that (statistically speaking, anyway) there is no particular explanatory relationship between the respective movements of two assets. The 0.08 correlation between the S&P 500 and the HFRI Equity Market Neutral Index implies that whatever forces influence the U.S. stock market will have quite different effects on market-neutral exposures. One of the most reliable long-term sources of correlation benefits has been that between U.S. equities and commodities. In Table 7 the ten-year correlation figure between



the S&P 500 and the Dow UBS Commodity Index is 0.29 (remember that 1.00 means perfect positive correlation and -1.00 shows perfect negative correlation). That actually is higher than historical norms, reflecting the unusually high convergence of movement between these two assets during the 2008-2009 market crash.

Table 8 below provides a graphic example of why these low correlation properties are so desirable.

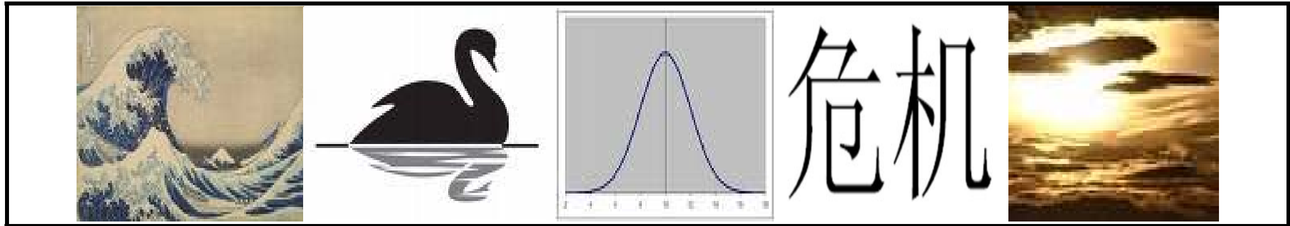
Table 8: Return, Risk and Correlation Properties of Equities and Commodities



Source: Zephyr & Associates LLC

The orange triangle in the middle of the chart is a hypothetical 50/50 blend of stocks and commodities over this ten year period (rebalanced annually). The really important emergent property to observe is the risk reduction: the combination of two assets with respective volatilities of 16.2% and 17.8% produces an exposure with 13.9% volatility. There is no black magic going on here. Because the correlation between stocks and commodities is so low, they do different things at different times for different reasons. There is actual mathematical value in that statement, and that value emerges in the risk reduction evident in this picture. This is why commodities exposure is a strategic mainstay of our portfolios.

For 2010 our positions in commodities are roughly in line with our long-term strategic default positions, reflecting a view that is neither particularly bullish nor particularly bearish on the prospects for commodities this year, but holding that reversion to the traditionally low level of correlation between



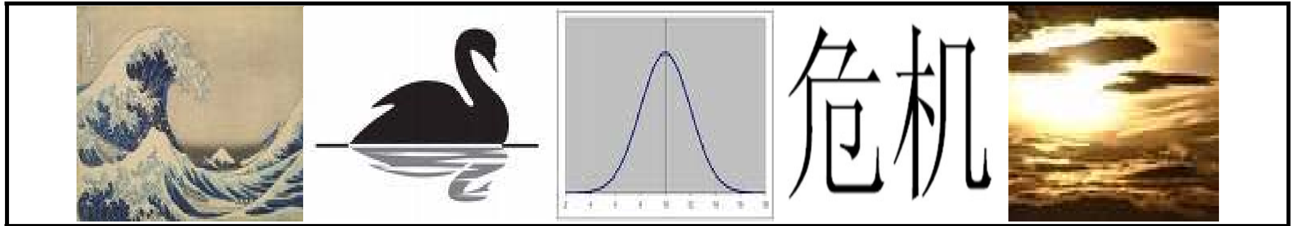
equities and commodities will perhaps be likelier than not this year. Commodity indexes are an amalgam of primary exposures: energy-related commodities like crude oil, natural gas and refined petroleum products; basic materials like tin and aluminum; and precious metals including gold, silver and platinum. Some primary market forces pull these different commodities in different directions, and in our opinion the net effect at present appears to be just about neutral. Precious metals, especially gold, have witnessed rather dramatic gains over the past twelve months, for reasons that are partly related to conventional wisdom on the U.S. dollar (it's going to hell in a handbasket, says the CW) and partly related to…well, there always has to be at least one asset class exhibiting bubble-like build-up properties. Oil prices also tend to be a destination for weak dollar-fleeing capital, though the generally firm floor under crude oil prices over the past half-year or so also can be attributed to rising expectations that the next leg of the global economic recovery will be led by China, and hence the voracious demand for energy and industrial materials that are inseparable from Chinese economic growth.

In 2008 and 2009 low volatility assets served the function primarily of offering an alternative to direct exposure to long equities. In 2010 we view this asset class somewhat differently – as a way to keep overall volatility in our portfolios lower while diversifying away from the risks we described above in relation to the bond market. Over the course of the past twelve months we have expanded our universe of available asset classes in the low volatility space. In a fits-and-starts economy the most important thing we can do, in our opinion, is to surgically carve out low-correlation opportunities wherever possible in our portfolios. Wherever possible we see distinct benefits from using 1940 Act-registered products across a broad range of portfolios and strategies, with hedge funds and other non-registered products having their place in more limited circumstances and only where the client fully appreciates the practical implications of illiquidity and the other distinct risks of non-registered products.

