2010: The Bridge Between Chaos and Opportunity

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Earlier this week, the snow was coming down heavily. All of a sudden, a half of a dozen robins landed on the tree outside of our window. Robins are usually the harbinger of spring, yet here they were in Morristown during a blizzard. It made me wonder what they knew that we were missing. This caused me to think about where we are in the economic cycle. Can we identify the robins in the midst of an economic snowstorm? Are there harbingers of better things to come that we missed because we've been blinded by a blizzard of bad news and economic uncertainty? Have stocks and bonds already discounted the early stages of an economic thaw?

We're fortunate to have some of the best investment minds working on our behalf. Sitting down with managers and listening to their views is always a fascinating and exhilarating process. Given what we've been through over the past two years, it is particularly interesting now. All of our managers have strong views about the asset classes they operate in. That, and managing risk in the context of their views, is what we pay them for. By the nature of our business, we are also fortunate to have the opportunity to interact with a group of savvy and successful clients. Many of them own or run businesses and are on the front line of economic activity. We are grateful for their insights. They allow us to develop a viewpoint composed of many inputs. Our hope is that this perspective will create positive investment outcomes.

A year ago, the world was on the brink of economic collapse. Unprecedented government intervention in the form of zero interest rate policies, the backstopping of financial institutions and some modicum of economic stimulus brought us back from the brink. Financial markets, hitting their stress points in early 2009, staged unprecedented rallies as cash flowed from low interest bearing Treasury Bills and money market accounts back into financial instruments. The S&P 500 rallied 67.23% from its March low of 666.79 to close the year at 1115.10. Bonds also rallied as the combination of artificially low interest rates, the compression of risk premiums and hundreds of billions of dollars of new money forced yields lower. Despite the poor economic backdrop, investors focused on the potential for future inflation. Market participants flocked to gold, moving the price from $880.80 to $1,095.60 on December 31 after an interim high of $1,214.80 on December 2, 2009. On a broader basis, the Goldman Sachs Commodities Index gained 11.22% in 2009. The dollar lost roughly 15% versus a basket of global currencies. So……where do we go from here?

We view 2010 as a transition year – a bridge between chaos and opportunity. Investors need a chance to catch their breath and reposition portfolios for longer term opportunities. 2010 will represent the year of portfolio reconstruction. Below, we'll set forth key points for consideration, recognizing that each pool of capital we advise has its own unique set of guidelines, risk tolerance, and time horizon.

Investment Time Horizons Are Expanding

The volatility and sense of panic that was the hallmark of the securities markets in late 2008 and early 2009 caused some to take a short term view on investing. Many investors sold at or near the bottom, unable to stomach the violent downdraft in their portfolios. Others stayed the course, somewhat pleased that the rally from the March lows helped them regain some lost ground. Still others shifted away from risk assets (stocks) to less riskier assets (bonds). In any case, few were satisfied with the paltry yields offered by money market funds and Treasury Bills. If you compound a 10 basis point per year return, it would take 693 years to double your money. As PIMCO's Bill Gross wrote in December of 2009, "The Fed is trying to reflate the U.S. economy. The process of reflation involves lowering short-term rates to such a painful level that investors are forced or enticed to term out their short-term cash into higher risk bonds or stocks."

For reasons to be discussed later in this paper, we believe we are probably through the worst of the economic decline. Now is the time to reflect upon what you want your investment capital to accomplish over the next five years. How much risk and volatility are you willing to assume? If you couldn't open your monthly statements for the next five years, what would you hope the investment outcome would be? It's time to take stock and rebalance portfolios to the appropriate time horizon. Forget about the short-term. Patience and disciplined rebalancing are key ingredients to investment success.

Fundamental Analysis Matters Again

For the past two years, capital markets pricing was being driven by macro factors and emotion. We're in the process of re-entering a more normalized investment environment where a company's underlying business fundamentals will drive its stock price and credit spread. The markets are in the nascent stages of separating "The Good" from "The Bad" and "The Ugly" (please see our investment strategy piece dated October 13, 2008 at www.masseyquick.com). This plays into the strengths of our managers. As many of you know, we have always focused on hiring managers with a deep research process steeped in fundamental analysis. Whether it is in equities, fixed income, or other asset classes, fundamental analysis will rule the day. This belief underscores our view that long/short equity and credit will most likely provide the highest risk-adjusted returns over the next several years.