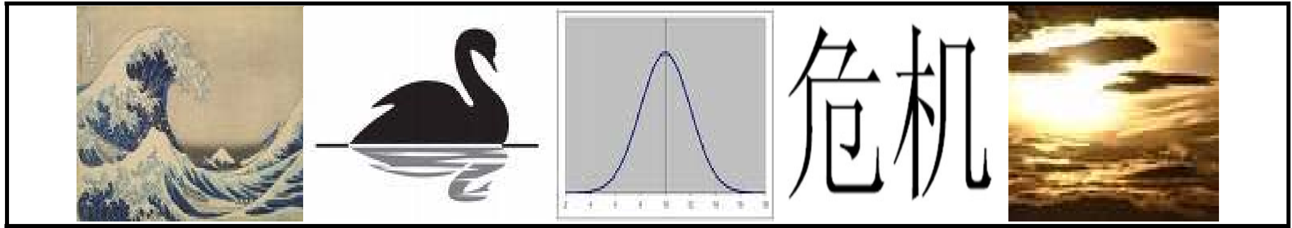
In Conclusion

At the dawn of a new decade there is both hope and uncertainty. The dismal performance of the U.S. stock market in the past decade has had a chilling effect on popular attitudes towards the market: certainly the fervid days of late-90s day trading mania are long behind us. The ten years from 2000 to 2009 are an anomaly by historical standards. Mean reversion is something we always expect to happen: the problem is that we can never know exactly when it will happen, or even if (case in point: the seemingly terminal decline of Japan's equities market). Right now our economy is moving along in fits and starts, and our expectations as we look ahead to the next 2-3 years are tempered.

The global economic paradigm is shifting, though, as is the axis of growth. We believe that over the medium to long term the best strategy for capitalizing on this shift is through portfolio migration: go to where the growth is. That is easier said than done, of course, and if the past decade taught us anything it is that a simple "buy and hold" approach of parking one's capital in one broad-based exposure and leaving it there for years untouched is not necessarily a recipe for success. The paradigmatic shift is dynamic, and asset allocation strategies need to evolve and adapt in real-time.



Asset classes, and even whole investment categories like fixed income, are not what they used to be. Portfolio management models that have worked more or less for some 30-plus years may not be ideally suited to the challenges of the future. Fortunately there is a very broad array of equities, fixed income and alternative asset vehicles from which to create intelligent, prudently diversified portfolios. The challenge will be in understanding how to make them work effectively and to learn from the emergent properties of these new portfolio ecosystem. The only thing we can say with certainty at this time is that we by no means have all the answers to solve these challenges. Success will require nimbleness, agility, intelligence and discipline like never before. “May you live in interesting times” goes the ancient Chinese proverb. Interesting times, indeed.

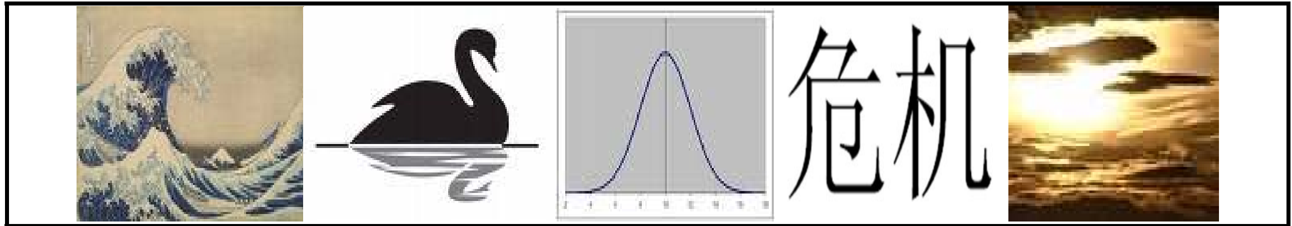


About Those Icons

What do the icons at the top of our Research and Commentary reports like the one you are reading actually mean? Let's start from the central icon. This is the Gaussian distribution curve (after the 18th century German mathematician Carl Gauss), or what we more commonly know as a bell curve or a normal distribution. The curve represents the distribution of a sample population of observations around a central tendency (the mean, represented by the vertical line bisecting the curve), and the distributions fall in the familiar bell shape representing deviations, or variance, from the mean or expected outcome. This curve is fundamental to the practice of quantitative portfolio management and is the basis for how we calculate and analyze expected outcomes (returns) and the magnitude of variance of those outcomes (risk, or volatility).

No statistical tool is foolproof, however. A tool like the Gaussian distribution can give a probability for the occurrence of an event and a range of possible variations outside of which the probability of occurrence is "unlikely". The lesson we learn from history, though, is that unlikely things happen. Consider the picture to the left of the Gaussian distribution – a black swan. Once upon a time in Europe, nobody had ever seen a black swan. For all intents and purposes they didn't exist. The statement "if swan, then white" could be considered to be accurate within 100% probability. Then some explorers went to Australia and came upon some interesting indigenous fauna including…yes, black swans. One single outcome (a single black swan) completely negated the probability model that served so well until then. Low-probability events often come with a high impact, and in the investment world this can feel like nothing as much as a destructive tsunami turning our lives upside down (see the picture on the far left).

Rough seas indeed – but where some see only danger, we at MVCM also see opportunity. This is the meaning of the Chinese character to the right-center of the image: it is Chinese for "crisis" which consists of two ideograms: one connoting danger and the other connoting opportunity. At MVCM we know that danger is an unavoidable part of life. It is how you respond to a crisis situation that determines whether you seize the opportunities that may present themselves. "This too, will pass" goes a wise old adage, and the sun will always come out again. We have an indestructible confidence in the power of the human spirit and a firm belief that the sun will always shine again.



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