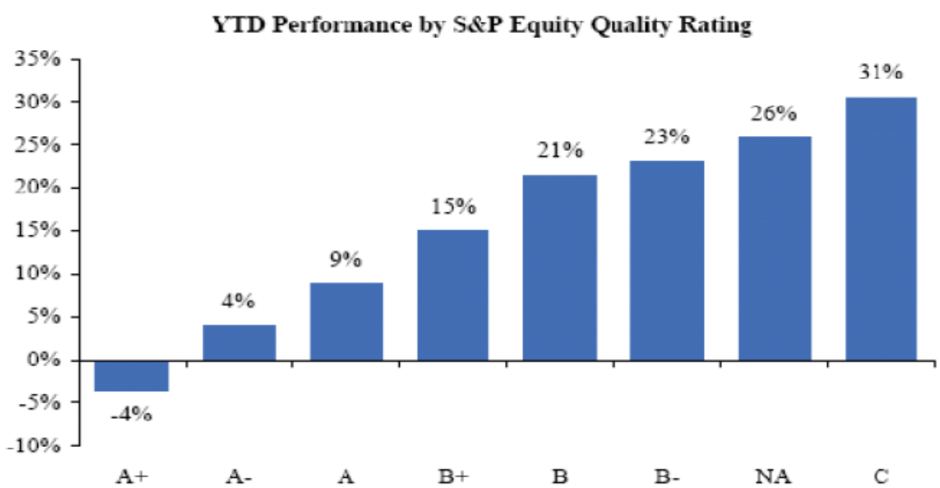
The CBOE has introduced an index that tracks the implied correlation of S&P 500 components to each other. In the latter part of 2008 and early 2009, correlations rose to very high levels. Everything was going in the same direction at the same time: down. Recently, the correlation between individual stocks has normalized. This is an indication that fundamentals do matter again. Companies with good results and strong prospects are moving higher while struggling companies are flat or moving lower.

The bond market tells a different story. Correlation in fixed income has been very high, fueled by the enormous money flows into this asset class (more on that later). We expect this correlation to diminish throughout 2010, creating tremendous inefficiencies that our credit managers should be able to exploit.

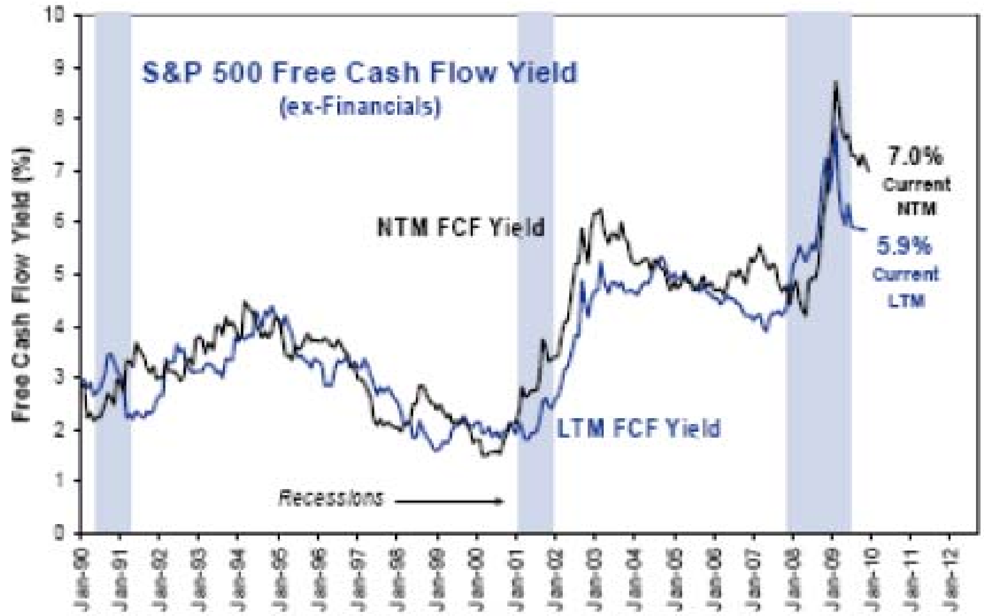
2009 Marked the End of a "Lost Decade" for Equity Markets

$1,000 invested in the S&P 500 on January 1, 2000 was worth $907 on December 31, 2009. What a disappointment. Modern Portfolio Theory makes the assumption that equity returns will compound in the range of 9.5% - 10% over multiple market cycles. That being said, there was plenty of opportunity to take advantage of volatility over the past 10 years to adjust asset allocation and rebalance portfolios, resulting in a much better outcome. Looking back five years from today, we believe it is highly likely equities will meet or exceed that return assumption. The key question is - can you live with the volatility along the way?

In our past strategy pieces, we've discussed the phenomenon of the "Junk Rally of 2009". Lower quality stocks outperformed their blue chip counterparts by a wide margin. The following chart depicts the performance of S&P rated stocks, focused on their quality rating as opposed to their credit rating.



We believe that quality mega-cap companies with high free cash flow yields will outperform the broad market in the early stages of the next investment cycle. One fascinating data point that was brought to our attention by one of our managers is that the S&P 500, (ex–financials) now has a higher cash flow yield than intermediate term corporate bonds. Why allocate to fixed income when you can invest in a company with a cash flow yield, invested at a higher ROE, than the coupon you would receive on a bond? By this measure, with the S&P 500 (ex-financials) trading at a 7% free cash flow yield on 2010 projected earnings, it's a good time to allocate to equities.

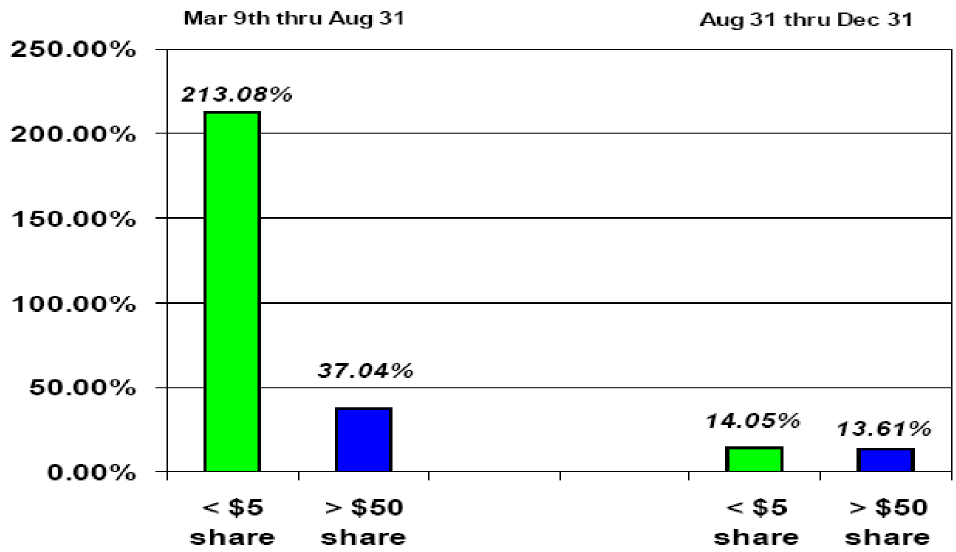


The Case For Mega Cap Equities

In our previous strategy pieces, we have discussed the post-crash phenomenon of the "junk rally." During the period from March 9 through August 31, 2009, stocks that were $5 or less per share in early March rallied 213.08%. Stocks trading at more than $50 per share rose 37.04% in that same period. From August 31 through December 31, 2009, lower priced shares were up 14.05% and those trading at $50 and above rallied 13.61% on average. To us, this indicates several things. Assuming that companies with poor fundamentals fall into the low price category, many of these businesses may now be overvalued relative to mega cap names. Our long/short equity managers are telling us that the prospect for individual stock shorts is rich with opportunity. Courtesy of our friends at Schafer Cullen, the second set of charts indicates the following four points for calendar year 2009:

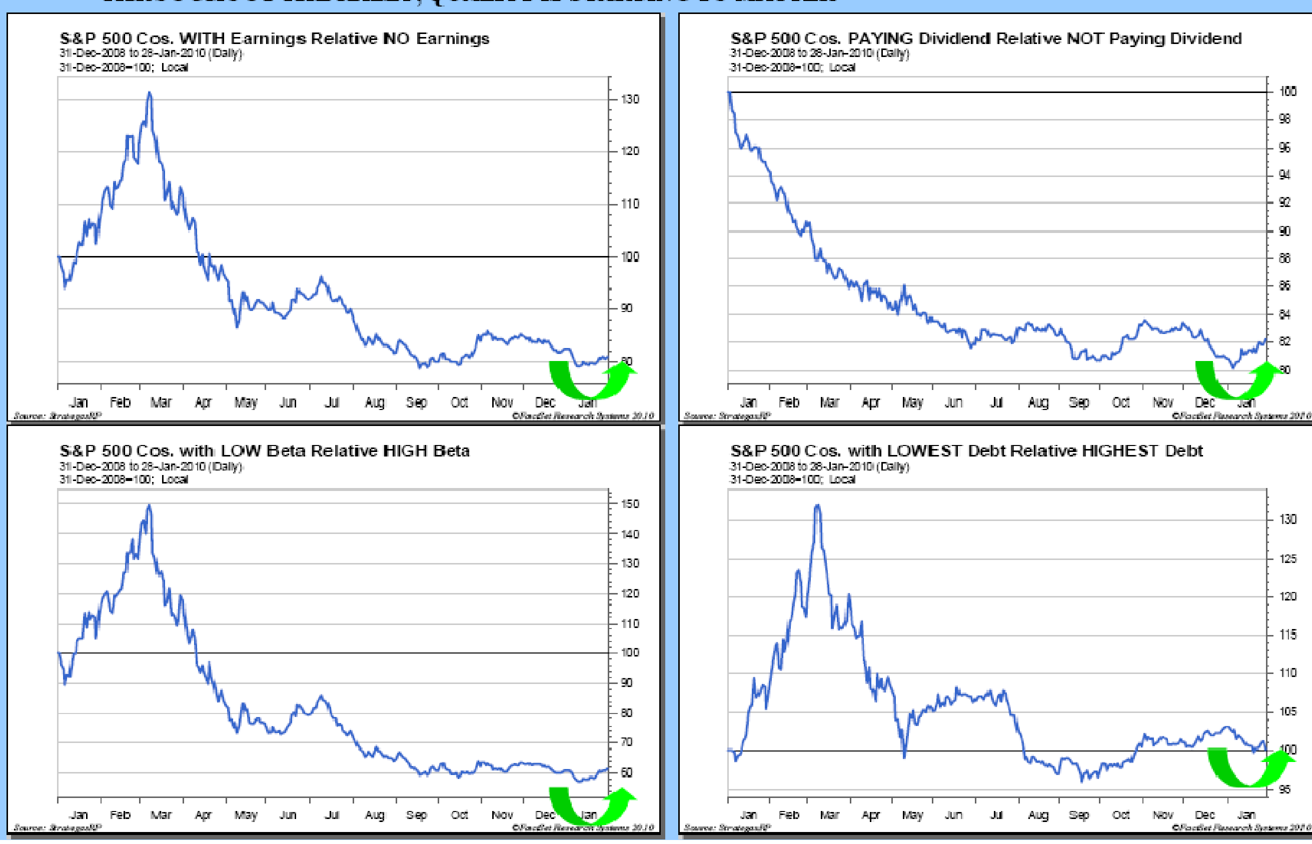
- S&P 500 companies with weaker earnings outperformed S&P 500 companies with stronger earnings;
- S&P 500 companies that pay dividends underperformed S&P 500 companies that pay no dividends;
- High Beta companies outperformed low Beta companies;
- S&P companies with the highest debt ratios outperformed S&P companies with low debt ratios.

It is time for a reversion to the mean. Companies with stronger earnings, relatively low debt, and those that return capital to shareholders in the form of dividends should perform better going forward.



Top 1000 U.S. Stocks by Market Cap

THE LOW QUALITY NATURE OF THE RALLY OFF THE MARCH LOWS HAS BEEN CONSISTENT WITH MARKET BEHAVIOR ONE SEES AT THE END OF A RECESSION. AFTER UNDERPERFORMING THROUGHOUT THE RALLY, QUALITY IS STARTING TO MATTER



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The Dawn of the "Frugalista"

We sense there is a secular change amongst both corporations and households when it comes to spending and balance sheet management. Frugal is in, and may be here to stay for a while. One of the pleasant surprises of 2009 was the ability of corporations to react quickly to the difficult economic environment, improving their operating efficiency and asset utilization. This resulted in two successive quarters of better than expected earnings announcements. Granted, we saw very little top line growth, but if these efficiencies stay intact as the economy turns, there is enormous earnings leverage out there. It is highly likely that the growth in S&P earnings will outpace the growth in the economy when we see a turn.

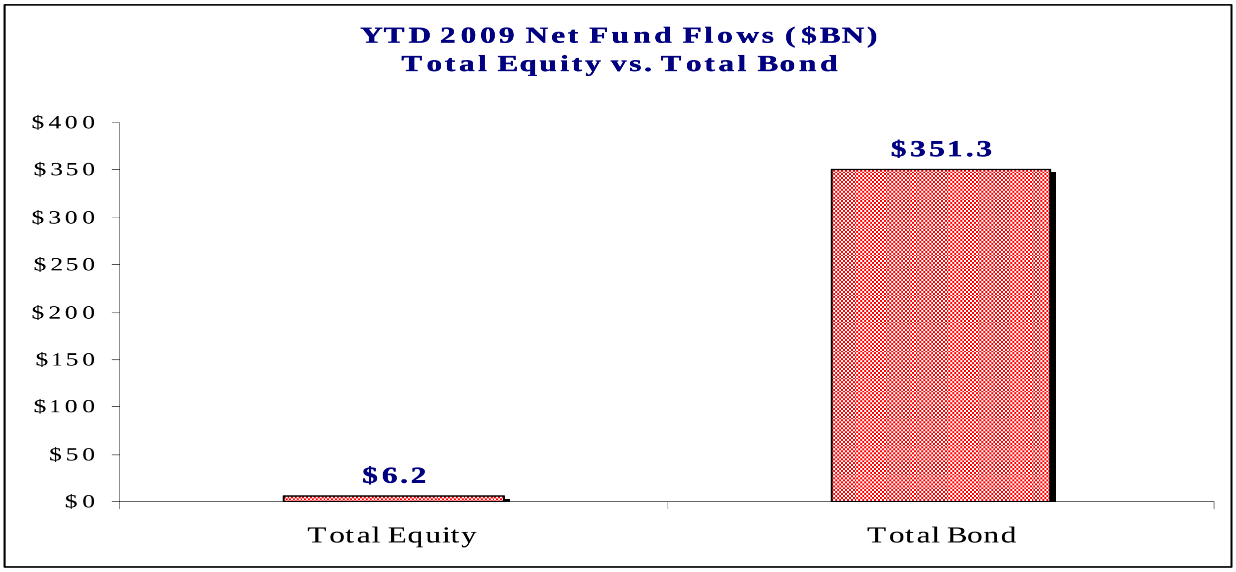
The consumer is also continuing to take a more cautious stance. Spending is out; saving and debt reduction is in. Very few care about keeping up with the Joneses any longer. The deep recession we have experienced may breed a new generation of "Frugalistas" focused on a more conservative financial posture.

The Fed Will Raise Rates. It is Not a Matter of If, But When

Central banks around the globe have provided immense amounts of emergency liquidity to help stem the economic crisis. Their next important job is to design an exit strategy for all of the stimulus money pushed into the system. To quote Mark Gilbert of Business Week, "The risks of getting the timing wrong are considerable. If the Fed abandons its zero interest rate stance too soon, it could ruin a recovery that is already undershooting economic forecasts. Wait too long, though, and cheap money might inflate new asset bubbles of the kind that led to the credit crisis in the first place." Given that banks and households are still in the process of rehabilitating their balance sheets, the Fed may err on the side of caution, keeping rates near zero for the better part of the year. In addition, we expect economic stimulus to shift from the financial services sector to "pick and shovel" programs designed to address high unemployment rates. That being said, markets are discounting mechanisms. The bond market may anticipate an increase in rates long before it occurs. When the Fed raised the discount rate from .50% to .75% on February 18th, it was the first step in a long journey to higher rates.

Bond Market Investors are Underestimating Risk

"I need yield!" is a statement we've heard over and over again from investment committees and individuals alike. Low interest rates have caused a number of investors to chase yield by increasing duration and decreasing credit quality in their fixed income portfolios. This is a very dangerous path. During the fall of 2008 and the first two months of 2009, there was a dramatic flight to cash. Individuals and institutions were "de-risking" their portfolios at an alarming rate. As markets improved in the spring of 2009, that cash began looking for a home. Being once burned in equities, the vast majority of that money found its way into fixed income. Mutual funds experienced $357 billion of net inflows last year. $351 billion of that amount went into bonds. The following barchart depicts mutual fund flows in 2009. It indicates a significant amount of "flight risk" cash has been redeployed. Most of it went into bonds at the bottom of an interest rate cycle.



Interest rates can't move much lower. We are clearly in the bottom of the cycle for rates. Furthermore, the Treasury and the Fed, aside from keeping the Fed Funds rate low, have been active purchasers of Treasury and Agency debt, creating false demand for our sovereign debt and mortgage-backed securities. This has had the effect of keeping the benchmark for all debt pricing (Treasury bonds) lower than the free market would allow. This exercise was designed to subsidize the balance sheets of large financial institutions and keep residential mortgage rates low, hoping to serve as a catalyst for a housing recovery. Eventually, the repurchase program will stop. Concurrent with this interest rate manipulation, our domestic deficit continues to grow and must be financed by further sales of Treasury securities. Some of the largest purchases of these securities are other nations with large surpluses (China, Taiwan, Japan, etc.). What rate will they demand to subsidize our deficit, particularly in a weak dollar environment? Our belief is that Treasury rates, particularly at the short and intermediate portions of the curve, are near their low ebb. Current yields are as follows:

Fed Target Rate:	.25%
2 Year Treasury	.85%
5 Year Treasury	2.29%
10 Year Treasury	3.74%
30 Year Treasury	4.71%

Once an investor ventures outside the realm of Treasury bonds, the fixed income market becomes multi-dimensional. While Treasuries represent the benchmark yield, corporate and municipal bonds trade at higher after-tax rates taking into account the credit risk one is willing to assume to achieve higher yields. Yield spreads approached all-time highs in the depths of the financial crisis. The flight to quality moved investors away from risk. The massive flow of funds into bonds in 2009 brought spreads right back in. The following table illustrates the dramatic changes in yields and risk spreads for various types of bonds over the past year.

Component	Yield % 52 Week Range			52 Week Spread Over Treasuries		
	Current	Low	High	Current	Low	High
Barclay's Aggregate	3.41%	3.15%	4.60%	60bps	55bps	197bps
AA Rated Corporate	3.73%	3.46%	6.34%	127bps	103bps	406bps
BBB Rated Corporate	5.07%	4.93%	9.55%	213bps	202bps	694bps
High Yield 100	7.87%	6.96%	13.03%	587bps	488bps	1108bps
7-12 Year Tax Exempt	3.24%	2.89%	4.01%	58bps	49bps	80bps

The dramatic rally in bonds combined with a cyclical low in rates has created the perfect storm. Our belief is that we are in the midst of a bond bubble. Investors may be pouring money into fixed income at exactly the wrong time. If one purchases a 10 year bond with a 4% coupon at par today and rates move to 5.5% two years from now, the value of the bond would be 90.4 cents on the dollar. Investors will have the opportunity to achieve much higher yields in their portfolios two years from now – maybe sooner. We are urging our managers to keep maturities short and credit quality high.

Stop The Printing Presses Please!

While some of our clients live and work outside the United States, most are located in America. They earn in dollars and they spend in dollars, yet they are concerned about the potential for dollar weakness. The huge liquidity wave created by the central banks of developed nations has debased their currencies. The dollar lost roughly 15% of its value in 2009. Subsequently, the Euro fell a quick 10% against the dollar between December 1st and mid-February. The more money they print to try to rehabilitate households, companies and countries (i.e. Greece, Portugal, Ireland, etc.), the weaker the currencies become. As we discussed earlier, the Fed and other central banks have the difficult job ahead to now drain that liquidity from the system without damaging a nascent recovery. This uncertainty should be taken into account when constructing portfolios. Gold is a natural hedge against currency debasement. Participation in emerging markets is another. We're keeping an eye on both and seeking the best solutions to protect portfolios from this potential outcome. That being said, many of our managers share this concern and are already participating in these asset classes in various forms. We're monitoring their portfolios carefully to make certain our clients have some protection on this front.

The Worry List

The global economy is not yet in a perfect place. Many of the same problems that triggered the economic crisis are still in play. The recovery has been propped up by easy money and government stimulus. At some point, we must see real growth begin to take place. We've seen a few robins in the snowstorm (improving corporate earnings, an abundance of cash on the sidelines, the potential for inventory restocking, additional stimulus), but here's what keeps us up at night:

- The potential for sovereign defaults in highly indebted countries (Greece, Hungary, Ireland, Estonia, etc.) could cause the extension of loose monetary policy causing further debasement of the Euro. When most pools of capital allocate to “International Equity” it flows to stocks in developed nations. This could prove to be a massive disappointment over the next couple of years.
- If China is forced to continue to take measures to slow their economy, an important growth engine will diminish the global recovery. The Chinese central bank is already worried about an asset bubble. Rather than reign in their banks, they should revalue the Yuan.
- State and municipal governments have very little flexibility in their budgets, having passed or expanded irreversible spending programs. Revenues from income, real estate and consumption taxes have dropped. Their ability to raise taxes has diminished. The potential for municipal defaults is on the rise.
- The dawn of the “Frugalista” dampens consumer demand and slows the rebuilding of America’s workforce. Unemployment remains an issue.
- The continuing decline in the value of commercial real estate places an added burden on global financial institutions. “Extend and pretend” can only work for so long.
- We may experience inflation in a slow growth economy as the dollar is weakened by reduced demand for Treasury Bonds issued to finance our growing deficit. The Fed may be forced to move rates higher despite the lack of a robust economy. P/E ratios on stocks will drift lower.
- Higher income taxes dampen the entrepreneurial spirit.

Summary and Conclusion

Disaster scenarios aside, we believe the economy is entering a period of slow recovery. Unfortunately, the rally in stocks and bonds has already discounted a positive outcome scenario. We believe the S&P is likely to trade in a range of 950 – 1250 in 2010. That being said, there will be a wide dispersion of performance between individual companies. Managers grounded in strong fundamental research will perform well. In our best case scenario, intermediate and long term fixed income is “dead money” for the next couple of years. Active management focused on credit research is imperative, especially in the tax-exempt arena. Portfolio duration should be focused on the short end of the curve. Don’t chase yield. The world landscape is changing. Embrace a global point of view. Allocate money to managers who share that global view. Most importantly, take time to reflect on the time horizon for your pool of capital. Don’t react to the short-term noise. Think in years, not months. The real money is made from trends, not trades.

Attractive	**Buy on Dips**	**Unattractive**
Long/Short Equity	Gold (below $1,000)	Euro Denominated Securities
Long/Short Credit	Emerging Markets (10-15% lower)	Intermediate Duration Bonds
Mega Cap Domestic Equity	Domestic Equity (Below 1000 S&P 500)	Long Duration Bonds
Distressed Debt	TIPs	High Yield Bonds
Actively Managed Municipal Bonds		Treasury Notes and Bonds

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